FINANCIAL STATEMENTS--HOW RELIABLE?

Address of

Andrew Barr
Chief Accountant

Securities and Exchange Commission
Washington, D. C.

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Editors of accounting and business journals have found a popular subject in what many authors allege are inadequacies in financial reporting. "Financial Statements--How Reliable?" has been suggested as a topic for discussion.[1] I interpret this as an invitation to comment on the problems of consistency and uniformity in application and general acceptance of accounting principles as reflected in corporate financial reporting today. There is no shortage of material for such an undertaking. However, I feel that I can pass over much of the academic discussion of the problem, which ranges from pleas for information not now found in financial statements[2] down to assertions that the balance sheet as prepared today is misleading[3] and that "unless agreement can be reached among certified public accountants regarding reporting rules, the degrading subservience existing under totalitarian regimes seems very real and possible even in the United States."[4]

A comparison of present accounting and financial reporting practices with those that prevailed in 1934 when the SEC was established will show that a great many improvements have been made, including the very significant one of wide acceptance of the publication of an income statement along with the balance sheet. The SEC's requirements as to financial statements have been developed in cooperation with the profession and have been changed from time to time as experience dictated. And today most authorities, and even our critics, agree that the financial

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[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

[2] See The Journal of Accountancy, February 1963, p. 56.

[3] See NAA Bulletin, February 1963, Section 1, p. 27.

[4] The Federal Accountant, December 1962, p. 58.

data presented to the public in the United States is superior to that generally presented in any other country, although some foreign companies have adopted accounting procedures which their managements and auditors believe are more advanced than ours.

Constant efforts for further improvement are being made by the profession as well as by other interested parties, such as the SEC. But it seems to be a never-ending process.

It has often been said that accounting is not an exact science and that precise rules or mathematical formulas cannot be devised as guiding principles and that accounting decisions are largely a matter of judgment. The principles or postulates or conventions, or whatever they may be called, which have been the guideposts of accounting judgment and decisions for so many years may require further reexamination in light of the changing social and economic conditions of our world. Like common law, they develop by an evolutionary process.

In his preface to the revised and enlarged edition of his pioneering treatise for non-professional readers,[5] William Morse Cole of Harvard College observed that the community at large had "come to realize that no business can be efficiently conducted without adequate accounting, and that no one can form a correct judgment about public economic affairs without both publicity for those affairs and a knowledge, on the part of the public, of the method of interpreting accounts." "Accounting," he said, "is nothing but sublimated common sense applied to finding and telling the truth about business." Innumerable teachers of accounting must have said the same thing in the last fifty years, but of course there will always be considerable difference of opinion as to whose "common sense" should prevail and what is truth in accounting.

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[5] Accounts--Their Construction and Interpretation, Houghton Mifflin Company, Boston, 1915.

A. C. Littleton, who has spent a lifetime in seeking the truth and guiding others in the process, said twenty-five years ago that "Rules are authoritarian in nature; they seem to dictate conformity with indicated procedure. But business conditions are so varied, and managerial judgment plays such an important role in business success that enough rules could not be constructed to anticipate all situations; and it is obviously impossible to reduce the accounting of an enterprise to a few rules."[6]

What are the problems that face us today? The most basic one, of course, is the lack of agreement as to the basic principles of accounting. Closely related problems arise from the great difference in results which may be obtained by the application of accepted accounting principles to seemingly similar factual situations. These latter problems represent the crux of the differences of opinion between those who favor uniformity in accounting and reporting practices as against those who favor a more flexible approach.

Those who advocate more uniformity cite factors which they believe contribute to the unreliability and non-conformability of financial statements and render them less meaningful to the average reader. One factor is found in variations in accounting data presented by companies which appear to be similar in nature, such as the deferring by one company of research and development costs and the immediate writing-off by another; capitalization of intangible drilling costs versus expensing as incurred and variation in treatment of related tax effects; the use of straight-line depreciation by one company and an accelerated plan by another; or a FIFO inventory plan versus a LIFO plan, etc. Another factor is found in variations in accounting data between years for the same company, such as the expensing of research and development costs

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[6] The Journal of Accountancy, August 1938; reprinted in Essays on Accounting, University of Illinois Press, Urbana, 1961, p. 380.

one year and the deferring of them in the next year, or the change from one depreciation plan to another in a subsequent year.

Those who favor a more flexible approach point out that, while it is true that changes such as these affect the comparability of income as between companies and between years, it also must be considered that the accounting policy reflects management decisions which may change from year to year on operating matters and that the operations of different companies are seldom identical.

Although a brief quotation is inadequate recognition, Littleton and Zimmerman in Accounting Theory: Continuity and Change sum up the situation very neatly in two short paragraphs:[7]

> ". . . because some apportionments may necessarily remain estimates, a judgment factor is introduced in assigning the flow of costs between the present and the future. For example, individual judgment is unavoidably involved in pricing those inventories of goods deferred to the future while determining the cost-of-goods sold amount to be used in the calculation of net income. A more difficult area for the exercise of judgment is found in connection with the assignment of fixed asset invested costs between present and future periods. The acceptability of 'judgment' and 'estimate' in accounting does not extend to willful or wishful expedience on the theory that the nontechnical definitions of these terms could support a less limited interpretation. These beliefs are limitations as well as explanations. The estimates and judgments must have a rational basis under the circumstances, that is, justification stronger than self-seeking, arbitrary choice and stronger than a desire to have accounting figures show what one wishes them to show.
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> "How far can management go in flexing accounts to its will? Can it use any chosen price for inventory items? Avoid treating fixed asset amortization as a charge against revenue? Vary at will the rate at which depreciation is computed? Charge new assets against current revenue? Who is to say 'This far and no farther'? Perhaps rational, justifiable, and interrelated beliefs (theory), when carefully considered and convincingly presented, will finally prove by dependable, useful results to be more persuasive than either unhampered discretion or enforced regulations."

[7] Prentice-Hall, Inc., Englewood Cliffs, N. J., 1962, p. 147.

There seems to be some confusion in current literature as to where the responsibility lies for the financial statements and the principles reflected in them. As between the responsibility of management and that of the independent auditor the SEC stated the case quite clearly in an early decision.[8] The Commission in this decision cited the registrant's brief as making much of the confidence which the management "reasonably" reposed in the auditors but then said, "The fundamental and primary responsibility for the accuracy of the information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting." And in another well-know case the Commission said that an audit for the protection of the public "should not exclude the highest officers of the corporation from its appraisal of the manner in which the business under review is conducted."[9]

This relationship between auditor and client is expressed by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants in paragraph 17 of Statements on Auditing Procedure No. 31, Consistency:

> "Although the independent auditor's advice is frequently sought and followed, management has the responsibility for the selection of the appropriate accounting principles to be employed in its financial statements. The expression of the independent auditor's opinion of changes affecting consistency will vary with the circumstances . . . ."

The circumstances cited are the change to an alternative generally accepted accounting principle; the change from a principle or practice which lacks general acceptance to a generally accepted

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8 In the Matter of Interstate Hosiery Mills, Inc. 4 SEC 721 (1939).

9 Accounting Series Release No. 19, 1940, page 35, as republished in Releases 1 to 77, inclusive, 1956.

accounting principle; and the change to a principle or practice which lacks general acceptance. Appropriate references are made in this bulletin to pertinent rules of the Commission dealing with changes in accounting principles and practices and the opinions to be expressed by the independent accountants.[10]

Our certification rules, in effect, require the opinion of an independent accountant, based upon an adequate audit, as to the fairness of the financial statements taken as a whole, as to the accounting principles and practices reflected therein and as to any change in the application of principles and practices or adjustments of the accounts which materially affect proper comparison. After listening to accountants debate for many years over whether changes of material importance in accounting methods were matters of accounting principle, we revised our rules in 1950 to state as clearly as we could that the specific opinion of the accountant was required with respect to any change in accounting which affects proper comparison. Our rules still require this. Comment on the phrase "generally accepted accounting principles" will come later.

This is as good a place as any for a comment on accounting for the investment credit. As nearly everybody undoubtedly knows from the recent news releases on the subject, the problem of the appropriate accounting for the investment credit under the Revenue Act of 1962 evoked a great deal of discussion and sharp differences of opinion in professional accounting and business circles.

The discussion first arose in 1961 when the investment credit was proposed as a tax reduction incentive for new property additions, but since the legislation was not passed in that year the problem was not resolved at that time. When the plan was included in the Revenue Act

[10] Regulation S-X, Rules 3-07 and 2-02(c).

of 1962 which became law on October 16, 1962, and was made applicable to that year, it became apparent that guidance would soon be needed regarding the accounting to be followed.

On November 1, 1962, the Accounting Principles Board of the American Institute of Certified Public Accountants issued for comment an exposure draft of a proposed statement on the subject and in December issued its Opinion[11] which in essence stated that the investment credit should be reflected in income over the productive life of the acquired facilities rather than in the year of their acquisition. This opinion had been approved by 14 members of the 20-member board. Five of the six dissenting members believed that the pronouncement should also recognize the propriety of the 48-52% method of accounting for the investment credit, and the sixth member, while preferring the method set forth in the opinion, believed that, with adequate disclosure, the 48-52% method should be considered acceptable. A third alternative plan, the 100% flow-through to income, was recognized for use in regulated industries in appropriate circumstances.

In recognition of the substantial diversity of opinion that exists in this matter the Commission issued an Accounting Series release[12] in January which stated that it will accept with certain limitations the method endorsed by the Accounting Principles Board or the 48-52% method or, in the case of regulated industries, the 100% flow-through method when authorized or required by regulatory authorities. The release also specified that the balance sheet credit should not be made directly to the asset account, that income tax should not be stated in excess of the amount payable for the year, and included other comments regarding adequate disclosure, details of certain other accounts, and acceptance of appropriately qualified certificates in cases

[11] Opinion No. 2, Accounting for the "Investment Credit," December 1962.

[12] No. 96, January 10, 1963.

where an alternative accounting treatment acceptable to the Commission is followed by the registrant.

While the Commission felt it necessary to publish its views on the disclosure contemplated by the securities acts with respect to the investment credit, the release also pointed out that the use of the term "accounting principles and practices" as used in our rules has the same broad approach to the matter as was demonstrated in the exchange of letters between the AIA special committee on cooperation with stock exchanges and the committee on stock list of the New York Stock Exchange during the years 1932-1934, which was contemporaneous with the legislative history of the securities acts. The importance of this exchange of letters to the development of the accounting profession in the United States should not be disregarded. It represented the consensus of the best accounting thought of its time and is the principal authoritative source from which our certification and basic financial reporting requirements were derived. The Commission's own role in the evolution or development of accounting principles and practices was described in the second paragraph of Release 96:

> In Accounting Series Release No. 1, published April 1, 1937, the Commission announced a program for the purpose of contributing to the development of uniform standards and practice in major accounting questions. Accounting Series Release No. 4 recognizes that there may be sincere differences of opinion between the Commission and the registrant as to the proper principles of accounting to be followed in a given situation and indicates that, as a matter of policy, disclosure in the accountant's certificate and footnotes will be accepted in lieu of conformance to the Commission's views only if such disclosure is adequate and the points involved are such that there is substantial authoritative support for the practice followed by the registrant, and then only if the position of the Commission has not been expressed previously in rules, regulations, or other official releases of the Commission, including the published opinions of its Chief Accountant. This policy is intended to support the development of accounting principles and methods of presentation by the profession but to leave the Commission free to obtain the information and disclosure contemplated by the securities laws and conformance with accounting principles which have gained general acceptance.

Much excitement has been created over the differences of opinion on the Board and between our release and what is often referred to as the first opinion of the Accounting Principles Board. But this was in fact the second opinion. The first opinion dealt with "New Depreciation Guidelines and Rules" which did not stir up a ripple of comment despite five assents with qualifications.

Despite the risk of getting into deep water, some comment on the well-known phrase "generally accepted accounting principles" seems to be in order. Eric L. Kohler in his A Dictionary for Accountants[13] defines "generally accepted" as "Given authoritative recognition; said of accounting principles or audit standards, and the pronouncements concerning them, particularly, in recent years, those of the American Institute of Accountants and the American Accounting Association." I might add, regretfully, that any marginal practice that appears in a prospectus or annual report which has not been challenged by our staff, whether from oversight, lack of materiality or what not, is often cited to us as conclusive proof that it is generally accepted practice. This seems to conform to the operation of Gresham's Law.

We have heard an insistent demand during the last few years for a concise statement of accounting principles which could be used to find the proper way to handle all situations. There have been some notable and useful contributions during this search for a consistent statement of principles. Outstanding are the series of compact statements prepared by the American Accounting Association beginning in 1936; Paton and Littleton's elaboration of this first statement in 1940;[14] and Audits of Corporate Accounts in 1934 and Sanders, Hatfield and Moore's A Statement of Accounting Principles in 1938, both published by the American Institute

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[13] Prentice-Hall, Inc., Englewood Cliffs, N. J., 1957, p. 234.

[14] An Introduction to Corporate Accounting Standards, reprinted in 1955 and known around the world.

of Accountants. These are not hoary with age when you remember that the first known printed treatise on accounting was published in 1494 describing the results of an evolution that had been going on for at least three hundred years.[15]

The two research studies on basic postulates and broad accounting principles published by the Director of Research of the AICPA were financed by the AICPA in an effort to answer the clamor for a logical statement of generally accepted accounting principles. The results call for such a wide departure from present accounting practice that the Accounting Principles Board was moved to say that "while these studies are a valuable contribution to accounting thinking, they are too radically different from present generally accepted accounting principles for acceptance at this time." As a member of an advisory committee, I commented that the statement of broad accounting principles reflected what the authors believed should be generally accepted rather than what they are today. The authors must take considerable comfort in noting that some foreign corporations of international scope do apply some of the principles they advocate.[16] While the campaign for change goes on, a summary of conventions and principles observed today would be helpful to many persons who prepare and use financial statements.[17] We seem to reach solutions of our day-to-day problems once we can agree on the facts. As the

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[15] See Accounting Theory: Continuity and Change, p. 1.

[16] See A. Goudeket, An Application of Replacement Value Theory, Journal of Accountancy, July 1960, p. 37.

[17] For a beginning see: W. Barry Coutts, Accounting Research, The Canadian Chartered Accountant, July 1959, p. 52; Paul Grady, The Quest for Accounting Principles, The Journal of Accountancy, May 1962, p. 45.

investment credit debate demonstrates, this is not always easy and where the differences of opinion are great the acceptance of alternative solutions appears necessary.

In recent years we have observed an increasing emphasis on “cash flow” and a concurrent subordination of earnings as developed on the accrual basis of accounting. The term “cash flow” is used by many companies in their annual reports to stockholders but the term does not carry the same connotation in all instances. Its most common meaning (net income plus depreciation) is, strictly speaking, neither cash nor flow. Its use in all cases, however, seems to be to suggest to the stockholder that his interest in the company should be evaluated in terms of “cash flow” rather than in terms of earnings. We have opposed this usage in filings with the SEC. For example, in a recent filing a company arranged its statements of earnings so that the last caption stated “net income before special credit plus depreciation and amortization amounted to:” and the amounts were given. We required that the caption and amounts be omitted and suggested that depreciation and amortization included in costs and expenses be disclosed as supplemental information (required in any case) as is done in many reports to stockholders.

Many variations of the term “cash flow” are used, some of which seem to be outright misnomers or at least tend to create confusion. Examples are “net cash income,” “cash income,” “cash earnings,” “cash throw-off,” “cash profit” and “cash flow income.” Other terms we have seen used to designate amounts which are variations from the reported net income are “basic earnings” which is defined by the inventor as earnings before the deduction of interest, depreciation and income taxes; and “adjusted earnings” which is stated to be net income adjusted by adding back the excess of depreciation over the estimated average for the industry. The equating of these terms to equity or to shares of common stock (as illustrated by the following expressions appearing in recent annual reports to stockholders: “cash flow to equity,” “cash flow per common share" and "price-cash flow ratio") add to the confusion and tends to mislead the investor.

Information regarding the funds or the financial resources of the business in addition to that presented in the balance sheet and statements of income and surplus can be very meaningful and helpful to the investor if presented properly but much of the present "cash flow" data does not seem to be of this order. As one author put it, "'cash flow' is often miscalculated, misunderstood or even misused."[18]

The inclusion of a funds statement which would provide information on all sources of funds and their application with the standard financial statements and its certification by the public accountant as recommended in Accounting Research Study No. 2 of the AICPA would go far in meeting the needs in this area. Any supplemental presentation in the area of "cash flow" could be put into perspective and better interpreted in the light of complete information provided in the funds statement.

Problems relating to the accounting for business combination continue to occupy a considerable amount of time and attention of the accounting staff not only because of the number of cases we review, but also because of the difficulty of evaluating the circumstances of each case against the available criteria for determining the appropriate accounting, and the further need to ensure that adequate disclosure is made in the financial statements and notes.

The principal problems relating to the acquisition of assets by the issuance or exchange of stock, from the beginning of the century when the great era of consolidations began to the present time, have perhaps been in the accounting for assets and surplus.

The two major problems are (1) whether the assets of the constituent companies are to be

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[18] Financial Analysts Journal, September-October 1962, p. 67.

recorded on the books of the continuing company at the carrying values shown by the books of the constituent companies or whether they are to be recorded at the fair value of the stock issued; and (2) whether the earned surplus of the constituent companies may be carried forward as earned surplus of the continuing company.

One line of authorities has held that in mergers, consolidations and reorganizations, the predecessor's costs, appropriately adjusted to a uniform basis, should be used except where there was an outright and complete change in ownership. In the latter case new costs were established.[19] In both situations earned surplus at date of acquisition of acquired companies would be eliminated.[20]

This line of reasoning runs into pressure generated from the fact that when two or more going concerns, each with established earnings and dividend records, are combined into one unit, there is a basic business need for the dividend policies to be continued and a presumption that the earnings and dividends of the combined operations will be at least as much as the combined amounts of the predecessor companies. When there is a change in ownership and new costs are established for the acquired companies, in addition to not having adequate earned surplus

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[19] See Accountants' Handbook, The Ronald Press Company, New York, 2d ed. (1932), p. 648. See also p. 949 where, following a series of illustrations, this paragraph appears: "SIGNIFICANCE OF ILLUSTRATIONS.--If the accounting principles which should underlie reorganizations could be definitely formulated, the income tax rules could be greatly simplified, and questions which the above illustrations raise could be easily answered. Little has been said thus far by the accountant concerning the principles to be followed in the recording of the various types of business organizations and reorganizations. His labors have proceeded on the theory that assets acquired by issues or exchanges of stock should appear on the books and in financial statements as reflected on the records of a predecessor business, or as shown in a bill of sale or formal appraisal, or in an amount equal to the par value of the stock, or at values determined by the board of directors. Where two or more of these values are present, he is inclined to prefer them in ascending order as named; and it is not unusual for him to adopt a number of them at once."

[20] Accounting Research Bulletin No. 43, AIA, 1953, Ch. 1.

available to maintain the dividend policy of the predecessors there is also a reduction of combined earnings as a result of additional depreciation and amortization charges.

There is another line of reasoning known as a pooling of interests concept which supports carrying forward the accounting basis of all of the constituent companies including all earned surplus, subject to adjustments necessary to bring the accounts in line with accepted accounting practice and to effect the combination of the companies.[21] The support for this procedure is found not in the nature of the consideration given or received in the transaction but in the attendant circumstances such as the relative size of the companies, the number of officers and directors named by each constituent company, the compatibility of the businesses, what the stockholders of the acquired companies do with the securities they receive in exchange, and the weighing of the cumulative effect of the factors present.

If this consensus is against the "pooling of interests" concept, then the company is forced to record the transaction as a purchase, which is usually at the quoted market value of the stock issued. In a purchase the type of the intangible becomes important. If it is deemed to be of limited life, the amortization of the intangible will reduce net income. If deemed not to be of limited life, it merely increases the balance sheet totals.

It is no secret that a small number of combinations recorded as purchases have been changed to pooling of interests accounting.[22] The change from purchase accounting to pooling of interests accounting troubles us particularly when purchase accounting was appropriate in the circumstances, it was adopted by the directors, and it included the allocation of excess payments

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[21] See Accounting Research Bulletin No. 40, AIA, September 1950; Accounting Research Bulletin No. 43, AIA, 1953, Ch. 7C; Accounting Research Bulletin No. 48, AIA, January 1957.

[22] See <u>The Journal of Accountancy</u>, June 1961, p. 35.

to fixed assets subject to depreciation and depletion or intangibles subject to amortization. When reports have been published in which a purchase transaction has become so firmly imbedded in the accounts, it seems unwise to make a retroactive change to the pooling basis of accounting. Such a change not only goes against the conventions of consistency and conservatism but also brings into question the integrity of the financial reporting.

Other studies have appeared in accounting and business journals which have discussed what appear to be erosions of the criteria for pooling accounting and have raised questions as to whether the decision to consider a combination as a purchase or a pooling of interests is being decided on the basis of which plan permits the most favorable accounting treatment.

Problems and questions such as these emphasize the need for a reexamination and clarification of this whole subject. Since serious studies are now underway, I shall not attempt to discuss a solution of the problem today.

As this brief discussion of pooling of interests indicates, uniform accounting treatment of goodwill has been a difficult problem for many years. Current authoritative pronouncements on the subject prohibit the write-off of goodwill to earned surplus immediately after acquisition or to capital surplus.[23] Present accounting for poolings is considered by some accountants to be an evasion of these rules. Most businessmen, bankers in particular, seem to be allergic to goodwill as a sound balance sheet item. It is clear, however, that there is something seriously inconsistent in paying substantial sums for goodwill and then by the immediate write-off representing that it has no value. The classic comment on the subject was made by Couchman forty years ago -- "To put it briefly, if you can write it down, you need not; if you cannot, you should! It is self

[23] Accounting Research Bulletin No. 43, AIA, 1953, Ch. 5, par. 9; Accounting Series Release 50, SEC, 1945.

evident that only in a profitable business can the element of goodwill be rightfully claimed to exist."[24]

A recent case demonstrates the difficulty of maintaining consistency and comparability on this subject. Within the past year the staff of the Commission in light of the situation in a particular case challenged the propriety of a registrant's continuing to carry goodwill on a balance sheet indefinitely and suggested that a program of amortization be adopted. This suggestion was not acceptable to the company and was not pressed by us in view of the representations made as to the plans of the company and proffered evidence of unlimited life. In less than a year's time, however, following some change in management, the company, supported by the same independent accountants, claimed that the goodwill had no value and should be written off in a proposed quasi-reorganization by which a substantial deficit augmented by the goodwill write-off would be charged to capital surplus created by the restatement of capital. By this time the staff, because of the inconsistency, was now in the position of demanding evidence to support the reversal of position. Situations such as this suggest that a reasonable program of amortization of intangibles during the period of good earnings should be required in most cases despite optimistic beliefs that the goodwill increases in value rather than diminishes. Sprouse and Moonitz, too, have trouble in working intangibles into a consistent theory and say that "these items are notoriously difficult to evaluate . . . ."[25]

The title of this paper raises the question, how reliable are financial statements? It is obvious to anyone who reads the financial news that some financial statements are not reliable--

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[24] Charles B. Couchman, The Balance Sheet, The Journal of Accountancy Incorporated, New York, 1924, p. 138.

[25] A Tentative Set of Broad Accounting Principles for Business Enterprises, An Accounting Research Study, AICPA, 1962, p. 36.

in fact we have many examples of more or less successful efforts to deceive investors by the use of deliberately false financial statements. Although administratively the Commission does try to detect these efforts, if possible before damage is done, and to deal with the perpetrators in an appropriate manner, under the Securities Act the Commission does not assume any responsibility for the accuracy or adequacy of the prospectus and it must carry a warning to this effect. Discovery after the effective date that a registration statement contained untrue statements of material facts or omitted to state material facts required to be stated therein or necessary to make the statements therein not misleading may lead to civil or criminal action against those responsible for the untrue or misleading statements.[26]

But this, I am sure, is not what was intended by the question. Reliability in the sense of being truthful must rest on the integrity of management in preparing the statements and upon the independent accountant in making an objective examination. Reliability in the sense of consistency and comparability of the statements of each company period by period is understood in the absence of explanations to the contrary. It is the disclosure required by our rules and the rules of conduct of the accounting profession which provides much of the material for criticism of the lack of uniformity in reporting by companies in the same industries and by all companies without regard for basic differences between various lines of endeavor.

However, in this matter of inconsistency it is my view that the reliability of financial statements is impugned to a much greater degree by the freedom with which companies will switch from one acceptable basis of accounting to another, with the approval of the old firm of accountants, or a new one, thereby usually relieving the income account of substantial charges or of again reporting in income amounts which have previously been reported. When changes of

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[26] Securities Act of 1933, Secs. 11 and 24.

this character are made by a new management, this is sometimes referred to as "the new broom sweeps clean."

It is sometimes difficult to support an objection to changes to better practices or even acceptable alternative practices, other than as a matter of consistency, but this objection carries more weight against recasting of the accounts. Little progress can be made if we object to changes to better practices, but we must object to changes dictated solely by a desire for immediate temporary benefits of dubious propriety.

As I have indicated before, the Commission has supported the effort to narrow the areas of differences in financial reporting but at the same time has recognized that rule making is not the answer to every question that is raised. There are some aspects of the problem which are of growing concern to the Commission and staff. One is the number of instances which come to our attention in which the management's report to stockholders ignores or misuses information in the certified financial statements included in the report. In other cases the financial statements in the reports to stockholders are different in material respects from those used in registration statements or reports filed with the Commission. Another variation is found in cases in which, after the financial statements are brought into acceptable form for the registration, the first report to stockholders, and sometimes the first filing with the Commission under the Securities Exchange Act of 1934, reflects a return to a method of accounting to which the staff objected during the processing of the registration statement. We don't believe there are different standards under the two Acts. Such inconsistency is not to be commended.

And, finally, what about comparability by industry? Efforts certainly should be made to extend the degree to which this has been accomplished. Despite some belief to the contrary, we endeavor to discourage the continuation of divergent methods of accounting when substantial support is observed for what appears to be a bound solution of a problem. A single right answer is not always immediately discernible. Another quotation from Littleton and Zimmerman[27] is pertinent:

> "An overemphasis on company financial comparability could foster an undesirable degree of uniformity and standardization of accounting. Some pressures for uniformity seem directed more to an outside supervision of operations than to the use of account data to picture the individuality of an enterprise and the precise degree of success of its own management. Most accountants view accounting as a medium that reflects enterprise peculiarities and managerial skills. In many aspects each enterprise is different from others. These differences are significant and might be blurred by excessive standardization. Objective judgment of a particular management through conversion of factual, recorded enterprise transactions to a supposed industrial or national norm would be difficult or impossible."

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[27] Accounting Theory: Continuity and Change, Prentice-Hall, Inc., Englewood Cliffs, N. J., 1962, p. 179.