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"THE INVESTOR LOOKS AT ACCOUNTING"

Address

of

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I have called this talk "The Investor Looks at Accounting". But it would be more practical, at least, to say "The Investor Does Not Look at Accounting". The average investor, and even most securities professionals who give investment advice are not interested in the technique of accounting. They are not interested in its technical disputes. The investor, either directly or through his advisers, looks not at accounting as such, but - when he looks at all - looks at accounts. And the stockholders' report is one of the direct ways of getting the accounts to the investors.

Sometimes the stockholders' report contains little more than the financial statements. Sometimes it is more elaborate. American business is beginning to realize that the stockholder welcomes a discussion of the progress and problems of management. I am whole-heartedly in favor of full reports. The wisecrackers may remark about the "gorgeous technicolor" of some of these "travelogues". But while some reports do seem unnecessarily elaborate that is error in the right direction. Managements' efforts to make the stockholders' report interesting and readable are to be commended. And I particularly congratulate the university and business groups that have combined to stimulate management to improve these reports. In making the stockholders' report more readable and interesting we are recognizing one of the essential obligations to the stockholder - the obligation to account for the stewardship of his money.

Through stockholders' reports millions of Americans are finding out about the businesses they have helped to finance; they are being helped to a more enlightened participation in the enterprises of which they are, ultimately, the owners. The stockholders' report is bridging the gap between management and investor. The interest and knowledge that results from good reports will be extremely important in keeping open the channels between savings and enterprise.

But it does not matter how elaborate a report is; it does not matter whether the report makes good or bad bedtime reading. The investor is likely to do what many detective story readers do - turn to the income statement to see how it all came out.

It is impossible, therefore, to talk meaningfully about the stockholders' report without talking about the role that the accountant plays in preparing the financial statements. And it is impossible to appraise some of the vital issues which the accounting profession faces without considering the investor and the investor's approach to a financial statement.

Certified by a public accountant, precise down to pennies, financial statements carry with them an atmosphere of definiteness and certainty. The ordinary investor does not realize how much judgment lies behind the making of a typical statement. He does not realize how great can be the effect of applying different principles to the same set of facts. He does not know how fundamental are some of the disputes over principle which rage in the accounting profession.

In his quick glance a stockholder may not notice whether a non-recurring item has been run direct through the surplus account rather than income. He is not likely to observe whether depreciation is taken on a replacement or historical cost basis. I doubt if 999 out of 1,000 stockholders who read reports can tell you whether their companies carry inventory on a last-in-first-out basis, or other basis. Even if the stockholder did notice these items he would not be likely to grasp their meaning. In short, the stockholder reads the financial statement as a book of revelation. Technical disputes about accounting are to him like the disputes of scholastics over theological mysteries.

It is easy to say what an investor should get out of accounting - he should get a simple statement of the truth about his company. In fact the accounting profession can share with corporate management and with the S.E.C. (whose statutory aim is to get truthful statements) great credit for the strides industry has made in this direction. We tend to take good reporting by many of our large enterprises as a matter of course. But not too long ago there were some managements who tended to regard the accounts as an internal secret to be kept from stockholders. Even as late as the 1920's accounting was sometimes called an art of "impublicity".

We have come a long way since then. To keep up with the growing demand for publicity, to provide the means for presenting, in an objective and understandable way, our increasingly complex business structures, accounting has left simple bookkeeping far behind. It has built up an impressive body of skills and concepts. In fact it has even built up organizations that can handle a project like a big audit which is in itself a big business.

Nevertheless, many accountants will tell you that accounting is far from perfect. They will tell you that, on some issues, "truth" in accounting is an elusive thing, even when the facts are handled honestly and skillfully. Don't expect all accountants to agree on what these issues are. Accountants are likely to have pet peeves against certain existing conventions

and practices while they find no fault with others. And, as you might expect, disputes about accounting principles are prone to change with changes in business conditions. When profits are low some managements may tend to hunt for accounting devices that will improve the showing of profits. When profits are high the tendency may be naturally to the contrary. Profits or losses, in the language of Shakespeare, are the stuff that accounting disputes are made of.

The science of accounting is a science of measurement. Adequate and objective accounting principles, uniformly applied, should give us a consistent story of the development of any one enterprise and a basis of comparing that enterprise with others. A management may wish to preserve, despite changing business levels, a normal income level in its financial reports. But a science of accounting that permits it is not a science at all. It is worth no more than a thermometer that always stands at 75 degrees.

We, at the Securities and Exchange Commission, have a vital interest in the development of objective and uniform accounting. We do not regulate the accounting profession. Our direct concern with accounting principles and practice is limited to financial statements officially filed with us under the statutes we administer. We do not generally pass on stockholders' reports; they are not even filed with us except in connection with proxy solicitations by companies whose securities are listed on an exchange. But companies that propose to make public offerings of securities are required to register those securities with us and to file financial data. Companies which have registered large issues and companies which have securities listed on exchanges are required to file annual reports with us.

The statutes administered by the Commission authorize it to prescribe the form or forms in which required information shall be set forth. The Congress, recognizing that financial information would be the most significant information, made specific provisions with regard to accounting. You will find some of them in Section 19 of the Securities Act of 1933, Section 13 of the Securities Exchange Act of 1934, Sections 14 and 20 of the Public Utility Holding Company Act of 1935, Sections 30, 31 and 32 and 38 of the Investment Company Act of 1940. Let me read to you some of the provisions of Section 19 (a) of the Securities Act - the statute that provides for the registration of public offerings of securities. Under that section the Commission has:

". . . authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this title. Among other things, the Commission shall have authority, for the purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of 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;"

Similar powers are granted under the Securities Exchange Act of 1934 in relation to annual filings of financial information with the S.E.C.

Both the Commission and the accounting profession have worked side by side in the evolution of accounting practices. We, at the S.E.C., do not want to create a tight little island of accounting under these laws remote from the mainland of accounting generally. Nor does the accounting profession want to see that happen. For that reason both we and the profession have put a high premium on constant and intimate contact with each other in the development of accounting practice.

The Commission has, of necessity, always defended objective and uniform accounting practices. The statutes we administer require information to be given to the investor. Financial statements are presented to us by thousands of companies who file official information that must be reviewed. Each of these statements, in some form or other, directly or indirectly, is destined for use by investors. These statements are guide lines and, unless they are objective and uniform, much of their usefulness is destroyed. We must, therefore, constantly be on guard to prevent the confusion that may result from a loss of objectiveness and uniformity.

It is not my intention to dispute or redispute accounting principles. My aim is to illustrate the importance of keeping accounting objective and uniform. I am going to cite some examples. Let me make it clear that I do not cite these to put into issue the principles involved. I cite them because they illustrate the hazards of sacrificing objectivity and uniformity.

One of my examples involves a large textile company that has many stockholders and whose stock is actively traded on one of our large exchanges. Recently the company made public an interim earnings report which indicated that a net profit of over \$500,000 arising from the sale of certain non-manufacturing properties had been credited direct to earned surplus. In a similar period for the previous year it had credited direct to earned surplus a similar net profit of over \$1,200,000. In neither year did the income account show these profits.

Both the New York Times and the Herald Tribune, on the same day, September 13, carried summaries of the company's report. One newspaper commented on the direct credits to surplus. The other did not. In 1949 the item not shown in the income statement amounted to fifteen cents a share. For 1948 the similar item amounted to over thirty cents a share.

Which newspaper do you read? Depending on the accident of your reading taste, it so happens that if you subscribed to one of these newspapers you would have been able to make a more adequate appraisal of the earnings than if you subscribed to the other. The fault was not, however, that of a financial reporter. He cannot be expected to do a full scale analytical job to find items neatly tucked away in the balance sheet that he would expect to find reflected in the income statement.

The company's official filings with us for the year 1949 showed that an aggregate of almost \$3,000,000 of such profits had by-passed the income statement and been charged direct to surplus. Of course our staff has taken exception to the treatment of these items.

Those of you who are familiar with this type of problem recognize that the filing I am discussing raised the issue of the so-called "all-inclusive income statement". Whatever your views may be about that issue I think you will agree that neither an analyst, nor an investor, nor a reporter would have had any difficulty in locating an item of that character if it were carried in the income statement with other revenues and expenses.

There has been some criticism of the practice of the S.E.C. to insist on including all such items in the income statement. One of the reasons frequently given for the criticism is that the inclusion of unusual, non-recurrent items in the profit and loss statement may distort that statement. However, this criticism overlooks the fact that the Commission accepts, and even encourages, a segregation of such items in the profit and loss statement so that their unusual character is made amply clear in an appraisal of the statement of net income.

Let me give you another example. Again I want to make amply clear that I am not citing this example in order to defend one side or another in a dispute over accounting principle. I cite it because it illustrates some of the problems that an agency like the S.E.C. can face in dealing with an attempt to depart from objective and uniform practice.

In my view, one of the most competent and dramatic presentations of the economic problems faced by management in a rising price cycle was made several years ago by United States Steel Corporation. U. S. Steel added an item of over \$26 million as additional "depreciation" for estimated replacement costs. The effect of that change was of course to cut down correspondingly the statement of net income for the year. Steel's argument was simple. It said in effect: "Costs have gone so high that when a machine now in use wears out, it will cost more to replace it than when it was installed. If, by the time the machine wore out we were to lay away only the historical cost, we would not be able to replace the machine. Therefore we must take added depreciation as an expense and show less profits."

The Commission decided that it could not accept Steel's income statement presented in that form. That presentation was not in accordance with the conventional concept that the aim of depreciation accounting is to amortize cost and not to provide for replacement.

But the critic of the conventional concept argues that the conventional concept does not show the real facts about profits. He points out that a statement of net income according to traditional accounting is far from being a statement of economic profit if some of that income must be retained to keep the business tooled up. The defenders of the conventional view recognize that for practical purposes the businessman and the analyst must look beyond the accountant's presentation to find significant economic realities. But that, they say, is no more regrettable than the fact that a good thermometer records temperature but doesn't diagnose sickness.

When we decide issues like those presented by United States Steel we know that practical businessmen and financial analysts cannot read the whole story in the financial statement without looking further into broader economic realities. But consider for a moment the other problems presented to the Commission as an agency having responsibility for corporate disclosure. If depreciation is not to be based on cost, why should assets be carried at cost? Shouldn't the plant account be reviewed with every change in the price level? And if so, whose revaluation will be accepted, and how often? What, if not cost, should be the basis of depreciation: - today's replacement price? or what? Should an index be used? Whose index, taken how often, and how many indices should there be for different types of equipment? Should this be allowed on a permissive basis, or should all companies be required to change their method of accounting? Suppose the new equipment is more productive than the old? And so on almost endlessly.

I repeat that only an objective and uniform system can avoid such problems.

The happy marriage between economic reality and accounting convention may never be achieved. Economic reality is perhaps no more "real" than accounting convention. Economic ideas are often as ambiguous as any others. What is income? There are as many answers as there are reasons for asking the question. But the accountant is expected to produce one single reliable statement of income.

Uniformity and objectivity in accounting are values that can sometimes be realized only at the cost of other ideals. Business life is dynamic - it surges through year-ends and other fixed periods; business values change in ways that are not comprehended in the accountant's idea of "realization"; and sometimes those changes cannot be expressed with certainty or adequacy in terms of a nominal dollar.

It is not surprising therefore that criticism of accounting conventions should be dramatized by rapid changes in business cycles. If you look back at earlier literature you will see that many of our accounting principles represent victories over internal manipulation of accounts. Early experience tended to show that if you let everyone tell the truth in his own way too many people were going to tell you something other than the truth.

But the fear of manipulation is not my reason for defending uniformity and objectivity in accounting. More important is the fact that even honest differences of approach in an accounting presentation will result in statements that may tell the truth in their own way, but will distort each other. Perhaps refined and detailed analysis can make any honest statement comparable with any other honest statement. But it is hopeless to expect the ordinary investor to make such an analysis. He looks at the end results and they are to him "like the mariner's compass in a fog".

The evolution of sound principles of accounting has represented what might be called a "tooling-up" development of the profession. It is only part of the profession's enviable history of achievement. A more fundamental development has taken place in the stature of the profession and in its ideals of service and independence.'

Let me stress that word - independence. The management of a company may hire and fire accounting firms. But the accounting firm's obligation runs far beyond management. It runs to the public. The accountant needs to be independent in order to fulfill that obligation. The Commission, under the law, requires certification by independent accountants. But, in addition, the very existence of the Commission is an aid in maintaining independence. It is a great comfort to a truly independent firm to be able to tell an occasional management that tries to depart from sound accounting that the S.E.C. has the ultimate authority to accept or question an official filing, and that the management cannot change an accounting principle by changing accounting firms.

The Commission has, since its creation, encouraged the profession itself to evolve accounting practice out of the actual, bread and butter problems with which the profession deals. The Commission continues to seek the cooperation of the profession because that cooperation has been so fruitful in the past.

Of course, differences of opinion develop. Our staff and we should be patient and willing to listen to justifications for unconventional ways of doing things. Sometimes we are persuaded. Often a middle ground can be worked out. But whether the arguments persuade us or not, the participants generally are convinced that we don't exercise our ultimate statutory authority for the mere sake of having the last word. We can't help but carry out our statutory job of umpiring the disputes. When we do umpire them we must bear the needs of the investor in mind. And those needs include objectivity and uniformity.

Often an accountant will concede to the point of volunteering to present in a footnote the facts according to conventional accounting if we permit him to make an unconventional presentation in the body of the statement. Our policy is to reject that procedure. The policy has been criticized; but the critics tend to forget that the law imposes upon us the responsibility for determining the presentation in financial statements officially filed. They must not forget that investors, dealers and newspaper reporters are not likely to be footnote readers. As my previous example showed, there is no assurance that what gets tucked away in a financial statement will ever see the investor's light of day.

At first blush it might seem that I have wandered from the main subject of this forum - the stockholders' report. In fact I have not wandered at all. As I indicated, in my view the financial statements are the heart of the stockholders' report. No fine words can cover up a surplus deficit. A net loss will show through the most gorgeously colored photographs. In the end the level of usefulness of the stockholders' report cannot rise above or fall below the level of accounting skill, independence and conscientiousness that goes into the preparation of the financial statement.

Many streams make the river of history; many factors have shaped and will shape the history of accounting. If I can play once more on the words of the title of these remarks, let me say that one fact will always be dominant in shaping the course of accounting - and it is the fact that whether directly or through his advisers, whether alone or through the medium of an agency like the S.E.C., the investor cannot help but look to the accountant. That fact is both the setting of the accountant's responsibility and the measure of the accountant's performance. It is what has changed accounting from a routine to a profession and, I think, a profession with great fulfillment and great promise.