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FINANCIAL STATEMENTS - THE BRIDGE  
BETWEEN DISCLOSURE AND  
INFORMATION

Address by

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to

American Institute of Accountants

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There is a peculiar fitness in my addressing you this afternoon. Accounting is my profession and I earn my living as a member of a government agency more deeply concerned than any other with accounting methods and standards. The laws administered by the Securities and Exchange Commission, with their stress on information, give it express power to define accounting terms and prescribe accounting methods. And most of the regulatory problems we face sooner or later require some reference to accounting facts and accounting methods.

It may be a mere accident that the present Commissioners of the S.E.C. include two accountants as well as lawyers and a banker - but it is a happy accident. No matter how much native talent and good sense you bring to the solution of corporate problems, sooner or later you must depend on the concepts and methods of accounting in organizing and appraising financial facts. As the legal and accounting professions learn to grapple with the problems of corporation finance they discover that each must in some way understand the work and share in the skills of the other. Particularly at the S.E.C., lawyers, analysts, and accountants are each parts of an organized team whose efforts are joined in a single purpose - to assure adequate information to the investor. Whether he is a lawyer, analyst, or accountant, a good man who has been on our operating staff for any length of time would find it hard to tell you whether he spends most of his time legalizing, analyzing, or in accounting.

These housekeeping details about the S.E.C. are related to the main message I want to leave with you this afternoon. One of the foundation stones of our structure of federal securities legislation is the Securities Act of 1933. Under that Act securities offered to the public must be registered unless they are exempt. Generally, the registration statement is divided into two parts: a prospectus which is supposed to set forth in brief the salient facts about the company (including financial statements) and an appendix which contains more detailed information.

The prospectus is the document which must be given to each buyer of the security in the course of the sale. It is, under the policy of the law, the primary vehicle of investor information in newly distributed issues of securities.

I want to stress the word "information". It is not the same as "disclosure". It is the end product of successful disclosure - it is the enlightenment of the investor about the facts he needs in order to make an intelligent investment decision. There has never been much doubt that both the Securities Act and our administration of the Act have resulted in ample disclosure. But we, at the S.E.C., have never been content with our achievements in informing the investor. We have attacked that problem in two ways: We have tried to improve the mechanics of getting timely disclosure to the investor and we have tried to improve prospectuses to make them more readable and understandable.

Our efforts have resulted in rules and policies that permit and in fact require the dissemination of data about public offerings during the waiting period (that is between the time a registration statement is filed and the time it becomes effective). And for years the Commission has been studying and debating methods of statutory amendment to improve the mechanics of prospectus distribution. But we have recognized that it does not make sense to struggle for improvements in prospectus distribution without being concerned with the usefulness of the prospectus when it gets to the investor. For that reason the Commission has repeatedly reviewed

its forms in order to get rid of useless requirements and throughout the years, by a patient process of education, it has tried to get those responsible for preparing prospectuses to make them simple and brief.

The statute does not in so many words require that the prospectus be written in the English language. But it is obvious that the Commission would not let a prospectus be used if it is written in Latin – no matter how complete a disclosure it contained. Undue complexity, the recital of prolix material in legal or technical gobbledygook can often hide essential facts as effectively as if the prospectus were written in Latin. They act like a moat, or deep ditch, between disclosure and information. The Commission has consistently tried to lower the drawbridge over that moat; and for that reason the Commission has always considered simplicity and brevity in prospectuses to be necessary in order to make the policy of the Act a living reality.

The Commission's task in getting prospectuses simplified has not been an easy one. Lawyers who are trained to think in terms of the liability provisions of the Act have always tended to stuff prospectuses with every fact which some court might conceivably regard as important in possible future litigation. The Commission itself has had to accumulate a good deal of experience and confidence before it has been willing to make aggressive efforts at simplification.

Nevertheless we have recently had, I think, remarkable success. That success has, however, been only partial. Those of you who are familiar with the typical prospectus know that it consists of two main sections. The business, the management, the securities, and other non-financial facts are described in textual form. In addition the prospectus contains the conventional form of balance sheet and income statement. Our success has, so far, been largely in cutting down the volume of text, and in having the text material presented in a form which highlights the important facts in a simple and precise way.

But we continue to cling blindly to tradition in the presentation of financial facts. Proper disclosure is rooted in the financial statements. Yet, while the Commission has made great strides in reforming the presentation of all other types of information it has rested content with the classical forms of balance sheet and income statement as the vehicles for disclosure in the prospectus. The strength of this tradition is revealed in the way we at the Commission have tended to refer to an example of a concise and readable prospectus. You may hear our staff describe such a prospectus as “only 10 pages long, exclusive of financials,” implying that simplification must stop at this ancient wall of convention surrounding the classical forms of balance sheet and income statement.

But I think the time has come to ask ourselves how useful, really, is the traditional form of presentation to the lay investor? I wonder how many of you have ever tried to put yourselves in the position of an individual without financial or accounting training, set adrift on the sea of a formal balance sheet and income statement, and attempting to find his way through to some sort of adequate appraisal of the company's financial affairs. I know of one case where an intelligent school teacher, when she saw the balance sheet of a prosperous company became very dubious about the investment because, after observing that the total of assets equaled the total of liabilities, she concluded that the company “Owes every penny it's got.” Unaware that it is only

a convention that capital stock, reserves, and surplus are listed as liabilities, such an investor may well be baffled by the meaning of these accounts until they are explained.

It is extremely easy for a lay investor to mistake a dollar statement of earned surplus for actual cash on hand. He is likely to make the mistake of believing that, should he purchase an investment in the company, he would be buying a share in an earned surplus having a present value equivalent to the amount set forth in the balance sheet. These and other conventional accounting concepts reflected in the accumulation of figures called the balance sheet add up to an unassembled jigsaw puzzle to the non-professional.

The income statement is likely to be more pertinent and informative. But, by itself, it still does not permit an adequate over-all appraisal of the company.

We are so deep in the woods that we are in danger of seeing only the trees. The journals of our profession storm with disputes about accounting theory and the meaning and application of accounting concepts. But neither the profession nor, I must say, the Commission has as yet paid enough attention to the basic problem whether the usual form of presentation of accounting facts is a meaningful presentation to the untrained investor. The analyst who is accustomed to using financial statements accepts the traditional form of balance sheet and income statement as a matter of course. His trained eye directs him to the pertinent parts of the statements containing the essential ingredients of his analysis. Because of his training he can relate the balance sheet, income statement and analysis of surplus in such a way as to enable him to make an appraisal.

But I can well imagine many investors scanning the usual types of financial statements in despair, and giving up the search because of their lack of familiarity with the terminology and the basic conventions of accounting presentation. Yet, since the Securities Act was passed, millions of prospectuses have been printed and distributed to investors on the theory that the usual type of balance sheet and income statement serve the statutory end of informing the ordinary investor.

We, ourselves, as well as the accounting profession, have at times confused disclosure with information. Many of us, trained in accounting and members of the accounting profession, are justifiably proud of the achievements both of the Commission and of the profession in making the modern financial statement a full and complete index of the financial position of an enterprise. But we have tended to forget that only a trained individual can make use of that index. And, while we have made significant progress in simplifying every other part of the modern prospectus we have made relatively little headway in the form of presenting financial data.

Let me make it clear that I am not dealing here with substantive accounting concepts or with disputes in accounting theory. My concern is with methods of presentation, rather than with principles. As I see them, the balance sheet, the income statement and surplus analysis are really an integrated presentation of the status of the enterprise. I am concerned with the fact that in disclosures to ordinary untrained investors convention continues to require the making of separate statements, often containing over-elaborate detail and in a form which is dictated by tradition rather than by its usefulness as an instrument of investor appraisal.

As I said before, a typical registration statement consists of two parts: the prospectus and the appendix. Only the prospectus is intended for actual distribution to investors. It is not intended to be the repository of detail which might be significant to a sophisticated analyst in making slide-rule appraisals of investment value down to fine decimals. That type of material, as well as material useful to the Commission in examining the statement, is contained in the appendix. These appendices are, of course, public information - and while they are not distributed to investors, they are frequently used by investing institutions, and by analysts and services in appraising registered issues.

Progress in simplifying the prospectus does not mean that information of importance to one skilled analyst must be sacrificed. To a great extent, simplifying the prospectus has meant shifting detailed data to the appendix rather than eliminating it altogether. Thus, while I discuss the problem of integrating and condensing the statement of financial condition I want it understood that I am talking about the prospectus and not the registration statement as a whole. The appendix is, in my view, the proper place for the traditional, detailed presentation.

In the course of preparing these remarks I had before me the prospectus of an industrial company containing a fairly typical set of financial statements. The current asset statement alone was broken into ten items. The current liability section contained six items. The income statement of this company was one which would be deemed, by ordinary standards, to be an excellent presentation. Yet in going from sales to net income a total of 25 items were set forth. From the statement of surplus at the beginning of the year to the statement of surplus at year end took an additional ten lines of items.

The inclusion of such a statement in a prospectus destined for the use of investors assumes the fantastic proposition that an investor could and would peruse the statement, item by item, through this catalogue. Not a single item was out of place - every item represented one of the necessary components of a calculation of net income. But to present that specification of items to an ordinary investor is about as sensible as presenting me with a set of engineer's blue-prints to convince me that I can safely use the Pulaski Skyway.

Both the balance sheet and income statement of this company were copiously footnoted. One item alone, that of depreciation, was footnoted with a schedule which gave pages of detail on expenditures and retirements, breakdowns of additions to reserves in various categories by income charges, breakdowns of reserve deductions through retirements, renewals and replacements, breakdowns of total asset and related depreciation reserves into five categories of capital assets, breakdowns of types of capital assets by cost, statements of ratios of annual depreciation accruals to the carrying value of various types of equipment - all of the above breakdowns given for a three-year period. In addition the note explained the difference between charges to plant asset accounts, depreciation accounts and maintenance and repairs - gave details as to the depletion policy with respect to certain natural resources owned by the company and gave a summary history of the depreciation policies for a twenty-year period.

To the trained analyst this note is a revealing statement. To the ordinary investor it is a frightening jumble of words and numbers which he cannot understand; and which has, as its most likely result, that of discouraging any reading whatever of the financial statements.

Other notes to the financial statements of this company were just as exhaustive. Yet the document in which this treatise was set forth is called a "prospectus" and was seriously prepared and promulgated to investors who have had no training in accounting or financial analysis.

So far I have described the detail which overburdens the financial presentation in prospectuses. However, I think we need not only to condense and generalize the statements of financial information, but that we need, also, to reorganize the form of presentation.

Just as we realize that the formal financial statements really aim at an integrated presentation to an expert so should our aim be to provide the investor with a single, integrated, simple story or picture. It should cull from the balance sheet, the income statement and the surplus analysis whatever pertinent facts are essential to an understanding of the financial position and operating results of the company. It should present them in layman's language and in an order which follows the rational order in which an investor would normally ask for information about the company.

I cannot believe that we lack the ingenuity to develop a means of furnishing to untrained investors the essential accounting information necessary to make a reasonable appraisal of the situation of any particular company. I do not think that we must remain wedded to the idea that the information must be presented in highly technical language and in the traditional form of a balance sheet, and an income statement set up in the conventional manner. I suggest we start from scratch and develop a technique for presenting this highly important information to the layman - to the man who cannot be expected to bring a technical background to the reading of financial statements.

I don't pretend that these goals can be achieved by a twist of the wrist. A good deal of hard thinking and reorientation will be necessary. Nor do I think that I am outlining a course which is the easiest to administer. Like the accountants who prepare financial statements, the men at the S.E.C. who review them are trained in the traditions of accounting. It is easy to follow the traditional course. But in order to do satisfactorily a real job of simplifying, condensing and integrating financial presentation in the prospectus both practicing accountants and Commission accountants will have to put aside their traditional approach to the form of presentation. They will have to put themselves in the position of the investor in order to anticipate his questions and answer them in the simplest and most direct way.

Accounting has in recent years made great strides toward uniform terminology and objective methods and principles. Whatever view one may take of the technical language of accounting the fact remains that financial statements presented according to uniformly applied principles mean the same thing when they use the same words. As you can readily appreciate, objectivity and uniformity are among the prime goals which the Commission has tried to achieve in its approach to accounting.

It is obvious, therefore, that in making any necessary revision in its thinking on this matter the Commission cannot lightly sacrifice these values. One of the tasks that lies ahead in simplifying and integrating financial statements is to preserve this uniformity and objectivity. However, the task will be considerably lightened when it is understood that we are not attempting to open the door to experimentation with accounting principles but, rather, trying to find simpler and more homely ways of talking about financial facts determined according to objective and uniformly applied principles and methods.

I venture to predict that the success or failure of a proposal such as the one I am making here will hinge largely on keeping this distinction clearly in mind. Of course, attempts to conceal financial facts, attempts to abandon objective principles in the guise of simplifying accounting statements will be resisted by the Commission. They will be resisted, also, by those elements of the accounting profession that are not willing to sacrifice the progress we have made toward uniformity and objectivity.

However, I believe the path will be considerably eased when the true purpose of this proposal is understood. Perhaps I can best summarize the proposal in three simple points. (1) I believe that we should abandon in the prospectus the formalistic presentation of financial data now in common use. (2) I believe that we should try to substitute for technical terminology in the prospectus simple and homely words to describe financial facts determined according to objective and uniform methods. (3) I think that we should eliminate unnecessary detail which is of limited usefulness to the ordinary investor and which serves only to encumber and obscure the financial story.

Again let me repeat that I am by no means suggesting that accounting presentation in Securities Act prospectuses shall substitute economic analysis for objective facts. Nor do I suggest the slightest departure from accepted accounting principles as we have evolved them and will continue to evolve them. Furthermore, I am not suggesting that the traditional form of balance sheet and income statement be deleted altogether from the registration statement. The appendices may be the appropriate place for them. I am suggesting merely that we take the long delayed step of bringing home to investors the facts so expertly collected by accountants and that we apply the pruning shears to the financial presentation in prospectuses as we have to other parts of the prospectus. I am suggesting that it is false to think of the prospectus as a divided responsibility of lawyers and accountants. We should think of the prospectus as a joint responsibility for accurateness, clarity and simplicity in presenting the facts to the investor. I am asking the accountants to join with us in an attack on that part of the prospectus - the financial presentation - which has so far shown so little improvement. I am asking that we assume fully the responsibility of the accounting profession opened up by the passage of the Securities laws.

The Securities Act has given the accounting profession a new stature. The Act recognizes that the accountant is a big wheel in the whole investment process - it recognizes that accounting is one of the prime instruments of getting disclosure to masses of investors brought under the protection of these laws.

If the Securities Act has given stature to the profession, events have given the profession a great mission and a great opportunity. Our economy has come to depend to a great extent on

the relatively small individual investor for the necessary supply of equity and venture capital. In order to attract that capital industry has got to tell its story. And the vital part of that story is told by the accountant.

Accounting has been useful to management. It has been useful to bankers and the large institutions it has been useful to the taxing authorities. But the Securities Act opened a new field for the profession - to be useful to the mass investor.

The continued cooperation of the S.E.C. and the accounting profession has produced remarkable results. We have, together, achieved a system in which accounting remains a professional endeavor rather than a mechanical means of adhering to a rigidly prescribed code. That system has come about, not only because of the willingness of the S.E.C. to cooperate with the profession but because the profession has so frequently demonstrated its sincere belief in the disclosure principle of the Acts we administer.

I think that a wholesale study of the form of accounting presentation in prospectuses should be a mutual endeavor. I hope that the profession and the Commission can, by successfully solving that problem, again justify the cooperation that has marked our relations in the past.