CAUTION - ADVANCE

FOR RELEASE UPON DELIVERY

ADDRESS

of

WILLIAM W. WERNTZ

Chief Accountant, Securities and Exchange Commission

before the

CONTROLLERS INSTITUTE OF AMERICA

WALDORF-ASTORIA HOTEL
New York, New York

Tuesday, September 27, 1938 – 3:45 P.M.

STANDARDIZATION OF ACCOUNTING PRINCIPLES

It is indeed a pleasure to meet with you who, as individuals and as a group, are charged with vital responsibilities in the development and improvement of accounting and of financial reporting. Much of the progress that has been made is due to your efforts. Much of what remains to be done can only be accomplished through your continued efforts and your cooperation.

The problem of standardizing accounting principles is one to which you and all persons interested in the welfare of accounting and business have given much thought and much discussion. What I have to say will be largely limited to the relation of this idea to the work of the Securities and Exchange Commission. I hesitate to refer to what I have in mind as "standardization of accounting principles" since so much question has been raised as to the precise meaning expressed by the words "accounting principles". What I have in mind as principles are those similarities between the financial statements of different companies that enable us on the one hand to speak of balance sheets and profit and loss statements as generic terms and, on the other hand, to expect that the reader of these statements will obtain the information we seek to convey without in each case first making a comprehensive and detailed study of all of the methods and policies pursued in their preparation. I believe you will agree that as a means of transmitting information, financial statements must fail if every company in recording its history and presenting its results follows methods that are wholly incomparable with the methods employed by other issuers.

As you know, one of the primary purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to bring about the dissemination of significant information about issuers of corporate securities. This purpose is accomplished in part by requiring issuers of new securities and issuers of listed securities to file registration statements and periodic reports with the Commission and the exchanges. One of the most important parts of these filings is the financial information about the enterprise.

To ensure that reasonably comparable principles be followed in statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934 these Acts give the Commission extensive control not only over the form of financial statements but also over the principles to be followed in dealing with many types of financial facts. These Acts grant the Commission the power by rules and regulations "…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 non-recurring 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…".[1]

[1] 48 Stat. 908, 15 U. S. C. 77s. (1931).

It is thus the duty of the Commission to bring about standards of accounting and reporting practice which will result in adequate, informative and intelligible financial information being made available to investors under the requirements of these statutes. When these Acts were being considered by Congress these provisions were thought by some to permit the prescription of uniform accounting systems. Uniformity to this degree has its place. When applied to sufficiently homogenous groups of companies, the uniform system of accounts can be effectively utilized. I need only refer to the uniform classifications prescribed for various types of utility companies and to those adopted by various trade associations. Thus, under the Public Utility Act of 1935 the Commission has provided uniform classifications of accounts for electric and gas utility holding companies and for mutual service companies. However, the legislative discussion at the time the Securities Acts were before Congress indicated that uniform systems were not deemed essential in attaining the objectives of these Acts, applicable as they are to an infinite variety of issuers. Nor do I believe that it is necessary or desirable that fully standardized forms be prescribed for financial statements.

Fortunately, at the time when these Acts became law, accounting had developed to such a point that it was believed feasible to prescribe forms that in large part asked only for disclosure of some of the more significant principles upon which the statements were based and for disclosure of a certain amount of information believed to be of particular importance to investors. The form of presentation, the method of description, the inclusion of information beyond the minimum, and the fundamental responsibility for the quality of the statements were problems left on the shoulders of the issuer and its officers. In addition, it was required that independent accountants make a review and express their opinion of the accounting principles followed and the statements presented. These burdens have not been light. I believe, however, that their imposition has encouraged self-analysis and has resulted in increasingly better statements in recent years.

Prior to the passage of the Acts considerable effort had been made by various groups to stimulate the recognition and adoption of some basic principles of financial reporting. Perhaps the earliest of these was the pamphlet entitled “Approved methods for the preparation of balance sheet statements” prepared in 1917 by the American Institute of Accountants at the request of the Federal Trade Commission and given tentative endorsement by the Federal Reserve Board. In 1929 and 1936 successive revisions of this booklet under different titles incorporated the developments that had taken place in the intervening years. In 1934 your organization and the American Institute of Accountants and the New York Stock Exchange cooperated in an effort “to make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance.”[2] As a result of this work several principles were formulated and a standard form of accountants’ report was developed. In addition, the New York Stock Exchange, through its control over new listings and its influence over companies already listed, secured agreements with individual issuers committing them to a number of other principles of disclosure and reporting. These mile posts of progress have gained such general publicity that I shall not stop to review them in detail. Suffice it to say that they not only were

---

[2] The American Institute of Accountants, Audits of Corporate Accounts, 1934, p. 12.

themselves important contributions to the standardization of accounting principles but also paved the way for subsequent developments.

Shortly after the passage of the Securities Exchange Act of 1934 there was recognition in an editorial in the official publication of the American Accounting Association that “standards must come”[3] and that the Securities and Exchange Commission had already acted as a powerful impetus to their development. Later, the American Accounting Association declared one of its official purposes to be “to develop accounting principles and standards, and to seek their endorsement or adoption by business enterprises, public and private accountants, and governmental bodies.”[4] In appealing for cooperation in the development of such principles the Association well stated the grave responsibilities of accountants in modern society:

> “Accounting, originally designed for the purpose of providing internal control of business affairs by private owners, now finds itself faced with the responsibility of compiling and expressing the results of business operations in a way which will meet the needs of investors, governmental units, and the public at large, as well as those of the immediate management . . .
>
> “. . . It is impossible now to escape the social implications of large-scale business enterprise. Its affairs are matters of public, as well as private, concern. Public accounting must, therefore, assume a full responsibility for the preparation of sound and informative reports on the operations of business, or await the time when the alternative of rigid governmental control of such matters will become an established fact.
>
> “To fulfill such a function, accountants can hardly limit themselves to comment on the statements prepared by business executives for their own purposes. It is essential that they develop and employ means of recording, measuring and interpreting the financial aspects of business transactions in accordance with principles and standards which shall be definite, meaningful, and widely applicable. Such principles and standards can be developed, and should be developed now.”[5]

The principles quoted are even more descriptive of the duties of controllers of publicly owned companies and of private accountants. Only through their cooperation can actual financial reporting be kept in step with advancing ideals.

At the present time there are current at least two attempts to formulate statements of accounting principles. One, sponsored by the American Accounting Association, seeks to

---

[3] Editorial, The Accounting Review, IX, 4(December, 1934), p. 334.

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

[5] Ibid.

establish "certain basic propositions of accounting which embody standards of adequacy and reasonableness in the presentation of corporate financial statements."[6] The other, prepared by Messrs. Sanders, Hatfield and Moore, attempts briefly and in general terms ". . . to set forth the principles and rules of accounting which dictate what should appear in a balance-sheet and income statement and in the accounts from which they are compiled."[7] Other writers have confined themselves to particular principles, or argument about whether a statement of principles is practicable.

It is too soon to evaluate these attempts to formulate principles or to forecast the effect they may ultimately have. While their appearance is timely and encouraging, agreement has not yet been reached. I believe, however, that most of these articles, as well as the two statements mentioned, do agree that there are underlying premises or principles upon which accounting and financial statements are based. Likewise, the form of accountants' certificate now generally used presupposes the existence of such principles since it contains the language:

> "In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 19__, and the results of its operations for the year."[8]

The policy followed by the Commission at the outset of the Acts has not been entirely successful. A review of statements filed with us and the accompanying certificates will clearly indicate that in many areas of accounting there exist nearly diametrically opposed theories. In some cases, practices are followed to which the certifying accountant takes exception. In many cases a statement made almost two years ago by Carman Blough still holds true;

> "Almost daily, principles that for years I had thought were definitely accepted among the members of the profession are violated in a registration statement prepared by some accountant in whom I have high confidence. Indeed, an examination of hundreds of statements filed with our Commission almost leads one to the conclusion that aside from the simple rules of double entry bookkeeping, there are very few principles of accounting upon which the accountants of this country are in agreement."[9]

---

6 The American Accounting Association, A Tentative Statement of Accounting Principles Affecting Corporate Reports, The Accounting Review, XI, 2(June, 1936), p. 188.

7 Sanders, Hatfield and Moore, A Statement of Accounting Principles, 1938, p. xvi.

8 The American Institute of Accountants, Audits of Corporate Accounts, 1934, p. 47.

9 Carman G. Blough, The Need for Accounting Principles, The Accounting Review, XII, 1(March, 1937), p. 31.

In view of the contradictory practices which at the present time have substantial support it is to be hoped that any statement of principles that is finally formulated will not permit of such flexibility in application as to destroy the basic comparability of financial statements resulting from their application to the business transactions of different issuers. The possibility of such flexibility is well illustrated in an essay by Howard C. Greer. Taking the statements for a number of comparable companies over a considerable period of years, Mr. Greer attempted to apply to them a partial list of broad general principles presented by one writer on this problem. The results of this study are summed up in this quotation:

> "The following fact, however, is noteworthy: for this group of companies, over the eight-year period reviewed, the most restrictive application of these principles with relation to profits would have produced an aggregate net profit for all the companies combined of about 125 million dollars, while the most liberal application, if consistently followed, would have produced an aggregate profit of about 275 million dollars. It is noteworthy also that none of the differences result from the difficulties of measurement of values (in which accounting judgment is considered so important); they arise exclusively from differing opinions as to what constitutes a profit."[10]

In view of these astonishingly divergent results, it is clear that to be of service in the improvement of financial reporting, any final statement of principles must avoid the pitfalls inherent in generalities.

As a result of the partial failure of its original policy the Commission has recently found it necessary to take measures to implement directly the provisions of the statute dealing with the form and content of financial statements and with the accounting principles reflected therein. As a first step there was instituted nearly two years ago a series of accounting opinions of the Chief Accountant. It was then announced that these opinions were for the purpose of contributing to the development of uniform standards and practice in major accounting questions. You are doubtless familiar with these opinions. One issued last spring I believe is worth repeating here since it suggests, in a broad way, our present approach to the problem of standardizing accounting. It is number four in the series of public releases announcing these opinions.

> "In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves only if the points involved are such that there is substantial

---

10 Howard C. Greer, What Are Accepted Principles of Accounting?, The Accounting Review, XIII, 1(March, 1938), p. 20.

authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations or other official releases of the Commission, including the published opinions of its Chief Accountant."[11]

This release should result in a careful sifting of accounting principles and the isolation of controversial points. Amendments in which financial statements are changed will henceforth indicate the correction of violations of generally recognized accounting principles. Amendments resulting in disclosure as to the principle followed will indicate the areas in which the principles to be followed are in controversy. There will thus be available a valuable record of the development of accounting principles. To further the dissemination of such information, we plan to initiate a series of public releases, as occasion warrants, dealing with cases in which amendments have been required. These releases will not express an opinion. Like a group of cases heretofore published in The Accounting Review, they will consist of a resume of the facts involved, a description of the manner in which the transaction was reflected in the financial statements originally filed, and a statement of the changes or disclosure made by amendment. The cases commented on in these releases will be selected as representative of the accounting problems upon which the Commission has had occasion to pass. They will not cover matters merely formal in nature. Duplication will be avoided. They will be selected with the purpose of informing those interested of action taken by the Commission on accounting matters. They should also serve as a basis for discussion on accounting rules and standards and thus submit the Commission's views to effective criticism. They, too, should give impetus to the development of standards.

A second step now in process is the integration of the provisions as to the form and content of financial statements required to be filed. At the present time there is a set of instructions included in nearly every basic form. Under the direction of Harold H. Neff, the Forms and Regulations Division has been engaged for more than a year in a comprehensive study of these provisions. Many minor differences and some important ones have been discovered. Many filings have been examined to determine how particular provisions have worked out in practice, whether old instructions should be changed or deleted, and whether new instructions should be added. In this work, all of the various divisions of the Commission have cooperated by offering suggestions and by criticizing proposals. Many of you have been invited to examine a proposed Regulation Z which is to replace all of the many sets of instructions now in effect under the two Acts with a single set applicable to all financial statements. The comments you have made are being carefully analyzed and utilized in the revision of the regulation now under way. This work in itself will standardize the rules applicable to statements being filed. For us, it will also facilitate the process of amendment as developments warrant. For you, it will minimize the difficulties of keeping abreast of the requirements.

While the proposed regulation contains substantially the instructions now in effect, there are a few instances in which definite principles are to be prescribed where formerly no direction was given. You will note also that the mechanical arrangement of the regulation permits, if

---

11 Securities and Exchange Commission, Accounting Series, April 25, 1938, Release No. 4.

necessity compels, the addition of further rules to govern the basis upon which financial statements are to be prepared and the form in which they are to be presented.

Finally, the importance of the Commission's opinions in cases involving delisting or stop orders should not be overlooked. Such cases represent the Commission's final application of the statutory standards of fair dealing to the use of financial statements. Stop order opinions usually involve newly organized, and often wholly speculative companies. Yet the principles therein applied are equally applicable to established companies if similar facts are involved. Delisting opinions on the contrary more often involve established and well known concerns. Since these opinions are now collected in bound form and have been carefully indexed by accounting topics, they serve as a readily available means of determining the position taken by the Commission on a considerable number of accounting problems.

To recapitulate, standardization of accounting principles as applied to our work will continue to advance through the use of forms in which an increasing number of undesirable practices are forbidden, through the publication of stop order, delisting and accounting opinions, and through the proposed factual releases.

Much study is being given to a wide variety of controversial problems. The results of these and future studies will take shape in changes in the forms and in accounting releases. It is hoped that the flow of these releases may be increased, with the ultimate possibility of combination into an integrated manual. We have in the past requested consideration of our proposed opinions by special committees of this organization, of the American Institute of Accountants and of the American Accounting Association. Here again cooperation and advice have been of inestimable value. This procedure, of course, takes time and in some cases has resulted in considerable delay in getting opinions into final form. For the prompt and thoughtful consideration which your committee has given to this work I want particularly to thank you.

I have outlined above some of the efforts that are being made to improve the quality of statements filed with the Commission. There remains the question of the influence that standards thus developed may have upon the progress of standardization in general accounting practice. The danger most frequently pointed out is that standards established by legislative and administrative action must needs be minimum standards; that the higher standards of progressive businesses and accountants will be sacrificed; and that the possibility of improvement is severely limited. One writer has justified legislative standards by remarking:

> "Nearly all legislation is in the nature of a leveling process, and if you view with regret the leveling down of the standards you have created, you must realize that may be only a small price to pay if the act has resulted in a much greater leveling up of the standards of the less satisfactory prospectuses that used to be issued."[12]

I question the application of this reasoning to the present problems of accounting and financial reporting. If in the absence of standards developed by the Commission, companies or

---

12 George O. May, Eating Peas With Your Knife, The Journal of Accountancy, LXIII, 1(January, 1937), p. 19.

accountants would nevertheless feel it essential to give certain information or to comply with certain principles, then the mere fact that minimum standards are prescribed by the Commission should not cause a change in view as to what the demands of fair dealing are and should not cause any relaxation in the standards to which they subscribe. Without pressing this view, however, I think it can be shown that in many fields the present standards of voluntary reporting fall short of the requirements that are prescribed for registration statements and periodic reports. This is borne out, I believe, by a study we have made in the field of financial reporting most closely analogous to the province of these Acts, but not now directly subject to them. I refer to the annual financial reports to stockholders.

The study we have made has indicated a continuous improvement since long before the enactment of these statutes. Since 1930 there has been gradual acceleration in the process. The recent progress can be attributed in part to the requirements prescribed in these statutes or by the Commission. There are many cases in which such requirements have served as an incentive and as justification for more informative statements. However, there still remains much to be done in this field.

Is it unreasonable to assume that issuers having a duty to meet the requirements for annual reports to this Commission would feel it necessary to maintain at least the same standards in preparing annual reports to their stockholders? In the case of other issuers, if ours be minimum standards, should we not likewise expect them to be met or surpassed?

Of course, condensation and omission should not sacrifice standards. The annual report to stockholders may well serve purposes partially different from those of a Form 10-K filing. Such differences in purposes may well justify certain omissions or inclusions. Beyond this, it would seem proper to omit a considerable portion of the detailed information required by the forms or to vary the form of presentation by appropriate recasting and condensing. In some respects the problem is similar to that of selecting the portions of a registration statement to be included in a prospectus under the 1933 Act. But the need for compliance with requirements to furnish specified information is absent. Likewise, in gauging the materiality of information, more flexible and more adaptable criteria may be used. Even after giving full weight to such considerations, the study of annual reports which I have mentioned shows there are often serious gaps in the information furnished. In a very large number of cases the standards of reporting are far short of any acceptable minimum. I think it is worthwhile to mention a few notable examples.

The first requisite of an annual report is a set of financial statements giving a reasonably complete and adequate picture of the company making the annual report and of the enterprise which it represents. Such statements should be furnished in sets consisting of at least a balance sheet, a profit and loss statement and an analysis of changes in the various surplus accounts. Each set should obviously be prepared on a consistent basis. These rudimentary principles are again and again violated. Often only consolidated statements are given although the company for which the annual report is being furnished operates in large part through subsidiaries in which there are important amounts of securities held by the public. Little or nothing can be learned in such cases, as to the income available to the parent’s stockholders. In many cases no statements are given for unconsolidated subsidiaries that are important and essential parts of the enterprise. In one case the principle of consistency was violated in an unusual manner. The balance sheet consolidated only wholly owned subsidiaries. The income statement consolidated all subsidiaries. The inconsistency of these two statements forced the use of a strange type of surplus analysis. To agree with the income statement the surplus analysis included the net profit figure and then, to agree with the balance sheet, the analysis was adjusted to exclude income from less than wholly owned subsidiaries.

Published consolidated statements, moreover, may be criticized for their failure to include information essential to their proper understanding and required by our forms for annual reports. Minority interests are not segregated. The treatment of inter-company profits and sales and purchases is not explained. The existence and treatment of consolidated goodwill is often glossed over. The increase or decrease of the equity in unconsolidated subsidiaries and the dividends received from them is rarely made clear. To me, inconsistencies and omissions such as these detract greatly from the usefulness of the statements.

Most of the balance sheets furnished differ in some respects from those filed with the Commission. Some of them differ substantially. In most instances, the differences or changes are limited to combining similar items, or omitting descriptive and explanatory matter for the purpose of condensing the statements. A few of the balance sheets examined are practically identical in both the report to stockholders and in the report to the Commission. On the other hand, some of the balance sheets in reports to stockholders are condensed to an unwarranted degree. Between these extremes the extent and manner in which statements are condensed or changed varies widely. Without attempting to indicate the extent to which condensation and omission is possible without loss of usefulness, it is clear that some companies have not stopped at merely abbreviating their reports: they go much further; they alter their statements in a way that cannot fail to be misleading. In the Form 10-K filed for one company “Land, buildings, machinery and equipment” are stated at $26,000,000. From this amount a “Reserve for depreciation” of $12,000,000 id deducted, leaving $14,000,000 as the net amount at which tangible fixed assets are stated. To this item “Goodwill” amounting to $22,000,000 is added and total fixed assets after depreciation are stated at $36,000,000. These facts are plainly shown in the statement filed with the Commission. In the report to stockholders by this company, however, the gross amount of tangible fixed assets and goodwill are combined and stated at $48,000,000 under the caption “Land, buildings, machinery, equipment and intangibles.”

From this amount the “Reserve for depreciation” of $12,000,000 is deducted and the net amount of depreciated fixed assets is stated at $36,000,000. The final figures are the same in both reports, but in the report to stockholders it is not disclosed that the term “and intangibles” represents “Goodwill” and that goodwill amounts to $22,000,000, nearly two-thirds of the total amount of fixed assets and intangibles.

A case which did not arise in the course of the study provides a somewhat similar example. A public utility company had filed an application with the Commission for exemption of the sale of certain securities from the provisions of the Public Utility Act. The company, in its balance sheet filed with the Commission, listed its fixed property at $93,000,000. An additional amount of $32,000,000 was shown under the caption “Excess of Estimated Reproduction Cost as Adjusted”. Such an account was not provided for by the classification of accounts prescribed by its state regulatory commission and in its balance sheet filed with that commission the fixed property was shown at $93,000,000, roughly the historical cost. In the corporation's published balance sheet, however, the fixed property was carried at $125,000,000 without a breakdown into its component parts. The Commission's opinion granting exemption was accordingly conditioned upon a proper disclosure to prospective investors. For the purposes of its sales literature, the company therefore agreed to show the fixed property at $93,000,000 with no reference to the $32,000,000 excess.

Another form of condensation that results in clearly false representation consists of grouping unlike reserves into a single total. Items shown in reports to the Commission as reserves for insurance, contingencies, prior years' federal income taxes and miscellaneous purposes are combined and shown in the stockholders report as one item under the caption "Other reserves" or "Reserve for contingencies". In one case items shown in the financial statements filed with the Commission as operating reserves $8,000,000, reserve for employees' bonus $2,000,000 and reserve for contingencies $3,000,000 are combined and stated as one item in the report to stockholders under the caption "Reserve for contingencies". Yet out of $13,000,000 this caption properly describes only $3,000,000. Except in the most unusual circumstances, the stockholder is certainly entitled to segregation and adequate description of such reserves if the amounts are material. This is particularly true if some of the items represent surplus reserves and others represent liabilities. A provision for prior years' federal income taxes ordinarily represents the management's best judgment as to the amount which will have to be paid. Such provisions are in the nature of liabilities rather than reserves and it is particularly misleading to bury such items in "Other reserves" or "Reserve for contingencies". In unusual cases it may be justifiable not to disclose the amount of provision for particular contingent liabilities lest the company's position in the controversy be prejudiced thereby. Such reasoning fails however when disclosure in a public statement is concurrently made.

In another report filed with the Commission, no improper condensation or omission is involved. The form of presenting the information has been rather subtly changed so as to tend toward a more favorable interpretation. To be specific, a company having a paid-in surplus and an operating deficit showed dividends paid as a deduction from current earnings in its 10-K report. The balance of the profit for the year was then deducted from the operating deficit. In the report to stockholders, however, the entire amount of the earnings for the year was deducted from the operating deficit. The balance of the operating deficit was in turn deducted from paid-in surplus and the remaining balance shown as the net amount of surplus before payment of dividends. Dividends paid were shown as a deduction from the net amount of the combined surplus. By this method of presentation, it appeared that the dividends were a charge against the balance of paid-in surplus after subtracting operating deficit rather than, as was reported to the Commission, a charge against the earnings of the current year. Thus, by the merging of the operating deficit, current earnings and paid-in surplus prior to the dividend deduction, the operating deficit was made to appear $5,000,000 less than the amount reported to the Commission.

Occasionally inconsistent condensation from the Form 10-K material is made – with amusing results. One report contained a very thoughtfully worded accountants' certificate which concluded by stating that, subject to the comments contained in the notes, which should be read in connection with the statements, the balance sheet and profit and loss statement correctly reflected the financial condition and the results of the year's operation. Perhaps intentionally, the certificate had been taken without change from a Form 10-K filing that included comprehensive notes to the financial statements. But these notes were omitted in the stockholders report.

There are likewise important differences in the methods of reporting on the operations of the year. The trend of thought among analysts, and I believe in general, is toward amplification. Progress has been rapid. Only a few years ago the average income display started with net profit after depreciation; showed a few financial and non-recurring items, and ended with net profit for the period. This barrenness has been replaced in 10-K reports by at least the salient items in an account of operations – sales, cost of sales, the principal classes of expenses such as depreciation and maintenance, and reasonable itemization of financial and non-recurring income and expense. A few companies request confidential treatment of some of the information, but for the most part, the entire statement is available to the public. The statements of a few outstanding companies point the way to the future by revealing sales by classes of products with quantities shown or giving further important figures such as prime cost and direct labor. Attempts are occasionally made in holding company groups to show the leverage in the income account resulting from securities of subsidiaries being held outside of the group.

Notwithstanding the 10-K requirements, the exceptionally higher standards of some companies and the increased importance being attached to operating statements, the average income statement in the report to stockholders is shown by the study to remain a skeleton. A considerable number of the reports examined showed little but earnings per share. One company did not even include a statement of profit and loss. Twenty per cent of the statements examined disclosed only the net profit before depreciation and provision for income taxes, the depreciation, the taxes and the net profit for the year. In forty per cent more of the cases sales were given but cost of sales, selling, administrative and general expenses and various other operating expenses were combined and stated as one item. In the remaining reports sales, cost of sales, and selling, administrative and general expenses were stated separately but were often condensed by combining various other operating expenses with cost of sales or administrative and general expenses.

This comparison of the financial statements in reports to stockholders with those filed with the Commission would not be complete unless the real improvements which have appeared were acknowledged. Nor has such improvement been confined to the customary financial statements alone. Many of the reports examined reflected the desire to aid stockholders in understanding the financial data. The inclusion of a statement of sources and application of funds, of comparative statements, sometimes for many years, or of a history of the surplus and related reserve accounts has been used to impart continuity and greater meaning to the current statements. In another direction the attempt has been made through presenting supplemental statistics of sales, revenues, inventories and fixed property. In some cases, ratio analyses and illuminating graphical presentation have been used. The accompanying explanatory letter of the president has been enlarged to include more and more information as to management and financial problems. These are steps in the right direction. They help to make available the information and opinions through which the management itself interprets the financial results. This field is yours and is one in which self-criticism will be most useful and productive.

As these examples illustrate, we have not yet solved the problem of conveying information to those who have not been in contact with the daily transactions and facts which make up the business enterprise. The reports to stockholders still show considerable divergence in quality and in the accounting principles followed. The average is well below the level attained in the annual reports under the Exchange Act. The reports filed with the Commission moreover, reveal the application of a wide variety of accounting principles and practices, of more or less general acceptance, but often highly contradictory. The need for the development of uniform standards and practice in major accounting questions is clear.

I do not mean that financial statements can be so drawn as to enable the casual reader to gain a thorough knowledge of the enterprise. I do mean that financial statements and the accounting principles back of them must be such that a reader with moderate training or experience in business and finance can form reasonable conclusions as to the financial condition and operating results.

With this goal in mind, our common effort must largely be devoted to obtaining more uniform standards and practice in major accounting questions and more informative and useful statements. None of us, I believe, will be satisfied to allow financial accounting and reporting to stagnate.

---oOo---