THE DEVELOPMENT AND PRESENT STATUS
OF CORPORATE DISCLOSURE

by

KIMBALL J. SORENSON

A THESIS

Presented to the School of Business Administration
and the Graduate School of the University of Oregon
in partial fulfillment
of the requirements for the degree of
Master of Business Administration

June 1953

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CHAPTER I

INTRODUCTION

This thesis deals primarily with only one of the several forms of business organizations. It has to do with the corporate form and to a large extent with those corporations of larger size where the capital investment is relatively high and where there is not usually an intimate relationship between those who own the business and those who manage and operate it.

More specifically, the subject matter is a particular problem which has arisen in connection with the corporate form. This problem concerns the disclosure by management to stockholders, bondholders, and those who are interested in becoming such, of the pertinent, vital information about the financial condition and operating results of the business which such persons are entitled to have.

The roots of the problem go deep and wide into our economy. They affect many of us directly and individually because of the widespread ownership of securities. They affect most of us a bit less directly but, nevertheless, materially because of the influence they have upon employment and upon the availability of many things which come to us through the effective operation of large-scale business. They affect the nation as a whole, because the nation's security and progress are closely tied to an efficient productive capacity and to the welfare and satisfaction of its individual members.

The problem was not great a hundred years ago. Even sixty or fifty years ago people did not think too much of the need for regulation or control in the determination of what management should tell the owners and how they should do it. This does not mean there was complete honesty then, or more than now, or that ownership did not entitle a person to the right to be kept informed about the business in which he had an equity. But businesses were usually small then in relation to those of today, and the owners either performed the management function themselves or employed others whom they knew personally and could contact directly or whom they could keep track of indirectly through agents. This is still true today with the individual proprietorship, the partnership, and many, many smaller corporations. With them there is still room for improvement in accounting and statistical methods used and in methods of presentation, but there is not the broad problem of informing many security holders who are unfamiliar with the business, or who are widely separated from it geographically, or who do not for various reasons wish to participate in its actual operation.

A great deal has been written and said about the important part played by the corporate form of organization in making life as we know it today possible. It, probably as much as any other thing, has facilitated the development of large-scale production, through its capacity to accumulate huge amounts of capital from a wide variety of sources. It has also provided a means by which people in humble circumstances or otherwise can put their limited or large savings to work. It has made it more possible for each person to own a stake in his country, and to do it under a free enterprise system.

Each investor has a choice as to the form and degree of risk he wishes to take. He may choose a high-grade bond carrying a low interest rate but very little chance of loss; he may venture into the common stock of an oil company which at the time has very little except high hopes and a prayer, with the hope of reaping fabulous returns; or he may choose to put his money somewhere in between. But--and this is important--he should have as much information as can reasonably be given him, within his ability to use it and within certain limitations of corporate costs and security of trade secrets, as a basis for making the decision; and then, after making the investment, he should be kept properly informed concerning the financial position and the operations of the business in which he has placed his money.

It is felt that, over the long run, the effectiveness of the corporate system has been and will be largely influenced by the degree of confidence between the investors and those who manage and are responsible for their property; and confidence is usually facilitated by an awareness on the part of the owners of what their business is doing, regardless of whether or not the results at any particular time are good or bad.

This brings us back again to the problem of disclosure--the problem of how much corporate management, which has stewardship over the corporate property, should tell the people who have financial interests in the property, and how this can most effectively be told.

The problem is now defined. There are certain areas which will not be discussed, although admittedly they pertain in some ways to the subject. One concerns specialized patterns of disclosure required by state or federal bodies for specific industries such as railroads, public

utilities, insurance companies, or banks; another pertains to the information furnished primarily for tax purposes; and a third deals with the growing practice of informing employees about the affairs of the company for which they work.

Each of these matters is important, but it is felt they cannot all be adequately included in a thesis of this type. It seems preferable to cover one broad area, many of the aspects of which have general application and, therefore, pertain also to situations other than those existing between the corporation and the investor.

Before proceding further there is need for definition of one term which will be used many times in the following pages. It is the term "full disclosure," and, although a summary statement of it must have certain limitations, it also has the virtue of being concise. It would seem that it should be stated somewhat as follows:

Full disclosure means the mention of every item of material significance, described and classified in such a way that those to whom it is addressed can understand what the significance is, and presented at the time when it is significant.[1]

Its meaning will be amplified as the discussion developes.

In the pages that follow an attempt will be made to (1) trace briefly the development of the corporate system in this country and, along with that, the gradual recognition of the need for disclosure, and its early progress; (2) to describe the development of protective legislation

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[1]A further discussion of this definition and the source of it is included in the final section of Chapter VII.

the purpose of which is to assure that investors be kept adequately informed and allowed to properly exercise their rights of indirect control; (3) to discuss recommendations to extend governmental control, and the implications thereof; and (4) to discuss the adequacy of information of different types now being supplied to investors (who vary greatly in individual abilities to assimilate and use the information), and the various trends and proposals for improving it.

CHAPTER II

DEVELOPMENT OF CORPORATIONS IN THE UNITED STATES

According to a survey made in 1937 by Twentieth Century Fund, Inc., up to the year 1800 at least 335 corporations had been chartered in the United States. A few had been in existence back in the Colonial period, but the majority had been formed during the period after 1780. A breakdown as to types shows that 65.4 per cent were for highways, 20.0 per cent were in finance, 10.7 per cent were of a local public service nature, and only 3.9 per cent were for other types of business.[1]

In those early days, in order for a corporation to be formed, it was necessary to obtain a special charter from the state; and each charter required a legislative act. The formation of the enterprise, therefore, was often dependent upon political favors.

In 1811 the state of New York passed the first general corporation law, and the other states gradually followed suit over a period of many years. Such laws made it possible to form a corporation without the special legislative enactment. Usually they required only the approval, by a designated state official, of the articles of incorporation.

Prior to these state laws, one writer has said, incorporation was a privilege which could be granted or withheld at the discretion of

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[1]Twentieth Century Fund, Inc., Big Business Its Growth and Its Place (New York: Twentieth Century Fund, Inc., 1937), p. 1.

legislative bodies; after their passage, it became a right that every citizen competent to make contracts possessed.[1] Such laws contributed greatly to the ease with which a corporation could be established; and, no doubt, they spurred the growth of that type of business.

There are also certain characteristics within the corporate form itself which have been very important in determining its extent and effectiveness as a part of a developing nation. Legally, it is an entity separate from its owners or its management; and its ownership rights are divided into transferable shares which can be passed from one person to another without disturbing that entity. At its present stage of development, the corporation can incur debts or make contracts without in any way obligating its stockholders;[2] their risk is limited to the amounts they have invested in the business. In addition, its organization is such that the function of management can be effectively separated from that of ownership.

These characteristics have proven worthwhile in connection with small businesses of many kinds, but they have applied in a particularly effective way where large-scale financing was necessary or desired.

To continue with corporate development as shown by the Twentieth Century Fund survey, railroads were appearing about 1830 in increasing numbers, and by 1860 they occupied first place on the corporate lists. Then,

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[1]Henry E. Hoagland, Corporation Finance (3rd ed.; New York: McGraw-Hill Book Company, Inc., 1947), p. 44.

[2]An exception to this applies when stock has been originally sold at a discount. In such a situation the holder of such shares can sometimes be held liable for the difference between par value and the original purchase price of the stock.

in the years following the Civil War, a broad expansion of the corporate form in nearly every branch of business activity got underway.

By 1929 corporations almost completely dominated certain major areas of our economy. These areas were, and still are, manufacturing, mining, transportation, and public utilities. Corporations accounted for over half of the income in finance and trade; and in construction, service-type, and miscellaneous other industries, their share of earnings was over one-third. Table I gives a more detailed and exact breakdown of this, showing the relative importance of various branches of economic activity in 1929, and the per cents of the total income produced by corporations in each branch.

During the past quarter century there has been further expansion, but more in size than number. Retention of earnings, sale of new securities, and combinations of different kinds have been the major methods used to bring about the development of larger and larger business enterprises.

It has become quite apparent that an outstanding feature of the corporate form is its facility for growth, for the accumulation of huge amounts of capital by widespread security distribution. This does not mean that large size is necessarily a concomitant of the corporate form, because, as has been mentioned, there are a great many small corporations. But it does mean that businesses have found incorporation to be a particular aid to expansion, with the accompanying benefits that derive from large size.

The discussion to this point has emphasized the increasingly important part played by the corporate form as compared with other types of business enterprise, and reasons for this. But the illustrations need to be extended further to show that, of all the incorporated businesses, a

TABLE I

RELATIVE IMPORTANCE OF VARIOUS BRANCHES OF ECONOMIC ACTIVITY, AND PER CENT OF TOTAL INCOME PRODUCED BY CORPORATIONS IN EACH BRANCH, 1929*

	Per Cent of National Income Produced	Per Cent of Income Produced by Corporations in Each Branch (Estimated)
Government	7.8	--
Agriculture and related industries .	9.1	6
Construction	3.7	33
Miscellaneous	5.2	33
Service: professional, amusements, hotels, etc.	10.2	33
Finance: banking, insurance, real estate, holding companies, stock and bond brokers, etc.	13.6	56
Trade	13.7	63
Transportation and other public utilities	11.1	86
Manufacturing	23.3	92
Mining and quarrying	2.3	96
ALL BRANCHES	100.0	57

*Source: Twentieth Century Fund, Inc., op. cit., p. 17

relatively few--the giants, the multi-million dollar group--control a very large part of the nation's capital and produce a like amount of its goods and services.

In 1933, according to summaries of income-tax returns published by the Bureau of Internal Revenue, the 594 largest corporations, 0.15 per cent of the total number, owned approximately 53 per cent of the total corporate assets. Some 5 per cent of the total number, those hav-

ing assets averaging over one million dollars, owned over 85 per cent of corporate assets.

In the same year 0.02 per cent of all income-reporting corporations received 35 per cent of the total net income. Those having assets averaging over one million dollars (6.2 per cent) reported 79 per cent of total net income.[1]

During the Congressional hearings in February, 1950 on the Frear Bill, which proposed to extend the so-called "protective provisions"[2] of the Securities Exchange Act of 1934 to certain large corporations not then registered with the Securities and Exchange Commission, Mr. Louis Loss, Associate General Counsel for the Commission, referred to the final report of the Temporary National Economic Committee in 1941. The report had listed thirty corporations each of which had assets of over one billion dollars, the largest being Metropolitan Life Insurance Company with assets of over four billion dollars.

Senators Maybank and Frear asked if the list could be brought up-to-date and furnished for the record. Mr. Loss replied that he would try to do so, and later he provided the list shown in Table II. This indicates that in 1948 there were fifty-one corporations each of which had assets of over one billion dollars. The largest was American Telephone and Tele-

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[1]Twentieth Century Fund, Inc., op. cit., pp. 1-10.

[2]An explanation of the Frear Bill and the "protective provisions" is made in Chapter V.

graph Company, which was listed as ten billion. General Motors, the largest industrial corporation, was listed as 2.9 billion dollars.

TABLE II

CORPORATIONS WITH ASSETS OF $1,000,000,000 OR MORE, 1948*

		Total Assets (Billions of Dollars)
1.	American Telephone & Telegraph Company	10.0
2.	Metropolitan Life Insurance Company	9.1
3.	Prudential Insurance Company	7.9
4.	Bank of America National Trust and Savings Association	5.6
5.	Equitable Life Assurance Society of the United States	4.9
6.	National City Bank of New York	4.6
7.	New York Life Insurance Co.	4.4
8.	Chase National Bank, New York	4.2
9.	General Motors Corp.	2.9
10.	Standard Oil Co., New Jersey	2.7
11.	United States Steel Corp.	2.5
12.	John Hancock Mutual Life Insurance Co.	2.5
13.	Guaranty Trust Co., New York	2.3
14.	Northwestern Mutual Life Insurance Co.	2.3
15.	Manufacturers Trust Co., New York	2.2
16.	Continental Illinois National Bank & Trust Co., Chicago	2.2
17.	Pennsylvania Railroad Co.	2.2
18.	First National Bank of Chicago	2.1
19.	Mutual Life Insurance Co. of New York	2.0
20.	Travelers Insurance Co.	1.8
21.	Cities Service Co.	1.7
22.	New York Central R. R. Co.	1.7
23.	Security-First National Bank, Los Angeles	1.6
24.	Standard Oil Co., Indiana	1.5
25.	Aetna Life Insurance Co.	1.5
26.	Socony-Vacuum Oil Co.	1.4
27.	Chemical Bank & Trust Co., New York	1.4
28.	Central Hanover Bank & Trust Co., New York	1.4
29.	First National Bank of Boston	1.4
30.	Bankers Trust Co., New York	1.3
31.	E. I. du Pont de Nemours & Co.	1.3
32.	Texas Co.	1.3
33.	General Electric Co.	1.3
34.	Atchison, Topeka, & Santa Fe Railway Co.	1.3
35.	Consolidated Edison Co. of New York	1.3
36.	National Bank of Detroit	1.2

TABLE 2--Continued

		Total Assets (Billions of Dollars)
37.	Mellon National Bank & Trust Co., Pittsburgh . .	1.2
38.	Bank of Manhattan Co., New York	1.2
39.	Gulf Oil Corp.	1.2
40.	Southern Pacific	1.2
41.	Mutual Benefit Life Insurance Co.	1.2
42.	Penn Mutual Life Insurance Co.	1.2
43.	Massachusetts Mutual Life Insurance Co.	1.2
44.	Irving Trust Co., New York	1.1
45.	Standard Oil of California	1.1
46.	Baltimore & Ohio Railroad Co.	1.1
47.	Union Pacific Railroad Co.	1.1
48.	Ford Motor Co.	1.1
49.	Commonwealth Edison Co.	1.0
50.	Cleveland Trust Co., Cleveland	1.0
51.	Bethlehem Steel Co.	1.0

*Source: U.S. Congress, Senate, Securities Exchange Act Amendments, Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 81st Cong., 2nd Sess., on S. bill 2408, February 7-10, 1950 (Washington: Government Printing Office, 1950), p. 8.

To close this chapter a summary statement might be made that big business has become largely corporate business and that, within the control of a small per centage of the corporations, numerically, is a preponderant share of the nation's productive wealth, and from it is derived a very large share of the nation's income.

As has been mentioned in the introduction, the larger corporations, those ranging in size from a few million to billions of dollars, because of their importance, and because of the problems of disclosure that accompany them, are the main subject matter for this thesis.

CHAPTER III

PROGRESS TOWARD CORPORATE DISCLOSURE PRIOR TO 1933

The policy of nearly all businesses during Colonial days, down through the 1800's, and even, on the part of many, well into the present century was one of keeping records of assets, operations, and profits confidential. For various reasons the idea was to tell as little as possible. For example, it was felt that competitors could use the information advantageously; so, therefore, it should not be published. Another reason was that workers might read the information and become dissatisfied with their shares of earnings. In other instances management did not want owners to have full information because of certain actions which had been taken or were contemplated.

These ideas still prevail, and some, perhaps, are justified to a certain extent; but they are not emphasized so strongly as they were then.

As an example of the attitude that was prevalent during the early post-Civil War period, Mr. G. L. Gerrard, Chairman of the Committee on Securities of the New York Stock Exchange, wrote to the Delaware, Lackawanna & Western Railroad Company, requesting financial information. The reply was one brief sentence:

"The Delaware, Lackawanna, & Western R. R. Co. make no reports and

publish no statements--and have not done anything of that kind for the last five years."[1]

The above statement was typical of the period. However, as indicated previously, comparatively few companies had widespread stock ownership at that time. In fact, only a small number, mostly railroads and banks, were listed on the exchanges.

The following information, summarized from Mr. Foulke's book, is indicative of the trend on the New York Stock Exchange over the period from 1880 to 1948:

TABLE III

UNITED STATES CORPORATIONS WITH STOCKS LISTED ON NEW YORK STOCK EXCHANGE*

Year	Total	Financial Companies	Railroads & Street Railway Companies	Public Utilities	Industrials
1880	183	64	81	10	28
1900	278				
1910	304				
1920	456	34	131	23	268
1948	999	32	86	89	792

*Source: Roy A. Foulke, Practical Financial Statement Analysis (2nd. ed.; New York: McGraw-Hill Book Company, Inc., 1950), pp. 25-27.

As the listings increased the New York Stock Exchange became vitally interested in seeing that a minimum amount of information was

[1] Roy A. Foulke, Practical Financial Statement Analysis (2nd ed.; New York: McGraw-Hill Book Company, Inc., 1950), p. 26.

given to stockholders and to the public. It made special efforts to obtain agreements with the listing companies to meet certain disclosure standards. These standards were far from being as detailed and inclusive as those of today, but they were indicative of progress being made. Two milestones along the way were:

> In 1897, the Kansas City Gas Company in its application to list \$3,750,000 first mortgage five per cent bonds, agreed to the suggestion of the New York Stock Exchange that the company would from time to time, make publication of its net profits, not less than twice in each year.
>
> In 1898, the Glucose Sugar Refining Co., in its application to list its preferred and common stocks, agreed that "a detailed statement would be made public" in time for its annual meeting of stockholders.[1]

These became examples to be followed by other companies listing their securities.

Stockholders and other interested parties were asking for more information. The exchanges were recognizing the need and beginning to work out disclosure methods for listed companies; in fact, the New York Stock Exchange required after 1900 that companies presenting new applications for listing agree to publish annual reports of their earnings and financial condition. And, no doubt, management in the more progressive companies could see that changes in policy were becoming desirable.

But, as the century turned, the general pattern of thinking still seemed to be in favor of little or no public disclosure of corporate affairs.

In 1900 a government report stated:

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[1] *Ibid.*

> One of the chief evils of large corporations is the lack of responsibility of the directors to the stockholders. In many cases the directors hold their positions for a series of years, and practically never make reports that are calculated to give to the individual stockholders much light on the actual methods of management.[1]

In 1901 a corporation in its annual report made the following statement:

> The settled plan of the directors has been to withhold all information from stockholders and others that is not called for by the stockholders in a body. So far, no request for information has been made in the manner prescribed by the directors. Distribution of stock has not meant distribution of control.[2]

In 1902 United States Steel Corporation published the first really modern type annual report. Its president, Judge Gary, stated at the time that "Corporations cannot work on a principle of locked doors and shut lips." This example was followed in 1916 by the comprehensive report of General Motors Corporation, the first company to announce formally that it would publish semiannual balance sheets and profit and loss statements in addition to its regular annual report.[3]

In 1926 the New York Stock Exchange began requiring every listed corporation to submit to stockholders at least fifteen days in advance of its annual meeting an annual report containing its financial statements. It also required publication of either consolidated statements of a parent company with subsidiaries or separate statements for the parent and for each of the majority-owned subsidiaries. Companies were also requested to publish semi-annual or quarterly earnings statements.

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[1]B. Bernard Greidinger, Preparation and Certification of Financial Statements (New York: The Ronald Press Company, 1950), p. 4

[2]Ibid., p. 3. [3]Ibid., p. 4.

Up to about that time the primary emphasis, apparently, of the Exchange was on quantity, i. e., to see that disclosure reports were furnished and at the proper times. However, from then on the emphasis shifted to quality. The Exchange became convinced that frequent reporting could be confusing and misleading where the statements failed to make a full and fair disclosure of the financial and operating data essential for appraising the value of the corporate securities. Efforts were made through discussions with accountants and officials of listed corporations and through cooperation with the American Institute of Accountants, which had already been working for several years with the problem, to develope proper standards and methods of disclosure and then to educate corporations and the public to use them.[1]

About the time these efforts were begun William Z. Ripley, Professor of Political Economy at Harvard University, wrote concerning the importance of and the need then for improved disclosure.[2] He compared the situation with an intersection which at first had been out in the open country and only used by a small amount of traffic. As time went by traffic increased, buildings were put up so as to obstruct the view, and it became necessary to add more and more traffic controls to keep the flow going smoothly and to prevent trouble. He went on to say:

> This homely figure is applicable to the present condition of our corporate affairs in the United States. The sudden advent of widespread popular ownership of corporations since the World War has

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[1] _Ibid._, p. 6

[2] William D. Ripley, "Stop, Look, Listen!" _Main Street and Wall Street_ (Boston: Little, Brown, and Company, 1927), pp. 156-207.

created entirely new circumstances and conditions in the business world. Main Street and Wall Street have come to cross one another at right angles--Main Street, our synonym for this phenomenon of widespread ownership, and Wall Street, as applied to the well-known aggregation of financial and of directorial power in our great capital centres. This intersection of interest, so often at cross purposes, is marked by an imminent danger of collision at the junction point of ownership and management. The volume of business, the high speed of propulsion, the growing obstructions which stand in the way of visibility, suggest that in this domain also a prime necessity is the letting in of light to the fullest degree. Our American business affairs, in so far as they have assumed the corporate form through this recent growth in public ownership, are still too largely carried on in the twilight. Great progress has already been made; but it is high time that the imperative need of putting things upon a universally sounder footing be generally understood.[1]

He then cited the progress that had been made, giving examples of numerous companies which were doing a good job of keeping investors informed. But he emphasized that, in spite of the increasing need for disclosure, many companies--important and large ones--did not recognize the need or did not wish to. He emphasized that speculation flourished where there was too much secrecy; and, in summary, he said:

Two things are happening at cross purposes with one another; namely, a centralization of industrial production in ever larger units and a decentralization of proprietorship. To hold the two on line with one another, keeping the ship on an even keel, nothing is more essential than that the spirit of speculation should be held in strict confinement. This it is which strengthens the thrust of our contention for adequate disclosure of all pertinent data.[2]

Others also had recognized that there was a problem here which somehow needed to be worked out. Many securities were being traded on the basis of tips and trends; there were abuses by corporate insiders; and proxy materials used were usually inadequate. President Theodore Roosevelt, President Taft, and President Wilson had all recommended some sort

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[1]Ibid., pp. 156-57. [2]Ibid., p. 207.

of federal laws. But the main securities legislation was not to come until 1933 and 1934.

It would be incorrect to say that disclosure was completely inadequate at the time of the financial crisis in 1929. It had improved considerably since 1900, particularly in regard to companies with securities listed on the exchanges. However, there was not yet a general widespread acceptance of the need for it.

Mr. J. M. B. Hoxsey, of the New York Stock Exchange, explained in an address to the American Institute of Accountants in 1930 that it was questionable as to whether or not accounting, which is fundamental in disclosure, had kept pace with the changes in business. He indicated that the art of accounting had, to that time, evolved with primary emphasis upon two objects, namely, (a) to give management accurate information for conducting the business, and (b) to provide information for purposes of obtaining credit.

These objectives, Mr. Hoxsey said, had by themselves been satisfactory where enterprises were largely managed by their owners or by the personally chosen representatives of a few owners in close contact with the business, and where it had been the custom to finance permanently for minimum needs and borrow for peak needs. But he then referred to the widespread diffusion of corporate ownership which had occurred, and added:

> There are few large enterprises which have not taken on the corporate form, and a large proportion of the total ownership is in the hands of millions of relatively small investors who have no direct contact with management and whose only knowledge of the company is derived from its financial reports. In recent years there has been a marked tendency to finance more or less permanently for peak

requirements, becoming lenders of money at the time of minimum requirements, and so tending to lessen the aggregate volume of bank credit needed.

Because of these changes, coupled with a growing tendency toward extreme broadness and flexibility in the corporation laws of many states, the time appears to have arrived for some changes of emphasis as to the objects to be achieved by sound accounting practice. While there have been able efforts devoted toward this end, the result so far generally attained does not seem to me sufficient to meet the needs. The need of accurate information for the aid of management is still paramount; but, under conditions of today, the next object in order of importance has become

> to give to stockholders, in understandable form, such information in regard to the business as will avoid misleading them in any respect and as will put them in possession of all information needed, and which can be supplied in financial statements, to determine the true value of their investments.[1]

In his opinion, then, the need for the use of accounting as a means of disclosing information to investors had become more important than the use of it for purposes of obtaining credit; yet, accounting had not adapted itself sufficiently to this new need.

Years later, looking back to the times in which Mr. Hoxey made the above statements, Thomas H. Sanders, professor of accounting at Harvard University, and a man who has participated in numerous ways in disclosure developments since then, wrote concerning that period of the 1920's and the early 1930's.

He said the New York Stock Exchange, in collaboration with a committee of the American Institute of Accountants, had taken steps during that time toward formulating accounting principles which might have authoritative professional status and acceptance, and had made considerable progress. However, when the Securities and Exchange Commission,

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[1]J. M. B. Hoxsey, "Accounting for Investors," The Journal of Accountancy, L (October, 1930), 252.

newly formed in 1934, began its consideration of accounting, and asked for a body of principles to be used as a basis for its regulations and as a criteria for that time, its request was surprisingly difficult to answer, not only to its own satisfaction, but to the satisfaction of those who became consultants and advisers to the Commission.

It was not that there were no satisfactory principles in use; much of what we follow now is the same as then. But there was not a general recognition of such principles nor a consistent use of them. The difficulty was in finding satisfactory standards which could be followed in disclosing accounting information to stockholders, and which had at that time attained general acceptance in practice.[1]

No doubt there were many reasons for the 1929 stock market crash, including an over-expansion of credit, largely tied up in the markets. Whether or not the general application of better standards for disclosure would have helped to give forewarning of the end of the trail that was being followed is only a matter of conjecture. It is possible that if investors had been more accustomed to relying on informative financial statements, the stage in which all stocks, good and bad, became speculative would not have developed. But there is no assurance such would have been the case.

Mr. Louis Loss in the 1950 Congressional hearings on the Frear Bill, previously mentioned, stated that:

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[1]Thomas H. Sanders, "An Analysis of the Forces Which Are Shaping the Future of Accountancy." The Journal of Accountancy, XC (October, 1950), 283.

> . . . the aggregate value of all stocks on the New York Stock Exchange, September 1, 1939, was $89,000,000,000. In the break of September and October they fell by $18,000,000,000. In 1932 that total of $89,000,000,000 was down to $15,000,000,000--a dead loss of $74,000,000,000 in 2½ years. Bonds fell from $49,000,000,000 in 1930 to $30,000,000,000 in 1933--a total loss in both stocks and bonds of $93,000,000,000.[1]

The years following 1929 were years of stagnation characterized by almost a complete lack of confidence. Investors were afraid to enter the market. Few new risks were taken, and there was little expansion of existing corporate enterprise. Employment declined, demand declined, then employment declined more, and the downward spiral went on.

Regardless of whether or not the status of corporate disclosure in 1929 was a factor in the disastrous drop in the markets, the "crash" and its aftermath provided the stimulus for federal legislation. They provided the setting for entry by the federal government as an active participant in the disclosure picture.

Chapters IV and V, which follow, attempt to summarize such legislation from 1933 to the present time.

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[1]U.S. Congress, Senate, Securities Exchange Act Amendments, Hearings before a Subcommittee of the Committee on Banking and Currency, U.S. Senate, 81st Cong., 2nd Sess., on S. bill 2408, February 7-10, 1950 (Washington: Government Printing Office, 1950), p. 10.

CHAPTER IV

PROTECTIVE LEGISLATION

The Securities Act of 1933

In 1933 the first part of a series of federal legislation designed especially to protect the interests of investors and the public was passed by Congress. It was given the title, "Securities Act of 1933,"[1] and its specific purpose as stated by Congress was "To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."[2] It applied to securities to be newly issued from 1933 on, and not to securities outstanding prior to that time. It was applicable regardless of whether or not such securities were to be listed on an exchange.

Administration of the Act for the first year became a responsibility of the Federal Trade Commission; but the Securities and Exchange Commission, after its establishment in 1934, was given the duties, and continues to perform those duties at the present time.

Under the disclosure provisions of the Act, companies planning to issue new securities by means or instruments of transportation or com-

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[1] U.S. Congress, Securities Act of 1933, as Amended, Public Act No. 22, 73d Congress (Washington: Government Printing Office, 1948).

[2] Ibid., p. 1.

munication in interstate commerce or of the mails must file with the Commission, usually twenty days before date of issue, a very complete registration statement giving detailed information concerning the background and present condition of the issuing company; names, addresses, holdings, and remuneration of directors, principal executives, underwriters, and principal stockholders; purposes of the new issue; special contracts and agreements to which the company is a party; certified financial statements prepared according to Commission rules and regulations; and numerous other data.

One would be impressed with the bulk and detail of such a report, but also with the completeness of information for someone trained to utilize it. This will be discussed further in Chapter VII, which deals with the availability of information of various kinds to the general public and the usefulness of it.

The registration material is carefully scrutinized by the Securities and Exchange Commission to see that it meets requirements as to form and content. The Commission is authorized to prevent issuance of the securities until proper requirements have been met, or to issue stop orders on subsequently learning of untrue statements or omissions of material facts. However, it is emphasized by the Commission itself that the costs in both time and money to verify completely every item in each registration statement would be prohibitive and would seriously impede the financing of business ventures through the public sale of securities.[1]

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[1]U.S. Securities and Exchange Commission, The Work of the Securities and Exchange Commission (Washington: Government Printing Office, 1949), p. 3.

Section 6(d) of the Securities Act reads as follows:

> The information contained in or filed with any registration statement shall be made available to the public under such regulations as the Commission may prescribe, and copies thereof, photostatic or otherwise, shall be furnished to every applicant at such reasonable charge as the Commission may prescribe.

Here again it seems preferable to leave further discussion of availability, costs, and utilization of these statements by the public to Chapter VII.

A further provision relating to disclosure requires that a selling circular known as a "prospectus" be provided or made available to the prospective buyer. The Act defines the term, "prospectus," as meaning "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio, which offers any security for sale."[1] But it further specifies that the prospectus used must meet certain very definite requirements in regard to content, as indicated in Section 10. Essentially, it is to contain the first 27 of the 32 specific requirements for the registration statement. The last 5, required for registration but not for the prospectus, are, briefly: (1) a copy of the agreement with underwriters, (2) a copy of opinions of counsel, (3) copies of certain materials contracts, (4) copies of articles of incorporation and by-laws, and (5) copies of bond indentures for any issues which the company has outstanding.

As with much other legislation there are certain exemptions. Section 3 covers a number of types of securities which do not come under the

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[1]Securities Act of 1933, op. cit., Section 2(10).

registration and prospectus provisions. Some of the more important ones are: (1) securities of Federal, state, municipal, or other governmental instrumentalities; (2) securities of non-profit corporations organized for religious, charitable, educational, and similar purposes; (3) offerings not in excess of $300,000 under certain conditions; (4) private offerings to a limited number of persons; and (5) securities of common carriers covered by Section 20a of the Interstate Commerce Act.

The Commission, under the disclosure provisions, does not attempt to pass judgment on the quality or merit of any particular issue. But it does try to see that complete and reliable information is made available so that investors and other interested parties can exercise an informed judgment based on their own analyses. No claim is made that all risks are eliminated; no guarantee is given by the Commission that the facts are completely and correctly stated, but the objective is to make them so.

Section 11 provides for civil liabilities on account of false registration statements. Persons who have acquired securities as a result of such false statement may within a designated time sue for damages all persons who signed the statement; directors of the company; accountants, engineers, appraisers, or other persons professing authority who have with their consent prepared part of the statement or added to it in any way; and/or underwriters of the security. The burden of proof is then on the persons sued to prove that their actions were not fraudulent or negligent. These liabilities are worded in such a way as to be quite severe, particularly upon the issuer of the securities.

Under Section 12, any person who sells a security which should be but is not properly registered or which sale is not made according to the prospectus requirements can be held liable in a civil action.

In addition to its authority to prevent initial registration or to issue stop orders afterwards, the Commission, after conducting its own public hearings, can bring action in any United States district court to enjoin acts or practices which it considers to be in violation of the law. The Commission may also transmit evidence to the Attorney General, who may, in his discretion, institute criminal proceedings under this act.[1]

In addition to its registration and prospectus requirements for new issues, the Act contains an absolute prohibition against misrepresentation, deceit, and other fraudulent acts and practices in the sale of any security, whether registered or not. Violations are punishable by fines or imprisonment in criminal actions and may also be used as bases for suits by persons sustaining losses thereby.

By its own admission, though, the Commission has found that requirements for registration and otherwise adequate disclosure provide a more effective means of preventing abuses by persons selling securities than do the attempts to seek out the abuses after they have occurred and then to obtain convictions of those who have defrauded the public. The Commission has indicated in no uncertain terms that it considers the actual screening of disclosure material to be its most effective weopon against

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[1] Ibid., Section 20.

abuses from the standpoint of inadequate disclosure or misleading information.[1]

It was probably for this reason that Congress, in legislation after 1933, extended the registration requirements so as to cover other securities in addition to those newly issued and also expanded the amount of information to be provided by any one registrant.

The Securities Exchange Act of 1934

The "Securities Exchange Act of 1934," passed in that year, was a second very important piece of legislation dealing with the "disclosure doctrine."[2]

The reasons for this Act, as stated in Section 2, are very broad, including, but extending beyond disclosure made to individuals buying, selling, and owning securities. It emphasizes that transactions in securities on both the exchanges and the over-the-counter markets are affected with a national public interest, which makes it necessary for regulation and control over not only the transactions but also other matters pertaining to the securities. It reads partially as follows:

> . . . in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.

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[1]U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, House Document No. 672, 79th Congress, 2d session (Washington: Government Printing Office, 1946), p. VI.

[2]U.S. Congress, Securities Exchange Act of 1934 and Amendments, Public Act No. 291, 73d Congress, 2d session (Washington: Government Printing Office, 1948).

Congress emphasized that the large volume of the securities transactions constitutes an important part of interstate commerce. The mails, as well as other media of interstate commerce are used, the people buying and selling are often widely separated geographically, and the businesses of the companies represented by securities are often national and international in scope.

Credit is involved extensively, and along with it, the banking systems. Price quotations disseminated through interstate commerce help to establish the prices at which securities will sell, and thus help to determine the value of collateral for bank loans, and also valuations for tax purposes.

To carry the explanation further, sub-paragraph 4 of Section 2 says:

> National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.

In reading the introductory material of this legislation one feels the strong influence of the stock market crash four or five years earlier and its continuing after-effects upon the thinking of the lawmakers as they attempted to reduce the possibilities of a future recurrence. Also, this was an opportunity to help restore shattered public confidence in the security markets as well as the business institutions represented by the securities.

Section 4 created the Securities and Exchange Commission, which was given broad authority to administer the Securities Act of 1933, as well as the Securities Exchange Act of 1934.

Under Sections 5 and 6 registration of the national securities exchanges is required. The exchanges must prove that they are organized so as to be able to comply with the statute and the rules and regulations of the Commission thereunder, and that their own rules contain provisions which are just and adequate to insure fair dealing to protect investors. Provisions having a similar objective, but applicable to brokers and over-the-counter dealers, are contained in Section 15.

Sections 7 and 8 of the 1934 Act cover the duties given the Federal Reserve Board to set margin requirements and in other ways regulate credit on the exchanges. The Securities and Exchange Commission administers the rules and regulations after they have been formulated by the Federal Reserve Board.

Sections 9, 10, and 11 are designed to prevent manipulation of prices and trading abuses within the markets themselves.

However, the major provisions from a disclosure standpoint are contained in Sections 12, 13, 14, and 16. These are sometimes called the "protective provisions." They become the basis for a considerable amount of discussion in other parts of this thesis. They are, therefore, emphasized at this point.

The first of these, Section 12, states that, in order for a company to have a security traded on a national exchange, a registration statement must be filed with the exchange and copies filed with the Se-

curities and Exchange Commission. The requirements for the registration statement are similar to those for registration under the 1933 Act--quite detailed and complete as to the concern's background, operations, and present financial condition, as to its officers, directors, and principal stockholders, as to terms of the issue, and various other information. Exceptions are possible in certain instances wherein a security can be admitted to or allowed to continue with what is known as unlisted trading privilages on a given exchange without registration. It should be noted here that the date on which a security was originally listed does not matter; the provision is that, in order to remain listed on an exchange, a security must also be covered by a registration statement.

Under Section 13 each registrant is required to keep his registration statement up to date in accordance with rules to be established by the Commission. It requires that annual financial reports, certified if required by the Commission, and such quarterly reports as the Commission may prescribe be filed with both the exchange and the Commission. The purpose here is to keep fresh the original data filed so that interested persons can be sufficiently informed concerning the changing circumstances of an operating business.

Quite broad authority is given here, as well as in connection with the initial registrations, for the Commission to interpret the law and issue opinions to the public as to what these interpretations are. The quotation below is from part (b) of this section:

> The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in

the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; but in the case of the reports of any person whose methods of accounting are prescribed under the provisions of any law of the United States, or any rule or regulation thereunder, the rules and regulations of the Commission with respect to reports shall not be inconsistent with the requirements imposed by such law or rule or regulation in respect of the same subject matter.

As an additional disclosure safeguard, Congress, in Section 14, gave the Commission instructions and authority to set up standards to assure that the proxy material mailed to holders of registered securities be reasonably informative.

It was felt that, in many instances, security holders were being asked to give their votes without being informed as to whom or what they were voting for. The law was designed to prevent this, and one method used is to require that each registered company submit copies of its proxy material to the Commission for inspection before mailing it out.

The Commission also attempts to facilitate counter solicitation by minority groups.

Section 16 requires special reports by each officer, director, or beneficial owner of 10% or over of any class of any equity security registered on a national stock exchange. Any such person must file at the time of registration of such security or within ten days after becoming an officer, director, or ten per cent owner, a statement with the exchange showing his holdings. A supplementary report by the individual must be

filed at the end of any month in which he has made personal transactions in any of the company's securities.

In general, if such a person either buys and sells or sells then buys his company's equity securities within any six-months period, and makes a profit, such transaction is deemed prima facia to have been based on inside information; and the profit made by that person is recoverable at court by the company or by any other security holder on behalf of the company. This section also makes it unlawful for an "insider," as mentioned above, to sell short the equity securities of his company.

It is important to note that Sections 12, 13, 14, and 16, the "protective provisions" discussed above, were to apply only to corporations having securities listed on a national securities exchange. They did not and still do not, except for certain exceptions which will be mentioned, apply to unregistered securities sold via the over-the-counter market. As will be brought out in the discussion of proposed new legislation, the Securities and Exchange Commission feel that it was the original intent of Congress to require that registration and the other protective provisions be made applicable to all large corporations with publicly-held securities, regardless of whether or not they were listed.

However, neither in the 1933 Act nor in the 1934 Act did Congress give that specific authority. Hence, as a general rule, most unregistered corporations are not subject to the disclosure requirements. Congress did require registration of brokers and dealers doing business in interstate commerce through the over-the-counter markets. The Commission was given authority to establish certain rules of conduct to prevent manipulative, deceptive, or fraudulent practices by such people, regardless of whether

or not the particular issues which they were buying or selling happened to come under the registration requirements.

To quite a large extent brokers and over-the-counter dealers are, as the result of a 1938 amendment to the Securities Exchange Act,[1] allowed to form voluntary organizations to police themselves. The purpose here seems to be not so much to insure adequate disclosure as to maintain free and open markets and to prevent a dealer or broker from taking unfair advantage of his customers or clients.

Other sections provide for civil remedies to individuals who have sustained damages because someone has failed to comply with the law or has misrepresented or failed to state material facts, similar to provisions in the 1933 Act. However, the civil liabilities under this 1934 Act appear to be somewhat less severe than those under the one passed in 1933.

There are also penalty clauses and provisions for enforcement powers by the Commission, much like in the 1933 Act.

Other Legislation

After an intensive nine-year investigation by the Federal Trade Commission and hearings by both houses of Congress, the "Public Utility Holding Company Act of 1935" was passed. Its underlying objective, according to the Securities and Exchange Commission, is to ". . . free operating electric and gas utility companies from the control of absentee and

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[1]This amendment is now Section 15A of the Securities Exchange Act.

uneconomic holding companies, thus permitting them to be regulated more effectively by the states in which they operate."[1]

This objective has largely been accomplished. Many of the holding companies have been reduced down to the point where each makes up an integrated unit within one or two, perhaps three, states.

The preamble to the Holding Company Act includes a list of certain abuses which were prevalent in the public utility holding company field, and which Congress tried to work out provisions for correcting. One of these abuses was listed as "inadequate disclosure to investors of the information necessary to appraise the financial position and earning power of the companies whose securities they purchase."[2]

So, the Holding Company Act, applicable to a limited group of companies, was written so as to include "protective provisions" similar to those in Sections 12, 13, 14, and 16 of the Securities Exchange Act of 1934; i. e., requirements for registration of holding companies, periodic reporting, certain standards for the content and use of proxies, and reports by "insiders" of their ownership in and personal transactions with the company's securities.[3]

In 1936 an amendment to the Securities Exchange Act of 1934 was made effective, extending to companies issuing new securities under the

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[1]U.S. Securities and Exchange Commission, The Work of the Securities and Exchange Commission, op. cit., p. 10.

[2]Ibid.

[3]U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, op. cit., p. 4.

Securities Act of 1933 the requirement for periodic reporting to the Securities and Exchange Commission, in order to keep the initial registration statements up to date. The amendment applied only to new issues from 1936 on, and amounting to $2,000,000 or over. Without this amendment, some of the new issues--those subsequently listed on exchanges--would have come under the periodic reporting requirements of the 1934 Act. However, those which the issuing companies did not choose to list would have only been subject to the initial registration called for by the 1933 Act. Also, it should be noted that neither the proxy provisions nor the insider trading regulations were made applicable to this group of securities.[1]

The "Trust Indenture Act of 1939" provided, among other things, that companies qualifying indentures to issue bonds or other debt securities should thenceforth be subject to the periodic reporting requirements governing securities on the exchanges. This provided an extension of one of the four protective provisions to a few more securities, those debt securities amounting to over $1,000,000, and offered for public sale under trust indentures. Again, some, but not all, of these would have also been covered by other legislation previously mentioned.[2]

The four protective provisions were extended to investment companies, whether listed or not, in the "Investment Company Act of 1940." This act applies to companies engaged primarily in the business of invest-

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[1]Securities Exchange Act of 1934, op. cit., Section 15(d).

[2]U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, op. cit., p. 4.

ing, reinvesting, and trading in securities and whose own securities are held by the investing public.[1]

Since 1940, there have been no additional enactments. However, before bringing this chapter to a close, it should be emphasized further that the coverage of legislation up to the present time is not all-inclusive. It applies in varying degrees to different securities. For example, the 1934 Act states that all companies listed on national exchanges shall be subject to the protective provisions; i. e., registration, periodic reporting, proxy regulation, and control of insider-trading. The 1933 Act requires immediate registration when a concern floats a new issue, and this issue need not be listed. But, even with the 1936 amendment, it requires only part of the protective provisions: Registration for all such issues; periodic reporting, applicable to those of $2,000,000 or over; but proxy and insider-trading provisions do not apply.

The Public Utility Holding Company Act includes all four of the protective provisions, but it covers only a limited group of businesses. The Trust Indenture Act was passed for another segment of the companies, but it makes applicable to them only the periodic reporting regulations. Then, under the Investment Company Act of 1940, the coverage of all four of the provisions was extended to certain other enterprises.

At the same time, there are still a large number of corporations which are subject to none of the four requirements mentioned above.

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[1] Ibid.

So, one can see that there is a patchwork disclosure pattern which has gradually been filling in, but with different shades in different places. At the present time there is no plan which has been formally approved for completing the unfilled gaps or for standardizing the shading to make the coverage the same in all areas.

The Securities and Exchange Commission feels strongly that this situation should be remedied; and, twice in the past few years, it has presented to Congress a proposal to bring about what it considers to be a very desirable extension of present legislation.

Its recommendations thus become the basis for the next chapter.

CHAPTER V

PROPOSED NEW LEGISLATION

In June, 1946, the Securities and Exchange Commission submitted to Congress what was termed "A Proposal to Safeguard Investors in Unregistered Securities." In brief, this recommended that the Securities Exchange Act of 1934 be amended so as to extend the protective provisions as found in Sections 12, 13, 14, and 16 thereof to the securities of corporations which are not registered and which have at least $3,000,000 in assets and at least 300 security holders.[1] These four sections were explained in considerable detail in the preceding chapter.

In making its proposal the Commission presented strong evidence to support its contention that disclosure practices as required by the protective provisions are of great benefit to holders of securities which come under the laws which contain them. It feels that those four sections, 12, 13, 14, and 16, provide for what should be the minimum of information and protection available to people buying, owning, selling, or otherwise handling securities.[2] However, many investors and other interested persons are unable to obtain this information because the legislation does not apply to all large corporations, and many corporations do not furnish its equivalent voluntarily.

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[1]U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, op. cit., cover page.

[2]Ibid., p. 1.

This has been discussed rather extensively in the Congressional hearings and, to a lesser extent, in the press. The Commission's arguments, although presented in support of this particular piece of legislation, point up the disclosure problem as a whole. And the opposition which arose, very effectively at times, helps to make an analysis of the problem possible.

In submitting the proposal to Congress in 1946, Ganson Purcell, who was then Chairman of the Securities and Exchange Commission, wrote as follows:

> As a result of the limited coverage of these provisions, a security which is not listed on a national securities exchange, unless it happens to be a registered public utility or investment company security, lacks these vital protective features. Commission surveys show that these unregistered securities are commonly bought and sold on the basis of information which is at best inadequate and sometimes misleading. Financial statements of the issuers of such securities are bare and un-informative; they lack much of the information needed for an informed appraisal of the issuer's securities. Proxies are usually powers of attorney conferring blanket authority upon the soliciting persons, and the information to guide the security holder in the execution of the proxy instrument is withheld. The stockholder is provided with so little information that at times, when solicited for his proxy in connection with the election of directors, even the names of the nominees are not disclosed. Moreover, the stockholder has no way of knowing whether and to what extent corporate insiders are utilizing their inside information at his expense.
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> The only provisions of the securities acts applicable to unregistered securities are those which outlaw fraudulent and manipulative practices. Within the limits of its manpower, the Commission has sought to carry out the statutory mandate with respect to unregistered securities. It has discovered, however, that in this as in other matters, correction is not as effective as prevention; that security holders are much more adequately protected when issuers and corporate insiders are under an obligation to supply information.[1]

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[1] *Ibid.*, p. V.

According to the Commission's proposal it was the intent of Congress when it wrote the Securities Exchange Act in 1934 that investors in securities trading over the counter should have protection comparable to that afforded to investors trading on the exchanges. But, because of the lack of information about the over-the-counter markets at that time, the provisions put in the law in regard to them were very general. As set forth in Section 15, as originally written, Congress simply made it unlawful for brokers and dealers to trade over the counter except in accordance with such rules and regulations as the Commission might prescribe "as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided by and under authority of this title in the case of national securities exchanges."[1]

According to the Commission, Section 15 originally stated specifically that the Commission's rules and regulations might provide, among other things, for the registration of over-the-counter securities, the regulation of over-the-counter transactions, and the registration of brokers and dealers.

> In pursuance of the authority so granted, the Commission adopted rules for the registration of brokers and dealers, and rules designed to insure fair disclosure by brokers and dealers to their customers. It became evident, however, that further rule-making embodying the provisions of sections 12, 13, 14, and 16 would have been impracticable, for the phrasing of the section was such that the Commission could not compel action by issuing companies and the persons in control. The sanctions of this section were directed only against brokers and dealers. Violations by issuing companies would at most have resulted in barring brokers and dealers from trading in the particular security, thereby depriving investors of an active market. Since the provision

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[1]U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, op. cit., p. 3.

was not practicable the Commission concurred in a 1936 amendment which was largely declaratory of the administrative program which had already been adopted by the Commission under section 15. The new section 15 provided for the registration of brokers and dealers, and it gave the Commission a broad rule-making power for the prevention of fraudulent and manipulative practices.[1]

It seems very illogical, says the Commission, that the listing of a company's securities on an exchange should be the factor which might make the difference between protection or lack of protection. Yet, this is very often so. On the other hand, it is very possible that a person holding a security traded on a national exchange may still be unable to get full information about it; because quite a large number of companies are allowed unlisted trading privileges, particularly on the New York Curb Exchange.

Qoting again from the Commission's arguments, but with the addition of explanatory material in parentheses:

> An investor has just as much need of information with respect to, say, a large shoe manufacturing enterprise as he does in the case of a railroad (which files extensive reports with the Interstate Commerce Commission), or the operating subsidiary of a public utility holding company (which would file under the Holding Company Act). He has just as much need of information when he contemplates purchasing the stock of a company that has floated no new issues since 1935 as he does in the case of a company which, in 1946, refunded a debenture issue to take advantage of lower interest rates (and would therefore register and report under the Securities Act of 1933). He has the same need to know what is going to transpire at an annual stockholders' meeting for which his proxy is solicited, and to know the interests of the persons doing the soliciting, whether the shares are listed on an exchange or not. He has the same need to be protected against insiders trading on inside information.
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> The effect of the gaps in the protective scheme has been to permit evils to flourish with respect to unregistered securities which, in

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[1]Ibid.

some respects, are at least as bad as any of the other things the act was designed to eliminate.[1]

According to the Commission most of the fraud cases which have come to its attention involve unregistered securities, and in most of the cases, the type of disclosure required for registered securities would have made the fraudulent schemes difficult or impossible to execute. It cites a number of specific cases to illustrate fraudulent practices coming to its attention which might have been prevented by more adequate disclosure. Only two will be included here. One is the case of the Ward La France Truck Corporation, which had previously been reported in the Securities Exchange Act Release No. 3445 (1943); but it is quoted here from the 1946 proposal made to Congress:

> The Ward La France Truck Corporation, which had earnings of less than $3 per share in 1941, found its profits so much increased by the war that for the first 11 months of 1942 earnings were over $15 per share. Stockholders were informed of the profits for the year ended December 31, 1941, but at no time during 1942 were they informed of the phenominal increase in earnings that was taking place.
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> On September 24, 1942, the president and treasurer of the company, who together owned 74 per cent of its outstanding stock, began to negotiate for the sale of their shares to Salta Corp. At the same time they caused the company to start buying in its shares in the over-the-counter market, at prices ranging from $3 to $6 per share. Selling stockholders were not advised of the identity of the purchaser, nor were they advised of the negotiations that the insiders were conducting with a view to the disposal of their own controlling block of shares. The effect of this purchase program of the company at abnormally low prices was to increase the value of the outstanding shares in the hands of the insiders.
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> On October 19, 1942, an agreement was concluded with Salta Corp. by which the president and treasurer of the Truck Corp. were to sell substantially all their shares at $45 per share; and after obtaining control the third party was to liquidate the Truck Corp., take over its business, and give the remaining public stockholders the book value of their shares--which was approximately $28 per share. Having con-

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[1] *Ibid.*, p. 5

cluded this agreement, the third party itself began to purchase the shares in the over-the-counter market at prices as low as $6 per share. Again there was no disclosure of the identity of the purchaser, or of the extraordinary 1942 earnings of the Truck Corp., or of the deal with the insiders.

Subsequently, proxies were solicited from the remaining stockholders in connection with a plan to transfer the assets of the Truck Corp. to the third party and to liquidate. And here again there was no disclosure of the improved position of the company or of the special treatment accorded to the insiders; stockholders were simply told that on liquidation they would receive their "proportionate share of the net assets of the corporation"--and, lacking information, they made no objection to the plan at the stockholders' meeting.

Indeed, the facts might never have come to light in the absence of a complaint to the Commission. After the Commission's investigation the parties involved agreed to pay over to the public stockholders an amount equal to the difference between the amounts such stockholders had received for their shares, which had been as low as $3 in some cases, and $36 per share.

Had the securities of Ward La France Truck Corp. been subject to the provisions of sections 13, 14, and 16 of the Securities Exchange Act, the company would have been required to file current reports disclosing its improved financial position; Salta, when its purchase program made it a 10-percent stockholder, would have been required to file ownership reports under section 16(a); and the proxy statements sent out by Ward La France would have been incomplete, under section 14, unless they set forth not only the improved financial condition of the company but also the personal interest of its president and treasurer in the transaction. Even if, under the circumstances of the particular case, one or more of the reports previously alluded to had been filed too late or had come to the attention of the public security holders too late to put them on notice, the prospect of Commission action (to say nothing of possible stockholders' suits) upon public disclosure of the more significant aspects of the scheme might well have deterred the controlling persons from proceeding with the scheme in the first place. The action taken by the Commission in this particular case was possible only because a complaining person happened to direct attention to enough facts to prompt an investigation. This was largely an adventitious circumstance not foreseen by the controlling insiders.[1]

Another case, that of the L. J. Mueller Furnace Co., given by the Securities and Exchange Commission as an example typical of others, was one in which statements furnished stockholders had been very abbreviated and

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[1] *Ibid.*, pp. 6-7.

had not even shown the number of shares outstanding. In 1944 the book value per share of common was $43, and the net earnings per share were $4, which was less than the prospective earnings for 1945. No dividends had been paid for some time because of a restriction effective until an issue of preferred stock could be retired, but the 1944 net earnings alone were half enough to retire the preferred.

In March, 1945, the president of the company offered the common stock owners $2 per share for their holdings. Since the stockholders did not know the number of shares (because the company had been buying shares back for years), they were unable to determine book value per share or earnings per share. So they might have sold at that price. However, this came to the Commission's attention in time for them to obtain a temporary stop order and warn the stockholders before they had changed their position.

Concerning this the Commission said:

> Abbreviated financial statements of the type employed in this case are, of course, not permissible under the Commission's accounting regulations. Unless the investor knows the number of shares outstanding, financial statements are virtually meaningless. Yet current surveys show an inadequate description of capital stock in over 26 percent of the larger type of unregistered company.[1]

The Commission emphasizes that cases such as these often go undetected or are discovered so late that it is difficult to bring about adequate restitution of losses sustained by some people. Also, many other cases which are unfair and unjustified cannot be proven as being legally fraudulent. So, it says, the best method by far is to insist that the facts

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[1] Ibid., pp. 8-9.

concerning a corporation's affairs be given to its security holders so they can make their own decisions. Such a procedure prevents insiders from taking advantage of their positions; and, in case they should attempt to do so, either the Commission or the stockholders would be much more likely to find out about it.

From the standpoint of costs to the government, the Commission feels that such a procedure gives investors better protection than the largest staff of investigators could provide and at much less cost.[1]

Before making this proposal to extend protective legislation to non-registered companies, an attempt was made to get objective data in regard to just how much information investors in non-registered companies were getting. Before starting, it was reasoned that the information contained in the annual report was usually about all such people could get; although some could not get that.

A study was made in 1945, and included in the 1946 proposal to Congress, of the annual reports of 70 unregistered companies, objectively selected, each of which had at least $3,000,000 of assets and 300 or more security holders. Banks, insurance companies, and investment companies were excluded, because special controls, either state or federal, are in effect concerning them. The reports were obtained from the Marvyn Scudder Financial Library of Columbia University, and each report was the most recent one on file from the particular corporation which it represented.

In order to check the results obtained in the course of this study,

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[1] Ibid., p. 9.

"and to determine generally the willingness or readiness of companies of this type to supply financial information to interested investors, the Commission asked the library to solicit annual reports from a group of 90 companies having the same characteristics as the earlier group of 70. After 38 days, 51 of the 90 companies had submitted their annual reports, 5 had sent letters of refusal, and 34 had made no reply at all."[1] The second survey was made right after the first.

Each report was read in detail for the purpose of seeing what information it contained. "The criteria adopted as a satisfactory standard of performance were the Commission's reporting requirements under the 1934 act for commercial and industrial companies."[2] However, only serious departures from these requirements were noted.

The general conclusion reached in each study was that all of the corporate reports were "seriously deficient" from the standpoint of adequate disclosure. Again, though, it should be emphasized that this conclusion was reached by using Securities and Exchange Commission standards. (Further discussion of standards for financial reporting will be found in Chapter VII.)

A summary of the deficiencies reported in the first two studies, together with part of the discussion concerning them follows:[3]

The Absence of Nonfinancial Information

The failure of the annual reports studied to disclose important

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[1] *Ibid.*, p. 12. [2] *Ibid.*, p. 39. [3] *Ibid.*, pp. 12-16.

nonfinancial information was considered to be a serious omission. None of the companies made any mention of transactions between officers, directors, and large stockholders on the one hand and the company on the other. None of the reports mentioned any dealings by such "insiders" in the company's own securities in the markets.

Some of the reports gave information about bonus or profit-sharing arrangements, remuneration of top executives, and salient features of important contracts; but the Commission felt that, in general, information of this type was not disclosed.

Failure to Furnish a Full Set of Financial Statements

The three basic accounting statements are the balance sheet, the profit and loss statement, and the statement of surplus. Each tells a different part of the picture about a corporation's financial affairs. Each is necessary in order to provide a proper understanding of the condition of the enterprise, and the absence of any one may make the others misleading.

The profit and loss statement is prepared to show the results of operations for a given period of time. It presents information of major importance not only to investors, but to numerous other interested parties. Yet thirteen percent of the reports contained no such statement.

Twenty percent did not furnish an analysis of surplus. This was so, despite the fact that it is possible for a company not supplying such a statement to conceal gains or losses of the greatest significance. For example, a favorable earnings record can be shown by the profit and loss statement while, at the same time, losses of various types can be concealed by having charged them directly to surplus.

Apparently, each of the reports showed a balance sheet in some form; but in every case where consolidated statements were shown, the corporation failed to show separate corresponding statements for the parent company. An example is given of a sizeable debt of a parent company which did not appear to be out of proportion when shown in a consolidated balance sheet. But, if it had been shown in a separate statement of the parent company, it would have appeared in a much less favorable light.

Deficiencies in the Form and Content of the Balance Sheet.

About 52 percent of the balance sheets examined were found to be materially deficient when judged by the standards enforced under the Securities Exchange Act, the most common deficiencies being found in the treatment of reserves, inventories, fixed assets, and capital stock.

It is possible by arbitrary treatment of reserves to show almost any income or deficit figure desired; yet, in a number of cases, neither the titles of reserve accounts nor additional explanatory material gave much information about the purposes of the reserves shown or how they had been created.

In connection with inventories, most of the companies did not give the methods used in pricing their various types; and it was common practice to combine them all together on one line entitled "Inventories." Unless there is a proper classification, such as a segregation of raw materials, work in process, and finished goods, it is impossible for an investor to determine the composition or relative liquidity of the inventory.

Most of the companies, if they classified fixed assets at all, did not do so properly, by Commission standards. In many cases there was no

indication as to whether such assets were carried at cost, appraised value, or some other basis; and often a net figure of fixed assets less depreciation was shown, rather than listing the cost or appraised value first and then deducting the depreciation as a separate item.

Twenty-six percent of the balance sheets described capital stock inadequately. There was often a general lack of detail as to the different sources of net worth; and, in a number of instances, there was no mention of the number of shares outstanding. In the latter type of cases it would be impossible to determine book value per share unless additional information could be obtained from some source.

The Income Statement

This statement shows not only the final income figure but also the various sources of revenue and the nature and amounts of the various costs and expenses. It provides the basis for analyzing past operations and forecasting those of the future. Hence it is generally agreed among accountants and financial analysts that there are certain fundamental things that it should show, such as sales, cost of sales, and operating expenses of the business.

Some 34 percent of the companies did not show sales or cost of sales. Some began the statement with gross profit on sales; others began with net income before depreciation and taxes; and, as has been previously mentioned, 13 percent showed no profit and loss statement at all.

Explanatory Material

The Commission admits that it would be difficult, if not impossible,

to tell from merely looking at a statement whether or not there should have been additional explanatory material to supplement the data within the statement itself, and to know what the explanations should have been. However, there was a general lack of footnotes of the type frequently desirable in order to provide adequate disclosure. Examples might be notes explaining the bases for inventory or fixed asset valuations, preferred stock dividend arrearages or other reasons for surplus restrictions, or stock options granted to employees which might, when exercised, materially change the book value of the outstanding stock.

Improper or unsound Accounting Principles.

Since the financial statements were in so many cases "sketchy," as the study described them, only an estimate could be made of the degree in which generally accepted accounting principles had been followed. Several instances were mentioned, however, where the practices followed appeared to be unsound. For example, one company showed a goodwill item amounting to sixty percent of its total assets despite the fact that it had a large operating deficit. Other concerns showed treasury stock as an asset in their balance sheets, which is a very doubtful practice; and one reported dividends on such stock as income, which is pure padding of earnings.

Deficiencies in the Certification of the Financial Statement

Eighty-five percent of the financial statements had been certified by public accountants. Since, according to the study, most of these statements were unsatisfactory from a disclosure standpoint, the Commission concluded that certification of itself does not assure adequate information

to the investing public. This, together with comments by the American Institute of Accountants will be discussed further in Chapter VII.

As has been discussed previously, Section 14 of the 1934 Act is the one giving authority to regulate the proxy machinery of corporations subject to the provisions of that section.

In order to support its request that Section 14, along with 12, 13, and 16, be extended to cover non-registered companies, the Commission presented in 1946 the results of a further survey which it had made. It had studied the proxy-soliciting practices of 76 unregistered companies which were not subject to regulation. These were all large companies, including all of those having unlisted trading privileges on the New York Curb Exchange. The results are quoted below:

> (1) The proxy materials sent out in connection with 89 percent of the annual meetings, or 126 out of 142, did not name the persons whom it was proposed to elect as directors.
>
> (2) In only one case was there disclosure of the security holdings of directors and nominees, either individually or in the aggregate.
>
> (3) None of the proxy statements stated the remuneration, either individually or in the aggregate, of the management. In one case, the base salary of a general manager was given in connection with a proposal to increase his base salary. In another case, involving the adoption of a bonus and profit-sharing plan at a special meeting, information was furnished as to the base salaries and percentages of profits (but not the dollar amount) received by the management during the past year.
>
> (4) In connection with 59 of the 142 annual meetings, or 42 percent, one of the items of business was stated to be the approval and ratification of all acts of the management since the last annual meeting; in none of these cases was the nature of these acts disclosed.
>
> (5) The interest (by security holdings or otherwise) of officers and directors or their associates in any of the matters to be acted upon was not described in any of the proxy material for 151 of the 152 meetings.
>
> (6) Some 95 percent of the companies did not afford their stockholders an opportunity for a "yes" or "no" vote on specific items through a convenient ballot-type or box-type of proxy. However, several

companies did give notice to the stockholders of their right to approve or reject specific items, by stating that the proxies, unless otherwise specified, would be voted in favor of the items set forth in the notice.

(7) In connection with 28 of the 142 annual meetings, or 20 percent, the annual report of the company was not sent to the stockholders until after the meeting had been held.[1]

The proxy materials of a number of different companies were shown as examples, one of which will be reproduced here to afford a basis for discussion of some of the criticisms made:

ALUMINUM COMPANY OF AMERICA
Notice of Annual Stockholders' Meeting

The annual meeting of the stockholders of Aluminum Company of America will be held on Thursday, April 15, 1943, at 11:00 o'clock A. M., Eastern War time, at the principal office of the Company, 2033 Gulf Building, No. 439 Seventh Avenue, Pittsburgh, Pennsylvania, for the following purposes: (1) electing a Board of Directors; (2) voting upon the proposal to amend the By-Laws by adding a new Article VIII relating to the indemnification of directors and officers, as set forth in full on the reverse hereof, and by changing the former Article VIII of said By-Laws to Article IX; and (3) transacting such other business as may properly be brought before the meeting.

Only common stockholders of record on the books of the Company at the close of business on March 26, 1943, will be entitled to vote at this meeting.

If you cannot attend the meeting please sign and return the attached proxy which is being solicited by and on behalf of the management of the Aluminum Company of America.

Aluminum Company of America,
G. R. Gibbons, Secretary.

Pittsburgh, Pennsylvania,
March 26, 1943.

. . . .

PROXY

Know All Men By These Presents:

That the undersigned stockholder of Aluminum Company of America hereby constitutes and appoints P. J. Urquahart, M. M. Schratz, and C. C. Kurt, and each of them, the true and lawful attorneys and proxies for and in the name and stead of the undersigned to vote at the annual meeting of the stockholders of said Company, to be held at the

[1] *Ibid.*, pp. 18-19.

principal office of the Company, in Pittsburgh, Pennsylvania, on the 15th day of April, 1943, or any adjournment thereof, as fully as the undersigned would be entitled to vote if personally present, giving and granting unto the said attorneys and proxies, or any of them, full power and authority to do and perform all and every act and thing whatsoever necessary and requisite to be done in or upon any and all matters which may properly come before said meeting, or any adjournment thereof, including (1) the election of a board of Directors; and (2) the approval of the proposed amendment to the By-Laws by adding a new Article VIII relating to the indemnification of directors and officers and by changing the former Article VIII to Article IX, as set forth in the notice of said meeting. The majority of all said attorneys and proxies who shall be present and shall act at the meeting (or if only one shall be present and act then that one) shall and may exercise all the powers of said attorneys and proxies hereunder.

WITNESS the hand and seal of the undersigned this___day of_____, 1943.

____________________ (Seal)

Shares ____ [1]

The Commission states that no other information was supplied in connection with the matters to be acted on pursuant to the proxies. Stockholders were not told the names of the persons for whom the proxy agents intended to vote or the remuneration of directors and nominees. The statement that the matters to be acted upon would include "such other business as may properly be brought before the meeting" did not constitute adequate notice to investors of the matters to be acted upon. There should have been a separate listing of each item of business which it was proposed to transact at the meeting. Commission rules would have required further disclosure of reasons for the proposal to amend the bylaws, including information as to whether or not there were at that time any pending lawsuits against directors or officers.

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[1] Ibid., pp. 77-78.

The Commission feels that its proxy rules are quite simple. They have evolved gradually as the result of administrative experience since 1934; and, in their present form, they are functioning efficiently and smoothly. "They are probably the most useful of all the disclosure devices established by the various acts and represent an effective contribution to corporate democracy."[1]

In 1950 the Securities and Exchange Commission again made the same proposal to Congress, once more recommending the extension of sections 12, 13, 14 and 16 of the Securities Exchange Act of 1934 to unregistered companies having over $3,000,000 in assets and 300 or more security holders.

The Commission's supplemental report to Congress at that time[2] gave the results of 1949 surveys similar to those reported in 1946.

A study of 159 corporate annual reports of unregistered companies in 1949 showed that the same type and extent of deficiencies existed then as in 1946. Also, a study of proxy machinery was made in 1949, comparable to that of 1946. The results indicated that some companies had improved their methods in accordance with the Commission's previous suggestions, but there were still many which were deficient when judged by the enforcement standards set up under Section 14.

This chapter has summarized the case for extending federal con-

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[1] Ibid., p. 18

[2] U.S. Securities and Exchange Commission, A Proposal to Safeguard Investors in Unregistered Securities - Supplemental Report to Congress (Washington: Securities and Exchange Commission, 1950).

trol over corporate disclosure. It has emphasized the feeling of the organization which now has the task of administering federal securities legislation that the "disclosure doctrine" should be applied on the basis of size and degree of public ownership, rather than on the basis of type of industry or type of market for its securities.

The Commission admits that, when it says "corporations having at least $3,000,000 in assets and at least 300 security holders," it is being quite arbitrary. It says the figures may need to be changed in the light of further study. However, if those figures were used, some 1,118 new corporations would be placed under the protective provisions. Also, 646 other companies which now are required to comply with only part of these provisions would be made subject to all four types.

In relation to the total number of business enterprises in the country these numbers are not large. But the businesses included range in size from $3,000,000 to over $850,000,000 in assets, with a total combined valuation of over 19 billion dollars; so they represent a very important part of our economy.

According to the Commission, "The burden of compliance with the proposed legislation would be slight, for no large corporation with $3,000,000 in assets and substantial public investor interest can do business today without the accounts and records from which all the information required by the proposed legislation may be readily ascertained. The question posed by the proposed legislation is not whether such records

should be maintained, but whether they should be made available to the public stockholders--the owners of the enterprise."[1]

Congressional hearings, publications of the Commission, articles in independent publications such as The *Journal of Accountancy*, the *Wall Street Journal*, and the *Commercial and Financial Chronicle* have debated the issues brought up by the Frear Bill, which has been summarized in this chapter. In fact, the airing of these issues has provided, to a certain extent, a public analysis of not only the proposed new legislation, but also of that which is now in effect.

Much of this public discussion is of such a nature as to help define further the meaning of corporate disclosure and some of the problems which arise with it. It, together with a considerable amount of supplementary information, will be presented in the two following chapters in order to help fill in the broad disclosure picture both on the part of those corporations which come within the requirements of the various legislative acts and those which are not subject to the legislation.

There are very influential groups and individuals who support the Commission in its contention that legislation which is closer to being all-inclusive is needed. There are others who say that, even though detailed reports are made by corporations to the Commission, the reports are actually not easily accessible to most of the general public. Also, they say the information as presented is too complex for the ordinary person--

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[1] *Ibid.*, pp. 18-19.

who is untrained in accounting and analysis--to understand. Others feel that additional legislation is unnecessary because, except in very rare instances, reporting by corporate management has reached a fairly high plane from the standpoint of both the quality and quantity of information provided. They attribute this to various reasons, including an improved status of accounting, an increased awareness on the part of management of its responsibility for adequate disclosure, and a number of other factors.

The questions are not completely answered by determining the types of information that corporations should give security holders and the forms in which it should be and is given. There are special interests who feel that they would either be benefitted or harmed by changes in the present legislative pattern. And, in most cases, those who have expressed themselves are either the corporations themselves, the associations to which they belong, or the various markets through which their securities are traded. Security holders themselves have not expressed their views publicly to a very great extent.

CHAPTER VI

SOME COLLATERAL ISSUES AFFECTING DISCLOSURE

Changes in legislative patterns are likely to have effects upon the markets through which securities are traded. Also, changes in the volume and content of information supplied by corporations to investors, and changes in the methods of supplying it, have a direct financial bearing upon the corporations because of the costs which they entail. They also may have effects upon corporate-community relationships and upon the competitive position of one business as against another. These are collateral issues, but they are important, because they must be considered and weighed in any judgment of the degree in which corporate affairs should become public affairs.

The remainder of this chapter will be concerned with these collateral issues. Then, Chapter VII, which follows, will attempt to discuss and evaluate the various sources of information available to investors and the efforts being made to improve reporting practices. It will also contain a final section on the problem of defining "full disclosure."

Possible Effects on the Security Markets

One problem, which is really a sort of collateral issue to the main one of full disclosure, is that which has to do with the effects of legislative changes upon the security markets. It is probable that the security exchanges would stand to gain directly if the Frear Bill, which

contains the Securities and Exchange Commission's proposal, were passed; because some management decisions in the past may have been made to refrain from listing because of the burden of registration and reporting. If this burden were made mandatory regardless of the market used, that particular reason for not listing would be removed, and it might result in increased listing.

However, it is quite possible that both types of markets would benefit by more comprehensive disclosure requirements. The over-the-counter market in particular would be able to obtain more complete information about its stock-in-trade, the stocks and bonds of corporations. It in turn could pass on more complete data and more effective advice to its customers, thus, perhaps, improving its competitive position as against the exchanges.

Among those supporting the Frear Bill in the Senate hearings were the New York Stock Exchange[1] and the New York Curb Exchange.[2] Also supporting it, but on the condition that unlisted trading on the exchanges would in the future be prohibited, were the National Association of Security Dealers,[3] with 2,743 members, (called a "satellite" of the Securities and Exchange Commission by the Commercial & Financial Chronicle[4])

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[1]U.S. Congress, Senate, Securities Exchange Act Amendments, Hearings on S. 2408 (1950), op. cit., pp. 69-70.

[2]Ibid., pp. 104-08. [3]Ibid., pp. 53-62.

[4]"In Opposition to the Frear Bill," The Commercial and Financial Chronicle, CLXXI (February 16, 1950), p. 35.

and the Investment Bankers Association,[1] representing 700 members. Registering doubtful acceptance of the bill were The Main Investment Dealers Association[2] and the National Security Traders Association,[3] representing 3,617 individual traders. These two associations gave the impression that they would not object to an extension of the various disclosure requirements to unlisted securities, but they were primarily interested in preventing what they considered would be a death blow to the over-the-counter market if coverage were extended and, at the same time, unlisted trading were allowed as it is at the present time.

The Investment Dealers of Ohio actively opposed, mainly on the grounds that they felt the proposed law would place an undue burden on the many moderate-sized corporations in the State of Ohio.[4]

Mr. Cyrus S. Eaton, industrialist, banker, and farmer, a stockholder in various companies and a part-owner of Otis & Company, which is a large and very independent securities dealer, is fundamentally opposed to the Securities and Exchange Commission. One reason for his opinion is that he believes the Commission is very partial to the exchanges and that it has "sold out" to Wall Street. To quote his own words: "For 15 years I have been quarreling with the Securities and Exchange Commission because, like too many other governmental agencies, it has been progressively taken over, and brought under the domination of those whom it is supposed to regulate."[5]

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[1]Hearings on S. 2408, op. cit., pp. 62-66.

[2]*Ibid.*, pp. 112-15. [3]*Ibid.*, pp. 197-99.

[4]*Ibid.*, pp. 115-29. [5]*Ibid.*, p. 154.

To substantiate this he cites a number of instances in which commissioners, after expiration of their terms with the Securities and Exchange Commission, have obtained lucrative positions as part of or closely connected with Wall Street interests.

The Commercial and Financial Chronicle, registering strong opposition editorially, said that present legislation as it is administered by the Securities and Exchange Commission is already a burden on the securities industry, particularly the over-the-counter market. It says further that present controls place reporting and other onerous requirements, which constitute a burden, on dealers; but, at the same time, the spreads which such dealers may take are regulated. This destroys the profit motive and makes it difficult to earn a livelihood. Further extension of controls would be an addition to the bureaucratic juggernaut which threatens to destroy the over-the-counter market along with the entire free enterprise system.[1]

The objection voiced by several of the above groups in regard to unlisted trading seems to be due to their feeling that what might be an effective market developed for a security by the over-the-counter dealers can be seriously disrupted by a limited number of transactions taking place in the same security on an entirely different type of market. This technicality of the markets is probably the major reason why the over-the-counter dealers oppose further extension of federal controls over corporate disclosure.

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[1] Commercial and Financial Chronicle, op. cit.

The Burden of Compliance with Regulations

The question of the costs to and the effects upon the corporations registering or filing the information required by the Securities Exchange Act is one which the lawmakers have probably considered very carefully.

As was mentioned briefly in the preceding chapter, the Securities and Exchange Commission feels this burden would not be very great, because corporations having $3,000,000 in assets would already have the accounting records and the organization necessary to prepare and submit the material needed. It points to the fact that such records are needed and are audited periodically for tax purposes and numerous other reasons; so the problem is only to make public that which is already in existence--according to what it considers to be decent accounting standards, of course.

In a statement made in the Senate hearings on the Frear Bill, Mr. Francis Truslow, President of the New York Curb Exchange, substantiated further the above view. He said:

> Such an addition to the law is not an impracticable experiment. About 2,000 companies in this country of all sizes and types of business have been meeting the requirements for an identical law for many years. They have not found the law unduly burdensome nor have they found that it restricted their freedom of decision.[1]

However, a number of other people have indicated that the additional expense and effort involved is by no means a minor item. They point out that a $3,000,000 corporation is not necessarily large; in some types of businesses it would be, but in others, not. And, even though an investment in assets might be large, it does not always follow that the

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[1]Hearings on S. 2408, op. cit., p. 107.

accounting, clerical, and management organization is also large or qualified to compile and present the comprehensive data as required by the Securities and Exchange Commission.

These people say further that changes in procedures of record-keeping would need to be made and additional personnel employed. It is also very probable that special legal counsel would need to be retained and that additional services from accounting firms would become necessary. Further, a portion of management's time and effort would need to be diverted from the tasks of making the corporation produce to that of dealing with the rules, regulations, interpretations, and directives of an additional governmental agency. Moreover, the contact between the corporation and the governmental agency, separated by geography as well as, perhaps, different degrees of knowledge concerning the corporation's problems, could reduce the speed with which decisions might be made and otherwise redece business efficiency.

Various estimates have been made as to the dollar costs involved, but they are not very well substantiated. For example, Mr. Ewing T. Boles, President of the Investment Dealers of Ohio, stated that his association estimated $10,000 to $15,000 per year to be the minimum cost for these additional services together with the printing expense involved; and the costs could run several times that.[1] Mr. Tyre Taylor, General Counsel for the Southern States Industrial Council, which represents 3,000 employers in natural resources, transportation, and manufacturing in the Southern

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[1] *Ibid.*, p. 121.

States, as well as 500 banks, stated that his information was limited regarding these costs, but he had heard of some initial registrations costing as little as $25,000 and others which ran to a quarter of a million dollars.[1]

The above figures are of doubtful value for anything except to give a general idea of what these people, who are associated with important groups of businesses, are thinking about such costs. For example, one cannot tell for sure whether or not the estimates of Mr. Taylor included some flotation costs other than those connected directly with registration.

Senator James Murray, opposing efforts to extend the coverage of existing legislation, questioned the desirability of the provisions regarding registration, periodic reports, proxies, and the activities of officers, directors, and principal stockholders. It seemed to him that they had done more harm than good to the economic welfare of the corporations covered. He said further:

> Registration has been far too costly and information furnished has never been of much help to the individual investor. In many of these reports covering hundreds of pages the essentials bearing on the value of securities could be reduced to a few typewritten pages, and clear-cut explanations given that the investor could understand. These reports have been a deterrent and a costly use of the time of management. If the billions of dollars that have been lost from business by the delays and time consumed by these unessentials could be correctly estimated, Congress would be amazed.
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> . . . With respect to the activities of officers and directors, someone should point out how many corporations have lost their able managements because the men of character and integrity do not wish to be a party to the present requirements which make it impossible for them to do their best for their investors and the public. Many a

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[1] *Ibid.*, p. 134.

strong corporation has lost its ablest men to small corporations where the management is free and can run its business for the best interests of the workers and those who furnish the capital.[1]

Mr. Cyrus Eaton, whose testimony has been cited previously, stated that access to capital markets has been practically denied to the medium-sized and smaller companies. According to him, the small company, wanting to do some financing, cannot afford to go through the expense and ordeal of registration. It costs too much, and the small company cannot afford the talent or risk the uncertainties and the delays. The result is that such companies wind up by going to an insurance company or, perhaps, the RFC. In regard to the costs of proxy material, Mr. Eaton cited the case of the Cleveland Cliffs Iron Company in which he was a director. He said the company had undertaken the simplification of its capital structure by uniting the parent company with its wholly-owned subsidiary. It took six months of contacts between the company and Washington, D. C. to get an approved proxy statement. The resulting statement was 89 pages in length, had cost over $10 per stockholder, or about $100,000 total; and Mr. Eaton felt that the only people benefitted were the lawyers who prepared it and the people in the Commission who went over it.[2]

This case is probably an extreme one and is the exception rather than the rule. The Commission has indicated that its proxy machinery operates

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[1]James Murray, "SEC Arguments for Control of 'Unregistered Companies' Unsound," The Commercial and Financial Chronicle, CLXIV (July 4, 1946), p. 114.

[2]Hearings on S. 2408, op. cit., pp. 151-59.

without much expense or difficulty, and it would seem that that should be so. However, Mr. Eaton's example shows the extent to which costs of disclosure can be made to go.

Statistical studies have been made periodically by the Commission to determine flotation costs. Some of the results from their 1939 study are summarized in Table IV.

TABLE IV

COST OF FLOTATION FOR REGISTERED SECURITIES 1938-1939*
(Costs are shown as percentages.)

	Bonds	Preferred Stocks		Common Stocks	
	Under-written	Under-written	Not Under-written	Under written	Not Under-written
Cost of flotation, total	2.6%	6.3%	16.0%	16.9%	19.0%
Compensation to distributors	2.0	5.1	14.9	15.1	17.3
Expenses	0.6	1.2	1.1	1.8	1.7
Expense attributable to registration (estimated)	0.25%	0.5%		0.5% plus	

*Source: U.S. Securities and Exchange Commission, Costs of Flotation for Registered Securities 1938-1939 (Washington: Securities and Exchange Commission, 1941), pp. 3-12.

In explanation of the above table and the study which it partially summarizes, the following points are noted:

1. Compensation to distributors was a much more important cost element than expenses.

2. Expenses included ten classifications, as shown below:

Expenses not attributable to registration	Expenses partly attributable to registration
Listing fees	Printing and engraving
Federal taxes	Legal fees
State taxes and fees	Accounting fees
Transfers, transfer agents, etc.	Engineering fees
	Miscellaneous
	SEC registration fees*

*Wholely attributable to registration.

3. The percentages given in the table are averages. Actually, there was some variation by industry and considerable variation because of size of company or issue. Costs of flotation became progressively smaller as the size of the issuing company increased. Costs of flotation became progressively smaller as the size of the issue increased, dropping from 7.5 percent on issues of underwritten bonds of under $1,000,000 to 2.4 percent on issues of $20,000,000 and over. Costs were consistently lower for equity issues of from $1,000,000 to $5,000,000 than for issues under $1,000,000. However, most preferred and common stock issues were less than $1,000,000 in size and showed little relationship between cost and size.[1]

The Commission states that a similar study made in 1945-47 and published in 1949 as part of its Survey of American Listed Corporations showed essentially the same picture as previous studies had shown, namely, "that the percentage of the investor's dollar which goes into the cost of flotation increases substantially as the size of the flotation decreases.

[1]From the same source as Table IV, preceding page.

Thus, in the three years, 1945 through 1947, the average cost of flotation for the 47 registered issues of $50,000,000 or over was 1.15 percent, and at the other extreme the cost of flotation for the 19 registered issues of $500,000 or less was 21.91 percent." They point out again that by far the greater portion of the cost of flotation, particularly in the case of small issues, consists of the underwriters' commissions and discounts.[1]

It is probable that such selling costs would be a more important factor than the problems of registration in deterring smaller concerns from floating new issues. There is very good reason to believe also that many concerns, particularly those which are already established, would find it economically advantageous for a variety of reasons to borrow smaller amounts from banks or insurance companies.

However, costs, though small as percentages, may be material in dollar amounts. Such direct dollar costs increase in importance when added to the less measurable but sometimes material burden placed upon management itself.

As a summary statement of the preceding discussion, it can be said that the burden of registration and continuous reporting by the corporation, its officers, and principal stockholders, together with the requirements for getting the proxy information approved and presented properly, constitutes one of the important factors influencing disclosure. Since the stockholders, as owners of the corporations, ultimately bear whatever burden this is, except for offsetting tax deductions, they should recognize that full disclosure, like other things, carries an attendant cost element.

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[1]Hearings on S. 2408, op. cit., p. 179.

Adverse Local Effects of Full disclosure

The first chapter discussed briefly the traditional feeling among businessmen that their company affairs should be kept largely confidential. It explained that it has only been in comparatively recent years that the general policy of secrecy has given way to one of presenting more or less publicly much of the affairs of an enterprise.

This new idea, even now, is often accepted with reluctance, and sometimes, is opposed strongly. This may be due in part to a resistance to change or a failure to recognize the increasing emphasis on detailed disclosure. But there are reasons, which still seem logical, why it might at times be more desirable to stop someplace short of full disclosure. One of these is the effect on a company's competitive position, which will be discussed in the next section. The other is the effect on local public relations and on employer-employee relations, which will be considered here.

To help in this explanation, the example of a Western company will be used. It is the Boise-Payette Lumber Co., which is engaged in the manufacture of lumber and in the merchandising of building supplies through retail yards located in Utah, southern Idaho, eastern Oregon, and Colorado. Morrison-Merrill & Co. is its wholly-owned subsidiary.

Those who manage Boise-Payette say that, in their opinion, disclosure of confidential information such as the salaries of directors and top executives, as required of those who file with and report to the Securities and Exchange Commission, would prove harmful to the interests of the company and its stockholders. And this would be reflected in damage to existing good labor and community relationships.

They express their position in this regard as follows:

> There is abundant evidence to support the belief that unscrupulous individuals can be expected to seize upon such information and so present it when it serves their purpose to do so, purposely to create misunderstandings and false impressions to the lasting damage of the good will and public sympathies which companies like ours now enjoy and must have successfully to operate; to meet pay rolls; pay taxes; compete in open markets, and to produce a profit for our stockholders.
>
> There are many and entirely justifiable reasons for jealously guarding management plans and operational details of a highly competitive business. In the case of our closely held corporation, where operation of the company over a long period of years has well established the respectable soundness of its conduct and where there has been no expressed dissatisfaction by stockholders and full information as to company operations has been made available to them; it seems unreasonable in the extreme to place our records and our company on exhibit. This would seem to be true in the case of any other company similarly situated where investor protection is scarcely in question. The parade of reports which the Securities Exchange Commission would demand of us under S. 2408 would serve no useful public purpose. On the contrary without providing investor protection it could react prejudiciously to the interests of our stockholders by way of furnishing information to competitors which they might use as they saw fit.[1]

Along this same line, Mr. T. Frank Watkins, representing the American Cotton Manufacturers Institute, Inc., said that in many instances, publicity concerning the number of shares held by certain officers and directors would be embarrassing in a small community. Publicity about salaries would cause jealousy and strife. Many small companies are in active competition with larger units, and,in order to obtain men of the required skill and experience, it has become necessary to pay the scales of wages adopted by those competitors. Such salaries might provoke unjustified unfavorable comment if publicized in local newspapers having wide circulation in the towns and cities in which the plants are located.[2]

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[1]*Ibid.*, p. 144.

[2]*Ibid.*, p. 190

One more example will be given. It is taken from a statement by Mr. Albert A. List, President, William Whitman Co., Inc., New York City.

Mr. List speaks about what he considers to be relatively small corporations which range from those having several hundred stockholders and a few million dollars, on down. With most of these companies, local ownership prevails to a large extent.

According to his statement, every company must employ a management staff capable of carrying on the business successfully, or it cannot survive. To employ capable people these companies must compete in the market for this staff, and often this demand for manpower is on a country-wide scale. So, if able management is not paid adequately, some competitor will take them away. Salaries for such people which on a national scale are moderate may seem exhorbitant to the local community. To require public disclosure of such confidential information as the salaries paid to such men brings no protection to the investor, but, instead, has the effect of stirring up local discontent and is often the subject of attack by labor unions. The ability of management is the thing that gives value to the security, but the value of this ability may not be fully recognized by the community.[1]

Competitive Effects of Disclosure

Of major importance in the minds of some businessmen is the question of whether or not the alleged advantages of full disclosure to security holders outweigh the competitive disadvantages. If the effects

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[1] *Ibid.*, p. 216

would be felt equally by all, the objections would be less valid. But it is very possible that some companies could and would use the detailed information filed by their competitors; whereas, the competitors might not be in a position to benefit reciprocally.

The situation of Peter Paul, Inc. might be used as one illustration. This company is a candy manufacturer, whose principal products are the two commonly-known bars, "Mounds" and "Almond Joy." According to its annual report of December 31, 1940, Peter Paul had about 4,000 stockholders and $16,000,000 in assets. It did not consider itself large in the candy industry, but it was a growing company.

Mr. Tom Whitaker, representing Peter Paul, Inc. in Congressional hearings, implied that there were other corporations which had considerably more in assets than his company but had fewer than 300 stockholders. He made the point that, from the standpoint of disclosure, it may not be necessary to publish detailed information if a concern had only a few stockholders; but, he said, if a large company with, say, 25 stockholders were not required to make detailed public disclosure, but another company of the same size or smaller having 4,000 stockholders were required to file such information publicly, the former would have an unfair competitive advantage.

Peter Paul, Inc. is not at the present time subject to the registration and reporting requirements of the Securities and Exchange Commission, but it would not object to furnishing the type of information required of registered companies--provided those in competition within the candy in-

dustry, whether with 300 stockholders or less, were required to make available that same information.

Mr. Whitaker emphasized that, when information is filed with the Commission, it becomes public. A competitor may by analysis of such information obtain company secrets. Therefore, to arbitrarily say that corporations of a certain size and with a certain number of stockholders should be required to file while others should not would be to give some an artificial advantage.[1]

The Ray-O-Vac Co., of Madison, Wisconsin, provides a further illustration.[2] In its own opinion it is second or third in size so far as the manufacture of dry batteries is concerned; yet, it considers itself relatively small. This is explained by the fact that some of its competitors, who manufacture only products similar to those of the Ray-O-Vac Co., are themselves subsidiaries of giant corporations which produce diversified products.

According to Mr. Ralph Axley, Attorney for the Ray-O-Vac Co., the big company in the field--the one generally considered to be the big one, for nobody can find out just how big--is owned by one of the largest industrial empires in America, an empire with which the Ray-O-Vac Co. has been proud to compete, and with which it had to that time competed successfully. In discussing that large company, and the general competitive position of his own company, Mr. Axley said further:

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[1] _Ibid._, pp. 96-99.

[2] _Ibid._, pp. 135-41.

> That enterprise, compared to our company, has unlimited capital, and at times a large part of our success in competing with that company has been the careful management of very limited capital that produced an efficiency that could compete with that unlimited power.
>
> There are other companies of comparable size to us in this industry. Some of them are about the same size. A few of them are a little smaller, but still would be affected by this bill (The Frear Bill). Every one of those smaller companies that is engaged exclusively in the battery business has to compete with this battery manufacturer, and there are two of them of this kind that in each case is a part of a great enterprise with a diversity of product that permits them to concentrate their effort at one place or another in competition in the way that the company manufacturing one product simply cannot concentrate it. If they want to effectuate a price war against the industry, there is no question of their ability to do it at any time. They haven't driven us out of the market. Why? They haven't done it because we have had the freedom to use our ingenuity to stay in that market.
>
> . . . Now there is a cardinal principle in competitive business. In highly competitive businesses you keep your own council about the way that you do business, and about the extent of your business at any given time. So it has been the uniform policy of this company for 44 years now not to ever tell anyone how much the sales are.[1]

In Mr. Axley's opinion, for his company to publicize detailed information concerning its business affairs would be to invite one of the giant diversified corporations to take advantage of periods of weakness in the smaller company. It would seem inconsistent, he said, for a government concerned with destroying monopoly to give additional powers to those people most capable of having monopoly in this country, and to destroy the opportunities that the smaller businesses have to exercise their ingenuity to still compete and to keep our free system free and alive and growing.

A third illustration is provided by the cotton industry. It is an industry in which there are hundreds, probably thousands, of competing firms, no one of which is a controlling factor. Competition is keen, not

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[1] *Ibid.*, pp. 136-37.

just between firms manufacturing cotton goods exclusively, but between such companies and those using wool and synthetic fibers. But, despite the fact that there are many companies, the investment in any one is usually quite extensive. As an indication of this extent, the average investment per worker in textiles has been estimated at over $16,000; which means that a plant with 200 workers usually needs an investment of over $3,000,000 in assets. Fixed costs are relatively high, therefore, and profit margins have to be kept low because of the competition.

It is customary for such concerns to plan their production months in advance, accumulating inventories of the various types of cotton required for the types of materials to be manufactured. So, if a competitor knows the composition of the inventory, he can guess in advance the company's future production and sales efforts.

According to Mr. T. Frank Watkins, representing the American Cotton Manufacturers Institute, who has previously been referred to, a detailed breakdown of inventories showing raw materials, work in process and finished goods might give a competitor a great trading advantage, particularly if the market were a little dull and the financial statements showed the accumulation of a large amount of finished goods. He did not imply that present rules of the Securities and Exchange Commission would go so far as to require a detailed breakdown of the various types of cotton in the raw materials inventories; but he did indicate that disclosure could be carried that far, that it would be welcomed by financial analysts and professional traders, but it would harm the company furnishing it.

In his opinion, like that of Mr. Whitaker of the Peter Paul company, it would be wrong to arbitrarily require disclosure by one concern and not

the other. For this reason, along with others, he felt that it would be desirable to let each company work out its own disclosure problems. He said that management generally has been doing a good job in this respect and that it will continue to improve where necessary as time goes by.[1]

The three illustrations given above do not cover completely all the competitive effects, but they point up further the problem of making a decision between complete disclosure and limited disclosure. They indicate on the one hand the fear by Company X that it will be required to publicize detailed information, while Company Y, its competitor may not do so because of technical exemptions from legal requirements. They indicate the feeling also that, although two competing companies may both disclose detailed information publicly, the one may be in the better position to work out and use the trade secrets of the other.

Many large concerns with diversified holdings can merge the results of various subsidiaries together in consolidated statements in such a way as to preclude a competitor from benefitting materially from them. Others who are not diversified may not be able to do this. If public information were available, the large concern could watch the working capital position, the sales, costs, and non-financial affairs of a smaller company, note its profit margins, and, at the most favorable time, could place extra advertising and more attractive merchandise in the area of competition with the smaller company. It could cut prices and, in other ways, exert pressure to weaken the smaller company further, perhaps forcing it to sell or to go out of business.

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[1]Ibid., pp. 185-91.

CHAPTER VII

AVAILABILITY AND ADEQUACY OF CORPORATE DATA TO INVESTORS

In 1946 when the Securities and Exchange Commission proposed to Congress that sections 12, 13, 14, and 16 of the Securities Exchange Act of 1934 be extended to most other large corporations not already subject to them, it made certain statements which were not entirely acceptable to the accounting profession.

The Commission, in its study of the annual reports of unregistered corporations, concluded that on the whole they were seriously inadequate, often to the point of being misleading. Its reasons for the conclusion have been discussed in Chapter V of this thesis. However, to recall them briefly again, some of the companies furnished their stockholders only a balance sheet without a profit and loss statement; many did not furnish an analysis of surplus; and even more companies, presenting consolidated statements, did not provide an unconsolidated statement for the parent company; over half of the balance sheets were materially deficient when judged by the standards set for the statements to be filed with the Commission under the Securities Exchange Act; a third of the income statements did not disclose the amount of sales or cost of goods sold; and improper or unsound accounting principles appeared in some cases.

In regard to this the Commission said:

> The fact that the financial statements examined in the course of this study were generally grossly inadequate, notwithstanding that

90 per cent had been subjected to the expert review of a certifying accountant, makes it quite clear that the procedure of certification does little to assure adequate information for investors. Excessive condensation and insufficient supplemental disclosure apparently do not prevent certification. Nor do they always give sufficient attention to the propriety of the accounting principles followed. Examples of improper or unsound accounting principles, referred to above, were found, almost without exception, in financial statements that had been certified.[1]

Whatever an accountant's personal views may be about the necessity or desirability of disclosure, it is apparent that management policy is the factor which determines the nature of the annual report. The Commission's experience has been that, unless accountants can point to legal requirements of good accounting standards, they are often unwilling or unable to insist on a position contrary to that of the management of the extent of the disclosure which is desirable. Accountants need and should have the support of the Commission's accounting regulations.[2]

The Journal of Accountancy immediately took issue with this. In an editorial in August, 1946 it said that a reader unfamiliar with the subject matter could hardly avoid the impression from the Commission's report that the accounting profession was faced with a serious indictment; whereas, to appreciate the significance of the observations in the report, one would need to understand the distinction between reports to stockholders and those filed with the Securities and Exchange Commission.

The editorial emphasized that none of the legislation requires that the same detailed information furnished to the Commission has to also be included in a corporation's annual report to stockholders, and that such information seldom is included in detail in the latter type of reports, even by registered companies. It added further:

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[1] U.S. Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities (1946), op. cit., p. 49.

[2] Ibid., p. 16

There is thus frequently considerable variation, in volume rather than in substance, between statements furnished to stockholders by listed companies and those filed with the Commission. A number of listed companies, for example, furnish consolidated statements without statements of the parent company, and income statements much more condensed than those filed with the SEC. Reports to stockholders are not to be deemed deficient merely because they lack certain details required in reports filed with the SEC. The public accountant who certifies financial statements, for either purpose, has to consider carefully whether any additional information should be disclosed to make them not misleading. Provided he satisfies himself that the statements are what they purport to be and that they meet this standard, he is entitled to express his opinion regarding them. Beyond that he is without power to compel a company to publish additional information. The SEC recognizes this limitation on the accountant's power. Would the SEC contend that because there was no authority to require the company to publish a financial statement as detailed as the Commission would wish, certified public accountants should refuse to certify any less detailed statements? Would investors be better protected if there were no independent audit and no impartial opinion as to whether good accounting had been followed in presenting whatever information was supplied?

The weakness of the Commission's criticism is that it rests on a faulty foundation, namely, a comparison between published annual reports to stockholders of unlisted corporations and Form 10-K requirements for listed corporations. A fairer basis of comparison would have been between the published annual reports of unlisted corporations and the published annual reports of listed corporations.

The most serious charge in the report is the statement quoted above that examples of improper or unsound accounting principles were found in financial statements certified by certified public accountants. This statement is unsupported by specific references. We suggest that if such cases do exist they be referred to the American Institute of Accountants committee on professional ethics without delay. Meanwhile, the allegation should be weighed in the light of the disposition of the SEC accounting staff, demonstrated on a number of occasions, to regard sound accounting principles as synonymous with its own rules. It is not always true that accounting procedure on which the SEC would issue a deficiency necessarily violates generally accepted accounting principles. Actually, though it sounds much worse, the Commission may only be stating the truism that corporations not subject to its rules are not following them.

The accounting profession has always stood for full publicity of corporate affairs. It has been responsible for great improvements in corporate financial reporting. It has cooperated closely with the SEC in efforts to improve corporate accounting. By the power of persuasion, certified public accountants have unquestionably brought about greater disclosure of financial information by unregulated companies than would otherwise have been made. As these comments have indicated, we are frankly disappointed with the tone of the Commission's allusions to the

> accounting profession in its report. In order that readers may form their own opinions, we reprint in the "Official Decisions and Releases" section of this issue passages from the report to which we have referred. The fact that the report has been transmitted to Congress accentuates the seriousness of the uncomplimentary references. We hope that the American Institute of Accountants will take prompt steps to counteract the unfavorable opinion of the entire accounting profession which this report might create in the national legislative body.[1]

Four years later, when the Commission submitted its Supplemental Report to Congress, it referred to the above statements by The Journal of Accountancy. It stated that, when it had made its studies of the corporate annual reports of unlisted companies, it had considered making the comparisons against the reports of listed companies, but had rejected that idea. In Regulation S-X, which was the basis actually used, it had established a minimum standard for financial statements for investors. It stated further that, although the financial statements contained in reports to stockholders are not subject to Commission jurisdiction and hence may not in all cases meet the requirements of Regulation S-X, investors, financial reporting services, financial analysts and other persons interested in the financial condition of companies registered with the Commission may consult its files or purchase for a nominal sum photocopies of statements for registered companies which do meet these requirements. This privilege is not available to persons interested in the affairs of unlisted companies.[2]

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[1] "SEC Seeks Control of Unlisted Companies," The Journal of Accountancy, XLVI (August, 1946), p. 73.

[2] Securities and Exchange Commission, A Proposal to Safeguard Investors in Unregistered Securities, Supplemental Report to Congress (1950), op. cit., pp. 24-25.

The Commission is admitting here that the reports which registered corporations submit directly to their stockholders may fall short of meeting the disclosure minimum contained in Regulation S-X; but it is saying that stockholders in such companies have something additional--the right to obtain detailed information from the public files; and stockholders in unregistered companies do not have that opportunity.

At this point there are a number of questions which probably should be answered--such questions as the following: Just what do the annual corporate reports to stockholders contain, and what part do such reports play in the disclosure picture? How and to what extent does information filed with the Securities and Exchange Commission get back to the investors? What other sources of information do investors have? How have the standards used by the Commission, such as those contained in Regulation S-X, been developed? What part is played by the American Institute of Accountants, and how does the accounting profession generally fit into this picture? Can we expect further progress in disclosure?

The remainder of this chapter, divided into three main sections, will attempt to give the answers.

Sources of Information Available to Investors

Corporate Reports to Stockholders.

One cannot very well make a general statement of what an annual report picked at random will contain; because there are probably no two just alike in form and content, and they vary from a simple card containing a printed financial statement to a very informative and attractive magazine-type report.

The Great Atlantic & Pacific Tea Company, a corporation with $416,000,000 in assets, used for the year, 1951, two cards. The larger card, about 4 x 9 inches in size, contained a consolidated balance sheet; and the smaller card, less than 4 x 5 inches in size, showed a very condensed consolidated profit and loss statement.

Many companies use a simple, unadorned type of report containing a letter from the president, a section of financial statements, an auditor's certificate, and usually, but not always, a page or two listing the products made, the plants owned, the names of directors and officers, and the transfer agents and registrars, if any. Some of these reports can be folded and mailed in a 4 x 9½-inch envelope; others, in booklet form and of various sizes, require special mailing envelopes. These are the traditional standard-type reports, presenting what is considered by the companies issuing them to be the essentials of information. Such reports are primarily the financial statements, in standard form.

A few of the corporations issuing this latter type are: (1) Fruit of the Loom, Inc., a $7,000,000 corporation manufacturing shirts and other products requiring similar materials, (2) B. Kuppenheimer & Co., Inc., having $5,500,000 in assets and making men's suits, (3) Harbor Plywood Corporation, a company with $17,500,000 of assets in 1950 and having its central offices in the State of Washington, (4) Columbia Baking Company, from Atlanta Georgia, with $4,800,000 of assets, (5) The Sherwin-Williams Company, in the paint business, and having consolidated assets of over $110,000,000, (6) Carnation Company, having $84,000,000 in assets, and (7) The Amalgamated Sugar Company, a $26,000,000 corporation.

What might be termed the "modern-type" report often runs to over thirty 8½ x 11-inch pages in length. It is usually in color and often shows pictures of some of the company's products, plants, or activities. It makes considerable use of what might be termed the "pie-chart" approach, showing not only the standard financial statements, but also showing important features of the operating results and financial condition in the form of simplified charts and graphs. It very often shows comparative statements for a series of years, and sometimes includes special statements such as one showing the sources and uses of funds, which includes an analysis of increases or decreases in working capital over a period of time. The president's letter often discusses in considerable detail the plans, policies, and progress of the company. As an example of what such a report might contain, the table of contents from the 1950 annual report of Marquette Cement Manufacturing Company is given below:

CONTENTS	Page
Fifteen Years at a Glance	2
A brief Summary of 1950	3
Cement Prices Continue Low	4
Comments of Marquette's President	5
More Gains for Our People	6
More Non-Wage Benefits	6
Net Income & Sales in Relation to Cost of assets & Working Capital	8
Current Net Income from 1939 Capacity Expressed in 1939 Dollars	9
How Common Shareholders Have Fared	10
Review of 1950 Operations	11
Auditor's Certificate	13
Balance Sheet	14
Income Statement	16
Where Sales Income Went	17
Retained Net Income	18
Sources and Use of Funds	19
Products and Operations	20

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Expansion	21
The Mississippi Project	22
Marketing Area for the Brandon Plant	24
Sales Staff for the Brandon Plant	25
The Des Moines Plant Enlargement	26
Who's Who in Marquette's Management	28

Also included with the main report was a supplement showing comparative financial statements for a fifteen-year period. The following remark was conspicuously printed on the back of the supplement:

> The statements contained in this supplement have been prepared for the use of those recipients of this report who may wish to make their own individual interpretive analyses of the financial data presented. If, in that connection, any additional details are desired, they may be readily obtained by addressing an inquiry to the Company.

This is a company having about $26,500,000 of assets, with central offices at 20 North Wacker Drive, Chicago 6, Illinois. Its report is generally well done; it is presented in an interesting manner, and it shows the results of what has, no doubt, been considerable expense and effort on the part of management to tell the story of Marquette Cement Manufacturing Company.

There are numerous other companies of various sizes and interests who are putting out good annual reports of the modern type. Such giant corporations as General Motors, U. S. Steel, and Standard Oil Company (New Jersey) have been leaders for years in efforts to present annual reports and supplementary interim information in such a way that they will be interesting and useful to readers of widely different interests and abilities for understanding business matters.

The annual report is the primary medium by which the corporation can tell its story. Progressive executives during the past few years have begun to realize several important things about such a report. For one thing, the audience, which has customarily been the company's stockholders and some of its creditors, is now widened to include the workers, the unions, schools, the government--in fact, for many companies, it includes the entire public.

Another important fact, which has been known for many years but has been emphasized more since the war, is that many of the people who receive corporate reports do not read them, are not interested in them, or do not understand them. A survey completed in 1948, sponsored by Controllership Foundation, Inc., was discussed extensively at that time and has probably been a stimulant for improvements since. As summarized in Business Week, it showed that 90% of the people contacted could not remember seeing a report, 25% said they did not read such reports when received, and 40% said the reports had no value to them; over half were not interested in or could not understand detailed statistics or elementary accounting terminology used in the reports. The run-of-the-mill stockholder was primarily concerned with the size of his dividend check and some reasonable assurance that the company was in good enough shape to protect his investment and pay the same or bigger dividends. Regarding the "new-style" (modern type) reports, there were still comments such as "not interesting," "too long," "difficult to understand," and "too complicated." There seemed to be a fundamental lack of financial education among stockholders.

Brokers, bankers, security analysts, and larger stockholders were very much in favor of the modern complete report; in fact, they would have liked to see even more complete reports published. They said that, to analyze most securities properly, one would need to utilize many more sources of information than most annual reports give. They wanted more details concerning contingent liabilities; they asked for comparative statements for two to ten years, more on labor costs, wage rates, etc., greater information on reserves and inventories and methods used in calculating such items, a breakdown of total income to show the sources from which it was derived, and more data on over-all operating costs, a reconciliation of the figures contained in income tax returns and those published in the annual report, and the extent of any hidden reserves.

These professionals disliked the trend to revamp statements for "housewife consumption." They also thought the annual report should stress the unfavorable as well as the favorable aspects of a business.

As a possible solution to the dilemma of writing a report to suit both the average stockholder and the sophisticated expert consumer of financial data the suggestion was made: "Try sending all stockholders a simple one-page 'newsletter' signed by the president, outlining earnings, dividend outlook, and the company's general position. At the same time offer to send on request a full-scale report scientifically designed for those who want the cold statistical facts."[1]

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[1]"Pleasing Nobody," <u>Business Week</u>, August 7, 1948, pp. 86-7

The survey re-emphasized what was already fairly well known. The problems which it pointed up still exist, although there seems to be a strong movement to overcome them.

Many of the reports are at the present time in an experimental stage in the search for improvement. Quite a number of them have adopted improved and simplified terminology for their financial statements, as suggested by the American Institute of Accountants. They are also trying to present the financial statements in ways that will be more easily understood by the average stockholder without detracting from their value to persons trained to use the statements in their traditional form. Some are using what is called the "single-step" income statement, which lists all of the income items, then lists all of the expense items, subtracting the total expenses from total income to arrive at net income. The 1950 statement of Standard Oil Company (New Jersey) is an example:

INCOME	
Gross operating income	$3,134,557,900
Nonoperating income, including dividends and interest	63,708,674
	$3,198,266,574
DEDUCTIONS	
Operating charges:	
Purchases of crude oil, petroleum products, and other merchandise	1,336,887,591
Operating, selling, and administrative expenses	892,696,102
Taxes, other than income taxes	69,091,530
Depreciation, depletion, amortization, and retirements	201,082,251
Interest on funded and other long-term indebtedness	12,462,938
Other interest	1,412,376
Foreign exchange adjustments arising in consolidation	(1,038,935)

Provisions for loss on investments.	6,016,457
Provisions for estimated income taxes	207,000,000
Income applicable to minority interests in affiliated companies	62,956,192
Restricted earnings from pipeline operations.	1,476,849
	2,790,043,351
NET INCOME	$ 408,223,223

There is also a new version of the balance sheet, called "Statement of Financial Position" or "Statement of Financial Condition," which is thought to be more easily understood and yet of equal value from the standpoint of its content. An example of this statement, without its accompanying explanatory notes, follows. It comes from the 1951 report of General Foods Corporation:

Cash (in banks and on hand)	$ 20,143,447
Receivables (less reserves of $691,613) . . .	42,444,464
Inventories (Note 2)	147,380,300
Expenses paid in advance (advertising, insurance, taxes, and others)	5,890,349
CURRENT ASSETS	$215,858,560
LESS:	
Notes and accounts payable and taxes withheld (Note 6)	$ 30,276,010
Acceptances and drafts payable	13,706,141
Accrued salaries and wages and other expenses	5,903,889
Income and excess profits taxes	33,665,823
CURRENT LIABILITIES	$ 83,551,863
WORKING CAPITAL	$132,306,697
Investments & other assets, less reserves (Note 3)	3,134,124
Property, plants, and equipment at cost, less accumulated depreciation (Note 4)	72,983,842
Trademarks, patents, and goodwill (Note 5). .	1
	$208,424,664
LESS: Long-term notes payable (Note 6) . . .	24,046,500
EXCESS OF ASSETS OVER LIABILITIES .	$184,378,164
DERIVED FROM:	
Preferred Stock--242,500 shares (Note 7) .	24,250,000
Common Stock--5,590,774 shares (Note 7) . .	105,400,109
Earnings retained in the business (Note 7).	54,728,055
	$184,378,164

This statement emphasizes working capital, which, though important, is not shown by the usual balance sheet. It also arrives at another figure of particular interest, the excess of assets over liabilities, which is the stockholders' equity in the business. It then breaks this equity down so as to show the different sources from which it was derived.

Many companies feel, and perhaps rightly, that the annual report cannot by itself do the entire job. It is quite customary for companies to send out brief quarterly statements showing sales and net earnings. General Motors is an example of a corporation which furnishes a detailed balance sheet and profit and loss statement each quarter.

Mr. Thomas H. Sanders, in an article in the Harvard Business Review, in 1949, referred to a survey of 111 different companies asking the type of communications they made to stockholders. The replies indicated that, among them, they sent 37 different varieties of communications to stockholders in addition to the annual report. He went on to say that the trend seems to be toward separate reports for employees, although employees tend to be suspicious of this. He said this might increase class consciousness, and that the desirability of a company's following that procedure would depend on its own individual situation.[1]

From the standpoint of the corporations, and of the accounting profession, there is a distinct challenge to make of the corporate report (or reports) an effective medium of communication to stockholders and others for whom it is prepared. The investor, on the other hand, needs to recog-

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[1]Thomas H. Sanders, "The Annual Report: Portrait of a Business," Harvard Business Review, XXVII (January, 1949), p. 2.

nize it as an important source of information but one that is limited because of such reasons as the hesitancy or inability of management to utilize it fully, the difficulty of producing it in a form to serve the different abilities and interests of a wide variety of readers, or a lack of progress in the art of disclosure. The utility of a report to any investor depends on how well that particular report has been prepared and how well that particular investor is prepared to use it.

Other Sources of Information.

In the Congressional hearings on the Frear Bill (discussed in Chapter V) the criticism was made rather frequently that the information filed with the Securities and Exchange Commission did not benefit the ordinary stockholder because it was too detailed and complex, and that it was not readily available to him. Some said that the very volume and intricacy of such information defeats its purpose, namely, the informing of investors. Several people charged that the information benefitted primarily a few experts who were near Washington and New York where they could have ready access to the public files. This point of view was expressed by Senator James Murray when he said:

> In the first place this information is almost always exploited by those in the know, whether in the Government or in private life, before it reaches the public. Then when these reports reach the public they are often misleading and misused. The Government spends millions of the people's money to provide reports which are valuable, but essentially to those who have a large research staff to interpret and use them after properly analyzing their meaning. The public has no such facilities.[1]

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[1]James Murray, "SEC Arguments for Control of 'Unregistered Companies' Unsound," op. cit., p. 114.

The Commission agrees that the prospectuses sent out are often so complete and detailed that they are not read, and it admits there is room for improvement in regard to them. It also agrees that many investors are unable to use directly the registration statements, periodic reports and other information on file at various places. But it says the information "seeps down" to the average investor through the people who advise him.

As an explanation of the way in which this frequently happens, Mr. Marvin Chandler, representing the New York Society of Security Analysts, Inc., said that the job of a professional analyst is to bore into the financial statements, interpret them, reach a judgment on the investment merits of the securities, and pass that judgment on to the investors. He also said:

> We do now utilize the statements filed. They are the everyday tools of our business. For listed companies, the financial manuals, such as Moody's and Standard & Poor's, to which we constantly refer, now publish these statements which are furnished to the SEC, in lieu of the statements which are furnished by the companies in their annual reports. They do this because the reports to the SEC are more complete, more uniform in presentation, and more useful to the experts who will study them.
>
> In addition, we go to the stock exchange or to the local office of the SEC where the statements are on file, or we study them at the Washington office of the Commission, or order photostats from the Commission.[1]

The Commission's booklet entitled The Work of The Securities and Exchange Commission reads as follows:

> The Commission's files have become a repository for a wealth of financial and related information concerning several thousand

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[1]Hearings on S. 2408, op. cit., p. 203.

companies whose securities are traded on exchanges and in the over-the-counter markets. These reports are available for public inspection at the Commission's Washington office (and, in part, in its New York and Chicago Regional Offices); and photocopies of any portion or all of any of such reports may be obtained at nominal charge upon request directed to the Division of Administrative Services. This is true also of all other registered or public information, including the registration statements and financial reports of brokers and dealers; the registration statements of exchanges, utility holding companies, investment companies and investment advisers; and related matter. Copies of hearing transcripts are supplied only if not available from the public reporter.[1]

The present charge for photocopies is 15 cents per page, $8\frac{1}{2}$ x 11 inches in size.

There are regional offices in Atlanta, Boston, Chicago, Cleveland, Denver, Fort Worth, New York City, San Francisco, and Seattle, in addition to the offices in Washington, D. C. However, most of these offices do not have extensive files for investors. The amounts of information available at each, according to a letter from the Commission, is as follows:

All public information on file with the Commission is available for inspection in the Public Reference Room of the Commission's Washington office. Insofar as practicable, the Commission makes available in its Regional Offices some of the more current public information. There are available in the New York Regional Office, copies of recent filings made by companies which have securities listed on exchanges other than the New York exchanges; and copies of current periodic reports of many other companies which have filed registration statements under the Securities Act. In the Chicago Regional Office, there are available copies of recent filings made by companies which have securities listed on the New York exchanges. In addition, copies of recent prospectuses used in the public offering of securities registered under the Securities Act are

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[1] U.S. Securities and Exchange Commission, The Work of the Securities and Exchange Commission, op. cit., p. 20.

available in all Regional Offices; as are copies of active broker-dealer and investment adviser registration applications.[1]

There are various media, however, by which this information attains a much more widespread distribution than the limited extent of Commission offices can give. These were referred to in the statement by Mr. Chandler on the preceding page. As he indicated, a major method is through the financial manuals such as those provided by Standard and Poor's Corp. or Moody's Investors Service.

Mr. James M. Garnett, of Moody's Investors Service says that, in the preparation by his company of its various manuals, the most important basic sources of information are annual corporate reports and data obtained from the Securities and Exchange Commission. He adds, however, that his company also draws on other sources such as prospectuses for new securities, proxy notices and other notices to stockholders, indentures, loan agreements, and various financial publications, magazines, and newspapers; also, a considerable amount of factual as well as background material is obtained from various governmental departments and agencies and from personal contacts by direct field investigators. All of these sources contribute to the complete picture which the manuals try to present.[2]

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[1]From a letter by Mr. Hastings P. Avery, Administrative Services Officer, The Securities and Exchange Commission, Washington, D. C., July 21, 1952.

[2]From a letter by Mr. James M. Garnett, of Moody's Investors Service, 65 Broadway, New York 6, N. Y., July 24, 1952.

However, it should be emphasized once more that the most important sources, according to his statement, are annual reports as prepared for stockholders and the files of the Securities and Exchange Commission. According to the Commission, the publishers of the manuals are usually unable to get much more information about unregistered companies than is given in the annual reports of such companies; hence, if the annual report is inadequate, so is the data about that company in the manuals inadequate. But, the Commission says, if a company comes under all the disclosure requirements of the securities legislation, all necessary information becomes available.

One of the questions which Mr. Garnett answered was: "Would it improve the services offered by Moody's to any great extent if all corporations with widely-held securities were required to register with the Commission and file periodic reports similar to those required by the Securities Exchange Act of 1934?" His answer was: "Such a requirement, from the point of view of our work, would be very definitely helpful, and would undoubtedly make available more complete information on a number of companies as well as make it easier for us to compile all the pertinent information on such companies."[1]

He indicated that the circulation of the five manuals of Moody's Investors Service (Industrials, Railroads, Public Utilities, Governments and Municipals, Banks and Finance) is around 25,000; but he did not tell the extent of Moody's other services, including its advisory services.

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[1]*Ibid.*

The publications of such companies as Moody's Investors Service and Standard and Poor's, Inc. are sold to libraries, banks, securities brokers and dealers, corporations of different kinds, trusts, estates, individuals, and various other purchasers. They are used extensively by the people who advise investors and, to a great extent also, directly by the better-informed investors.

So, the technical, detailed information filed with the Securities and Exchange Commission does, to quite a large extent, get down to the ordinary purchaser or owner of stocks and bonds. He can obtain it directly from the Commission or exchange or from the financial services in which it is published; or he can benefit because the specialist from whom he obtains advice is able to get and interpret the information for him.

Some of the additional, more specialized, sources, which will only be mentioned, are the various federal or state commissions or departments to which railroads, public utilities, insurance companies, and banks submit reports. Another is the corporate charter, which is filed with the state of incorporation and which contains information about the objectives of the corporation and about its stock issues.

A source which is of considerable importance and could be used even more is the corporation itself. Stockholders, as owners, can ask for specific information from the corporation officials so long as their requests are reasonable. They have the right under the common law to inspect the books and papers of the corporation for proper purposes at the proper time and proper place. Many of the states have included

this right in special securities legislation applicable within those particular states.

This method of direct contact with the corporation has a special advantage of being more confidential than some of the other ways.

Regarding the various sources of information, it might be said that the annual report to stockholders is by far the most widely used, because every corporation issues it in some form. It varies in quality from one corporation to another, and the story it tells is often limited, but there are favorable opportunities for improving it. The information required by the Securities and Exchange Commission is the most complete, but it is limited because it is not furnished by all corporations. What there is of it can be of considerable benefit to investors either directly or indirectly, but many do not know how to utilize it. Other sources, except that of direct inquiry, are more or less limited to corporations in special fields or to particular types of information about any given company.

Some Aspects of Accounting as They Pertain to Disclosure

This thesis would not be complete without some further discussion dealing specifically with accounting as it pertains to disclosure; for accounting records are the means by which the dollars-and-cents history of a business enterprise is kept; and accounting statements are the method by which that history is told. Most of the policies of a company or the decisions of its management are reflected in some way in the accounts, and eventually become factors in the operating results and financial condition as shown by the statements. Accounting data thus

becomes the heart of the annual report as well as of much of the information filed with the Securities and Exchange Commission.

It is, therefore, important that the art and practice of accounting not only furnish management with factual data properly interpreted for purposes of controlling and operating the business, but that it also provide that management with financial information interpreted in such a way as to be useful in presenting the company's story to owners and other interested parties outside of the business.

The increasing separation of ownership and control, the general expansion and growing complexity of business, and the changes brought about by governmental tax and regulatory policies--all with accompanying disclosure problems--have required parallel accounting change and development. Whether or not accounting has been able to meet the demands made of it in various respects is a debated question, but that it has had particularly difficult problems and has made considerable progress in meeting them seems to be quite generally accepted.

A particular effort has been made during the past twenty years to provide a certain uniformity in accounting treatment and presentation so that the financial statements would have more meaning for persons using them. At the same time, there has been the feeling, quite general within the accounting profession, that standardization should not be allowed to go too far; for, to present all cases in a uniform manner might be to conceal important differences between them. To have rigid rules of expression might eliminate the flexibility needed to adequately describe business change.

The problem has been to resolve these apparently conflicting objectives, namely, to develope certain standards of expression, and yet to retain flexibility.

Various organizations have worked toward the solution. In many ways they have cooperated together; but, to a certain extent, they have left some confusion because of their separate efforts. This will be explained more by the discussion which follows:

The Securities and Exchange Commission has been a major stimulus to the accounting profession because of its emphasis upon full disclosure and its strategic position for enforcement with regard to leading companies. For its own part, it has generally consulted with the American Institute of Accountants and others representing the profession before setting up specific regulations covering the responsibilities of auditors and the form and content of financial statements. Its interests have leaned naturally toward standardization of details as well as of principles, but it has wisely accepted the advice of the profession and left room in most instances for individual judgment. Its instructions regarding presentation of inventories in the balance sheet, as quoted below, provide a good example:

> Inventories.--(a) State separately here, or in a footnote referred to herein, if practicable, the major classes of inventory such as (1) finished goods; (2) work in process; (3) raw materials; and (4) supplies.
>
> (b) The basis of determining the amounts 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 indication of the method of determining the "cost"

or "market"; e. g., "average cost," "first-in-first-out," or "last-in, first-out."[1]

One can see that the Commission in this instance is allowing considerable room for a business to choose its own inventory method, so long as there is disclosure of the method used.

If there is only one acceptable way of showing a given item, full disclosure requires that it be shown in that way; if there is room for choice, or if a very unusual situation is involved, full disclosure requires explanation of the method used. This pattern has generally been set up by the Commission in its requirements.

The American Institute of Accountants has had and still has the primary role in the development of a body of accounting standards and in obtaining general acceptance of them. Particularly through the research bulletins of its committee on accounting procedure, the Institute has dealt with specific problems of lasting importance as well as some pertaining just to a particular time, such as the war period. It has not attempted to cover the entire field of accounting, but, in general, has concerned itself with problems which were controversial in nature or were of particular importance because they were new, trying to arrive at the most acceptable solution for general publication, but also publishing minority opinions of the committee. It has also contributed greatly in the efforts toward improving the terminology of accounting, a much needed

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[1]U.S. Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, (Washington: U.S. Government Printing Office, 1951), pp. 13-14.

activity because of the increased use of accounting data by people of very different training and backgrounds for using it.

In most cases the Institute's recommendations have been accepted generally by the profession. However, such acceptance is not compulsory and may not be complete or may take a considerable period of time. A business enterprise may not wish to make rapid change in its methods, feeling that confusion might result. However, if it does choose to make an important change in procedure, proper disclosure requires that the effects of the change be explained.

Usually the Institute's recommendations are also acceptable to the Securities and Exchange Commission, but there are exceptions where this has not been so.

Despite its valuable contributions toward uniformity, the Institute has continuously stressed the importance of allowing for flexibility; and the wording of its recommendations has been such as to do this. One of the many examples of this might be taken from Bulletin No. 32,[1] regarding the much debated question of what to include and what not to include in the income statement and, thus, in the net income reported for the period.

The issue involved, stated briefly, is whether to use the so-called "all-inclusive" income statement, which shows in the one statement all items affecting proprietorship during the period, except dividends and transactions in the company's own stock, or to follow the "current operating performance" method, and exclude from the income statement all ma-

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[1] Income and Earned Surplus, Accounting Research Bulletin No. 32, (New York: American Institute of Accountants, 1947).

terial items of gain or loss which are extraordinary in nature and are not directly applicable to the operations of the period. The first method is based on the idea that all income over the life of the business should be shown at some time or other through the income statement. The latter method assumes that the chief purpose of the income statement is to show operating results on a comparable basis from year to year, thus necessitating the use of the surplus statement for showing extraordinary items or items not applicable to the current year, such as corrections of prior years' profits, or gains or losses from sales of real estate.

The Institute took the position that "there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception to this presumption in any case would be with respect to items which in the aggregate are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period."[1]

The bulletin went on to give examples of items which might be excluded from the determination of net income for the year, and which "should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom."[2]

In discussing this bulletin before a meeting of the Pacific Coast Economic Association in 1949, Mr. Anson Herrick emphasized his belief that

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[1] Ibid., p. 263.

[2] Ibid.

it not only provided a favorable solution to a complex problem, but that it also allowed room for judgment so that it might be adaptable to varied situations. He made the following interesting observations:

> The conclusions of the bulletin are in one way specific and yet full play is given for the application of judgment. It is specific in the statement that there should be a general presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. It permits the application of judgment by the recognition of possible exceptions in the case of items materially significant in the aggregate in relation to the company's net income and it established criteria to assist the use of judgment in the application of the principles adopted. It becomes specific again in the requirement that when such extraordinary items would so impair the significance of net income as to permit misleading inferences they should be excluded. But even here what would be a significant effect is left, as it must be to judgment.[1]

It is interesting to note that this controversy over "all-inclusive" income versus "current operating performance" income, which is very important from the standpoint of disclosure, is one of the areas in which there is lack of uniformity between the organizations having most to do with the shaping of accountancy. The position in regard to it of the American Institute of Accountants, as given above, is something of a compromise between the two methods; the Securities and Exchange Commission has required the use of the "all-inclusive" method, but changed its most recent revision of Regulation S-X (1951) to allow a modified income statement showing a figure representing net profit from regular operations, then deducting or adding the "special items" below to arrive at a figure called "Net income or loss and special items."[2] This revision is not far

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[1]Anson Herrick, "A Review of Recent Developments in Accounting Theory and Practice," The Accounting Review, XXV (October, 1950), p. 365.

[2]U.S. Securities and Exchange Commission, Regulation S-X, op. cit., pp. 17-18.

from the point-of-view of the Institute, and represents a favorable narrowing of the gap between the two as well as improvement of accounting procedure as required by the Commission. Incidentally, the revision of Regulation S-X was only made after lengthy discussion with the American Institute of Accountants and circularization of proposed changes among leading accountants and groups of accountants throughout the country. In various ways, the Commission made changes in the light of criticisms or suggestions received.

The American Accounting Association, since its 1948 revision of Accounting Concepts and Standards Underlying Corporate Financial Statements, its formal statement of standards, has been on record as endorsing the "all-inclusive" form of income statement. It, thus, at the present time differs on this particular issue from either of the other two. And this, it is emphasized again, is only one of several areas where there is lack of uniformity among these three organizations.

Perhaps something more should be said here about the American Accounting Association. It is composed largely of University teachers; and its efforts, like those of the others, have been towards the formation of recognized standards by which financial statements could be prepared and interpreted. Back in 1936, in its annual meeting, the Association formally recognized the need for such standards, and decided as one of its objectives to work for their further development and acceptance. In the explanation of this action it said:

> Specifically, there should be a definitive, understandable explanation of what a set of accounting statements purports to signify. A balance sheet or an income statement cannot tell everything, but it should furnish significant information and, as nearly

> as may be, the same type of data every time. When a critic is asked to examine such a statement he should be able to say that it does (or does not) conform to some consistent body of principles, which can be expressed in clear, unquivocal language, intelligible to the layman of sound mentality and substantial acquaintance with business affairs. If accountants are to speak only to accountants it seems hardly necessary that they speak at all.
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> Such a body of principles would furnish an essential basis of judgment in constructing and appraising financial statements. The principles accepted would not need to be restrictive, except in the sense that any proper practice restricts departures from it. They need make no demand for a rigid "uniformity" of accounting classifications and procedures, so much abhorred; they should permit wide latitude in the application of individual accounting policies and practices. . .[1]

The above quotation indicates that the American Accounting Association, like the Institute, has sought uniform standards, but has also wanted to retain a certain area for judgment.

Perhaps the greatest contribution by this Association has been its influence upon the teaching of accounting and, therefore, upon the students who leave the universities and go out into practice or who will later use accounting information in various ways. However, it has also prepared and revised several times its statement of accounting concepts and standards, as referred to on the preceding page.

Mr. Thomas H. Sanders, who speaks with considerable authority on accounting matters, questioned the desirability of trying to compress the principles of accounting into some eight pages, as the American Accounting Association had done in its 1948 revision of concepts and standards. He suggested that the American Institute of Accountants,

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[1]"A Statement of Objectives of the American Accounting Association," The Accounting Review, XI (March, 1936), p. 2.

as the organized, national body of the certified public accountants, whose function is to express the opinion that the financial statements have been prepared "in accordance with generally accepted accounting principles," could not well avoid its parallel duty to the formation of those principles. He further suggested the possibility that the preferable role of the American Accounting Association might be to act as a large, disinterested "thinking group" to serve as a stimulus and corrective to the practicing group.[1]

For the American Accounting Association to accept the role of advisor and critic, and to leave to the Institute the final determination of accounting standards, might be a favorable step toward uniformity in accounting practice.

Many theses and many entire books have been written about the different aspects of accounting, and much of what has been written had something to do with accounting as a means of disclosure. However, the scope of what can be said here is of necessity limited to these few pages and to the objective of trying to indicate the movement of accounting to meet the challenge of modern corporate development from the disclosure standpoint.

This movement has been largely centered around the development of accepted standards of financial disclosure, with the objective of providing fundamental ideas and procedures rather than detailed rules of practice. At the present stage of this development, which is still

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[1]Thomas H. Sanders, "An Analysis of the Forces Which are Shaping the Future of Accountancy," op. cit., p. 284.

in process and will probably continue as long as there is change in business itself, it is possible for accounting to produce reasonably consistent results from one time to another and from one business to another as far as disclosure is concerned.

This does not mean that all statements will be or should be the same; they need to be tailored to fit the needs of individual businesses. But it does mean there is now available to people concerned with preparation of financial statements, where there was not some twenty years ago, fairly reliable guides for the presentation of accounting data which meets reasonably uniform standards of disclosure.

Such a development is of great importance; although one needs to recognize certain limitations to it. The investor needs to realize that part of what is shown in a financial statement is of necessity the result of estimate, judgment, and general reliability of those contributing to its preparation. Such limitations are quite well known by people very familiar with accounting but are often not properly considered by the layman. The latter too frequently either does not recognize that these limitations exist, or decides that, because of them, accounting statements are of little value. In either case he is wrong.

One more factor, which seems to be of great importance, is the feeling very prevalent within the accounting profession that further improvement is desirable, that accounting can, among other things, make an increasingly better contribution toward full disclosure. The investor stands to benefit from this as time goes by.

Further Discussion of the Meaning of "Full Disclosure."

Thomas H. Sanders, in his article on the annual report, which has already been referred to, said that "the term 'full disclosure' means not only the specific mention of every item that might have a material significance to the reader but also the description and classification of the item in such a manner that the reasonably intelligent man can make out what the significance is."[1]

This statement is a good partial definition of full disclosure. As it indicates, the mere publication of information is not enough; it needs to be done in such a way that the audience which receives it can use it. It is entirely possible that a mass of facts, though each one is true and important within itself, can be presented in such a way that it means nothing. It is also possible that one fact or group of facts, when presented in conjunction with other items, will show a situation as it really is; but, if all of the items are not presented together, the picture will be misleading.

Although Mr. Sanders indicates that the data presented should be prepared for the "reasonably intelligent man," many companies go further and make their interpretations in more than one form; because one class of readers may not understand the detail that another class feels it should have.

Another important consideration, which the definition does not include, is a proper timing of the information furnished. There are many

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[1]Thomas H. Sanders, "The Annual Report: Portrait of a Business," op. cit., p. 5.

things which, in view of the complexity of record-keeping for a large business and the costs of publication, can be told satisfactorily once a year. On the other hand, other information, to have maximum value, would best be disclosed more quickly.

It would seem, therefore, that a definition of full disclosure involves "what," "how," and "when." It was stated in the introduction to this thesis as follows:

> Full disclosure means the mention of every item of material significance, described and classified in such a way that those to whom it is addressed can understand what the significance is, and presented at the time when it is significant.

Someone may, with some justification, wish to criticize the above statement by saying that the definition fails to adequately disclose what full disclosure is. Stated simply as it is, the definition does not indicate the countless problems involved in determining what items are material to the extent of requiring disclosure, in deciding how to present the information so it will have meaning to its readers, or in timing it properly.

Many of the decisions need to be weighed against the costs in money, time, and possible collateral effects on public relations or competitive position involved. Sometimes, because of constantly changing business situations, decisions must be made without a satisfactory precedent to follow. Such decisions require initiative and considered judgment.

Over a period of years a body of knowledge has been developed which can be used as criteria for making such decisions. For example, the preceding section indicates that progress in accounting, which admittedly is

short of perfection, has provided a set of generally accepted standards or principles to be used in the preparation and certification of accounting data. These have been developed within the laboratory of business which is business itself. But they are still being tested, and some may be revised as time goes by.

Another important guide is the law of the land as it is contained in federal and state legislative enactments, in court decisions, and in the rulings, decisions, opinions, and established procedures of independent governmental commissions. In some instances compliance with such authority is compulsory. In other cases, procedures developed within the legal or quasi-legal framework can be and are used by businesses simply because such procedures might provide desirable bases for solving disclosure problems.

A considerable amount of the information furnished by banks, insurance companies, railroads, and other public utilities is done so on the basis of legal requirements. Also, companies subject to the securities legislation as discussed previously in this thesis have a required legal basis for making many of their decisions. However, much of the disclosure pattern, not necessarily <u>all</u> good, developed by the Securities and Exchange Commission in connection with registered companies has extended beyond the companies specifically covered, into the thinking of public accountants, text writers, comptrollers, and business management all over the country. It, thus, is part of the total sum of knowledge available for use in meeting and solving disclosure problems.

In addition, a particular industry may have had to solve problems

peculiar to it, and, no doubt, many individual businesses have had to disclose situations which were different than anyone else had experienced. Such experience is also in the present knowledge available for improving practices now followed and for meeting new situations which might arise.

It would be possible to work out a reasonably complete definition of what is considered to be full disclosure at the present time by using many illustrative examples taken from court decisions, SEC rulings, opinions of the American Institute of Accountants, and so forth. Such a definition could say what correct disclosure has been determined to be in each of perhaps hundreds of different representative situations.

This method was used, for example, by Mr. Brunson MacChesney in discussing some of the earlier developments in disclosure under the Securities Act of 1933. He cited various cases which had come before the SEC, one being that of Haddam Distillers, in which the Commission ruled that for a company to list assets at appraised values without stating that bona fide methods of appraisal had been followed was misleading.[1] Another case was that of Corporate Leaders Security Company in which the decision was that, in raising funds by the sale of securities, the purposes of the funds so obtained should be disclosed fully and in a manner not misleading.[2]

Another example of determining what proper disclosure is as it pertains to a particular limited area can be taken from the considerations in

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[1]Brunson MacChesney, "Further Developments in 'Disclosure,'" Illinois Law Review, XXX (June, 1938), p. 148.

[2]Ibid., p. 154.

1950 by the American Institute of Accountants of the problem of sale and leaseback agreements. Many companies in recent years, desiring to have more funds for working capital, have sold some of their major fixed assets on the condition that they can continue to use the property under a long-term lease. Often there is an option to renew the lease or to buy back the property at the expiration of the first lease. It has not been the usual practice for corporations to disclose the existence of leases, required rent payments, or other obligations which might be involved. However, the Institute's Committee on Accounting Procedure, believing that material amounts of fixed rentals under long-term leases and the existence of repurchase agreements constitute material facts affecting judgments based on financial statements of corporations, announced its opinion that disclosure in financial statements should be made of:

(1) The amounts of annual rentals to be paid under such leases with some indication of the periods for which payable; and
(2) Any other important obligation assumed or guaranty made in this connection.

It discussed further how such disclosure should be made.[1]

These examples, in addition to illustrating a detailed method of explaining disclosure, might also serve to give a further idea of the extent of disclosure.

However, it is believed the short definition, as given has considerable value as a concise statement of what full disclosure is. It actually represents a goal as much as it represents an accomplished fact, the goal being to inform those who have equities in the business of the material items affecting that business, and to do this in an understandable way, and at the proper time.

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[1]Anson Herrick, "A Review of Recent Developments in Accounting Theory and Practice," op. cit., pp. 367-68.

SUMMARY AND CONCLUSION

In tracing the development of the corporate form of organization, this thesis goes back over more than a hundred and fifty years of American history. It begins with the period following the Revolutionary War when corporations--very few in number--were formed to build canals or turnpikes, and when each based its right to do business on a special legislative act. It refers to the contribution by the corporate form of organization in financing the railroad building era before the Civil War; and it discusses briefly the rapid spread of corporations into all areas of business after that. It explains that, since the latter part of the nineteenth century, Big Business has become largely corporate business; and with this development has arisen the problem of corporate disclosure.

The third chapter emphasizes that the need for broad disclosure of business affairs to stockholders did not attain general recognition until well into the present century. And, even when recognized, this need did not immediately stimulate business management to open up its files of information in a public way. A policy of full disclosure was in conflict with the time-established policy of keeping business affairs confidential.

Progress was rather slow. Perhaps it would be better to say that developments in connection with business generally, and in the corporate form particularly, were so rapid that methods and ideas of disclosure did not keep pace. A well-considered criticism of the 1920's was that accounting data, which is of basic importance in disclosure, was still being used by most companies with primary emphasis on management control and secondary

emphasis on credit purposes. The secondary emphasis should have shifted sooner, as far as large corporations were concerned, to that of informing security holders of the condition and operating results of the businesses which they were financing.

Chapter IV outlines the pattern of federal securities legislation which followed the financial crisis of 1929. It discusses in some detail the Securities Act of 1933 and the Securities Exchange Act of 1934; and it refers to certain provisions in the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1934 which have direct association with corporate disclosure.

Particular emphasis is placed on sections 12, 13, 14, and 16 of the 1934 Act; because it was by means of these four sections that Congress hoped to guarantee to a large segment of the nation's security holders certain standards of disclosure in respect to their investments. Briefly, Section 12 requires the corporation to file a registration statement, explaining in detail its financial history, its purposes, its present condition, the holdings of its principal stockholders and executives, and other information which might be useful to investors; Section 13 requires the filing of periodic financial reports to keep the original registration current; Section 14 is designed to establish reasonably high standards of disclosure in connection with the corporate proxy machinery, the purpose being to assure stockholders of reliable information as a basis for deciding how their votes shall be cast in the control of the business; and Section 16 requires that principal stockholders and corporate management make frequent reports of their personal holdings of and transactions in the company's securities.

It is interesting to note that these provisions are contained in whole or in part in each of the other acts listed above. So, at the present time, corporations with securities listed on the national securities exchanges, public utility holding companies, and investment companies are subject to all four of those provisions; companies issuing new securities under the 1933 Act are subject to at least two of the four, namely, initial registration and periodic reporting; while companies qualifying indentures to issue debt securities under the Trust Indenture Act must meet the periodic reporting requirement. At the same time, there are about eleven hundred corporations with assets ranging from $3,000,000 to $850,000,000 each, and with widely-held securities, who are not subject to these disclosure requirements of the federal legislation.

Chapter V sets forth the position of the Securities and Exchange Commission in recommending a uniform extension of these sections, 12, 13, 14, and 16 of the 1934 Act, to nearly all large corporations with widely-held securities who are not already under these requirements. It discusses the Commission's three studies since 1945 of the annual reports made by such companies to their stockholders, and the conclusion in each study that such reports were seriously inadequate from the standpoint of disclosure when judged by Regulation S-X standards. It also discusses the Commission's studies of the proxy materials of large companies not subject to the legislation, and the conclusion reached by the Commission that such proxy materials do not meet adequate standards of disclosure.

Congressional hearings and articles in magazines and newspapers concerning these efforts of the Securities and Exchange Commission to ex-

tend federal regulation of corporate disclosure have not only debated the issue of government regulation of private business; but they have brought to the fore many of the sub-problems which are part of the broad problem of disclosure.

To keep investors informed concerning the businesses in which they have placed their money is a desirable objective. But there are collateral issues which must be considered and weighed against the favorable effects of full disclosure. Chapter VI discusses some of these. For example, an extension of disclosure requirements would have effects, some good and, perhaps, some of an unfavorable nature, upon existing securities markets. Also, as with most other things, the benefits received need to be weighed against the costs involved. The direct dollar costs to the corporation of preparing and disseminating information directly and/or indirectly through a governmental agency may be of a material nature; the less direct cost upon the time of management need to also be considered.

Of great importance to businessmen are the possible effects of public disclosure of detailed corporate information upon local community and employer-employee relationships, and upon the competitive position of one company as against another. The information furnished to security holders spreads beyond such persons and is used in numerous ways, both favorable and unfavorable to the enterprise from which it originated.

The final chapter, number VII, discusses critically the various sources of corporate information to investors, and some of the problems of developing satisfactory methods for telling the company's story in a useful way to people with widely different abilities for understanding and using it. Chapter VII deals with the importance and utility of the corpo-

rate report to stockholders; it attempts to evaluate the information filed with the Securities and Exchange Commission; and it explains, rather briefly, other means by which reliable information gets to the investor. It also has a section on accounting as a factor in the disclosure picture, and a few pages which attempt to emphasize some of the difficulties which arise in trying to understand the meaning and the various implications of "full disclosure."

Included within each chapter are summarizing statements which attempt to point up conclusions to be drawn from material covered within the particular chapter. However, certain concluding statements seem desirable at this point.

For one thing, it is emphasized that the need for broad public disclosure of corporate affairs arose as certain corporations became increasingly large and as the ownership in any one such enterprise spread beyond the stage where management and owners could keep close contact with each other. Further, a recognition of the need for such disclosure lagged behind developments in business itself. But, in the past twenty years alone, very material advances have been made, not only in the increased recognition of this need, but also in the development of methods by which the story of these large business enterprises can be properly told.

At the present time, accounting, the language in which much of the financial affairs of business is told, has reached a stage of development in which it can present reliable information to those who have a reasonable knowledge of business and who recognize that accounting data is of necessity in part a matter of judgment and estimate by those responsible for its

preparation and interpretation. And there is good reason to believe there will be further improvement in the art and use of accounting as time goes by.

The corporate report to stockholders, which is and should be the most important contact between owners and management, is for many progressive companies serving its purpose effectively. However, other companies, for various reasons, are not utilizing it fully. There is at this time a great deal of experimentation and study on the part of individual corporations and various organizations in an effort to improve this very important medium of communication--to make it actually tell the story, truly, and in a way that it will be read and understood by its varied audience.

Information filed with the Securities and Exchange Commission by corporations subject to the federal legislation provides the most complete and reliable source for holders of securities in such "covered" companies. It is technical and detailed, and is directly available to the public in only two or three places. A common complaint is that it is _too_ technical and _too_ detailed, and that it is not readily accessible except to a few people near the public files who are trained to use it. This may be partially justified; but photocopies can be obtained at moderate cost; and the information "seeps down" through financial manuals, investment advisory services, and other means so that the ordinary investor can get it and use it, or those who advise him can get it and use as a basis for their advice.

The most important criticism of disclosure at the present time is that it varies in coverage and in quality from one business to another. There is a patchwork pattern of legislation subjecting some 2,000 large

corporations to varying degrees of disclosure requirements, depending largely on the type of market used for their securities, but, in some cases, on the type of business. There are other companies who keep their security holders well informed, not because of legislative requirements, but because they recognize the desirability of doing so. There are others whose securities are held or traded almost entirely on the basis of "tips" or "trends"; and there are many companies in between. So, despite the general progress up to now, there is still lack of uniformity in the application of adequate disclosure standards.

Indications are that the development of the ideas and methods of corporate disclosure is still in process. There is much room for additional improvement; and, no doubt, there will be improvement and change as time goes by to meet existing and evolving business conditions. This will come about, not through any one source, but through the combined efforts of government, businesses themselves, professional organizations, and the education of the public to a better understanding of business terms and affairs.

The introduction to this thesis stated, in part:

> A great deal has been written and said about the important part played by the corporate form of organization in making life as we know it today possible. It, probably as much as any other thing, has facilitated the development of large-scale production, through its capacity to accumulate huge amounts of capital from a wide variety of sources. It has also provided a means by which people in humble circumstances or otherwise can put their limited or large savings to work. It has made it more possible for each person to own a stake in his country, and to do it under a free enterprise system.
>
> . . . It is felt that, over the long run, the effectiveness of the corporate system has been and will be largely influenced by the degree of confidence between the investors and those who manage and are responsible for their property; and confidence is usually facilitated by an

awareness on the part of the owners of what their business is doing, regardless of whether or not the results at any particular time are good or bad.

It is hoped that the great corporation will remain and progress as a democratic, productive force in keeping this nation free and prosperous. It is believed that high standards of corporate disclosure will help to make this possible.

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