THE INCOME STATEMENT – PROBLEM CHILD OF ACCOUNTANCY

Address of

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of the

SECURITIES AND EXCHANGE COMMISSION

before the

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of the

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The Income Statement – Problem Child of Accountancy.

Emerson wrote that "By necessity, by proclivity, and by delight, we all quote." I hope you will bear with me in resorting unsparingly to quotation for, in the circumstances, I find it a necessity.

In Accounting Research Bulletin No. 8, issued by the American Institute of Accountants Committee on Accounting Procedure in May 1941, it was stated that "Over the years it is plainly desirable that all costs, expenses, and losses of a business, other than those arising directly from its capital-stock transactions, be charged against income." This same statement, in substance, appeared in Bulletins Nos. 23 and 32.

In Bulletin No. 32, which was issued in December 1947, it was also stated that:

> "In dealing with the problem of selecting the most useful form of income statement, the danger of understatement or overstatement of income must be recognized. An important objective of income presentation should be the avoidance of any policy of income equalization. * * * The Committee is also mindful that the term 'net income' has been used indiscriminately and often without precise, and most certainly without uniform, definition in the financial press, investment services, annual reports, prospectuses, contracts relating to compensation of management, bond indentures, preferred stock dividend provisions, and in many other places."
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> And "In the committee's view, the above facts with respect to the income statement and the income which it displays, make it incumbent upon readers of financial statements to exercise great care at all times in drawing conclusions from them."

This bulletin stated further that:

> "The question of what constitutes the most practically useful concept of income for the year is one on which there is much difference of opinion. On the one hand, net income is defined according to a strict proprietary concept by which it is presumed to be determined by the inclusion of all items affecting the net increase in proprietorship during the period except dividend distributions and capital transactions. The form of presentation which gives effect to this broad concept of net income has sometimes been designated the 'all-inclusive' income statement. On the other hand, a different concept places its principal emphasis upon the relationship of items to the operations, and to the year, excluding from the determination of net income any material extraordinary items which are not so related or which, if included, would impair the significance of net income so that misleading inferences might be drawn therefrom. This latter concept would require the income statement to be designed on what might be called a 'current operating performance' basis, because its chief purpose is to aid those primarily interested in what a company was able to earn under the operating conditions of the period covered by the statement."

Under the Securities Act of 1933 and the Securities Exchange Act of 1934 the responsibility rests squarely upon the Commission to prohibit the dissemination of financial statements in connection with the sale of securities or their registration on an exchange, if, in our opinion, they are erroneous or misleading. It follows that profit and loss or income statements filed with us must be in such form that there can be no doubt as to what the net profits or net income for the period covered by the statement are.

It is our position – and both my predecessor, Mr. William W. Werntz, and I have so stated publicly on several occasions – that the "all-inclusive" income statement more nearly accomplished this purpose than does the "current operating performance" type of statement. In consequence the Commission authorized me to advise the Institute that exception will be taken to financial statements filed with us which appear to be misleading, even though they reflect the application of Bulletin No. 32, and the Institute was so advised in my letter of December 11, 1947, addressed to the Institute's director of research, which appeared in full in the January 1948 Journal of Accountancy immediately following the complete text of Bulletin 32.

It will be noted that our objection to Bulletin 32 was based not alone on its recommendation to exclude certain items from the determination of net income, but also upon the permission extended to commingle items so excluded with appropriations to general contingency and inventory reserves made from net income.

Such appropriations, as you know, have received considerable attention and have been the subject of much discussion not only within the accounting profession but also in corporation reports to stockholders and in the press.

Accounting Research Bulletin No. 28, entitled "Accounting Treatment of General Purpose Contingency Reserves," which was issued by the American Institute of Accountants Committee on Accounting Procedure in July 1947, contains the following statement:

> "The committee is therefore of the opinion that general contingency reserves, such as those created:
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> (a) for general undetermined contingencies, or
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> (b) for a wide variety of indefinite possible future losses, or
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> (c) without any specific purpose reasonably related to the operations for the current period, or
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> (d) in amounts not determined on the basis of any reasonable estimates of costs or losses,
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> are of such nature that charges or credits relating to such reserves should not enter into the determination of net income."

In Accounting Research Bulletin No. 31, which dealt with inventory reserves and which was issued in October 1947, the following position was taken:

> "The committee is therefore of the opinion that inventory reserves, such as those created:
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> (a) for possible future inventory losses on inventories not on hand for contracted for, or
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> (b) without regard to any specific loss reasonably related to the operations of the current period, or
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> (c) for the purpose of reducing inventories other than to a basis which is in accordance with generally accepted accounting principles
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> are of such a nature that charges or credits relating to such reserves should not enter into the determination of net income and that they should not be used to relieve the income account of any year."

And in December 1947 the Committee on Accounting Procedure in its Accounting Research Bulletin No. 33, entitled "Depreciation and High Costs," expressed the view that "It would not increase the usefulness of reported corporate income figures if some companies charged depreciation on appraised values while others adhered to cost. The committee believes, therefore, that consideration of radical changes in accepted accounting procedure should not be undertaken, at least until a stable price level would make it practicable for business as a whole to make the change at the same time.

"The committee disapproves immediate write-downs of plant cost by charges against current income in amounts believed to represent excessive or abnormal costs occasioned by current price levels."

It is, or course, no secret that the dollar amounts of reported corporation profits in 1947 were in general higher than ever before. And one need not be an economist or financial expert to realize that the economic future of industry is cloudy to say the least. With some "experts" contending that business in general, and prices in particular, will continue as at present for an indefinite period; others predicting even more business and still higher prices; and still higher prices; and still others taking the position that our economy is due for a nosedive, if not tomorrow then within the very near future, it is small wonder that corporation officials, charged with the making o current profits and the retaining of such part of those profits as is necessary to keep the business moving, have resorted to various and sundry ways to reflect in their financial statements the accomplishment of this purpose.

And certainly an apparent lack of agreement among accountants as to just which elements should and which should not enter into the determination of profits and as to the circumstances under which an appropriation to a reserve should be treated as a charge against profits or a reservation or "earmarking" of surplus cannot be expected to allay management's disinclination to accept as realistic profits determined in accordance with accepted accounting principles which contemplate adherence to cost and the matching of expired actual costs against revenues.

It is interesting to note in this connection the comments contained in an article entitled "Accountants Debate What Should Go Into Net Income: They Decide Everything but - - -," which appeared in the December 22, 1947 issue of Barron's National Business and Financial Weekly. This article stated in part that "Once insistent that a corporation's statement of 'net income' should recognize all items of profit and loss during the period covered, accountants are weakening on that opinion. In a bulletin released December 21, 18 of the 21 members of the Committee on Accounting Procedure of the American Institute of Accountants now show a veering toward the 'current operating performance' type of income statement as opposed to the 'all-inclusive' form. * * * The bulletin seems to try to straddle * * *. Essentially the conflict lies between two views * * *. But whatever conclusions the accountants reach on just what does constitute 'income,' it is up to corporations to try to present all the facts to their stockholders. Investment analysts, bankers and some others will check income accounts carefully to determine for themselves whether each item in it, and those not in it, would alter the actual net income. Barron's will call its readers attention to non-recurring items, explaining their true significance. But for the average stockholder, the 'net income' and 'dollars per share' is the one figure of interest."

It should be observed that the stockholders reports of most industrial companies are not subject to the jurisdiction of the Commission, and therefore, these reports provide a free medium for experimentation in form and content assuming, of course, that divergencies between statements included in such reports and those filed with us are not so great as to raise questions as to the propriety of certification of both sets by independent accountants as fair presentations of the data involved. It follows, of course, that newspapers and other financial publications are, and obviously can only be, free to comment upon financial data in the light of their own conceptions of significant disclosure. Furthermore, unless a corporation having securities listed on a national securities exchange has filed a registration statement recently pursuant to the Securities Act of 1933 in connection with the sale of securities, or has filed financial statements or its report to stockholders in connection with a proxy solicitation, we have no definitive basis for passing upon the merits of that corporation's current accounting practices until its annual report is filed with us. This filing is not due until 120 days after the close of the corporation's fiscal year so that, except in those relatively few instances in which a corporation's fiscal year ended prior to December 31, 1947, and in a very few cases where a corporation whose fiscal year ended on December 31, 1947, filed before the close of the 120 day period, we did not have available for examination the bulk of 1947 corporate annual reports (some 2500 or more) until the first of this month – just a few days ago.

I have emphasized this situation because I think the public generally does not realize that the reports of corporation earnings for 1947 currently appearing, or commented on, in the public press or in statistical services may be different in some important respects from those subsequently filed with us. And some of them cannot but be different if they are to meet our conception of completely informative and non-misleading statements.

I have been much interested in a feature of the Wall Street Journal headed “Digest of Earnings Reports.” This digest, in columnar form, shows the “Net Income” and “Earnings per Com. Share” for the years 1947 and 1946 of from 15 to 40 corporations daily. Similar data are shown for those companies which have made interim reports. At the bottom of the digest are footnotes indentified by various symbols directing attention to unusual or extraordinary circumstances affecting the reported net income. On April 1 the digest covered the reports of 49 companies, 15 of which were the subject of footnotes including the following:

> “Before deducting $10,000,000 provision for inventory price decline reserve”;
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> “After provision of $1,415,000 in 1947 and $1,558,000 in 1946 for possible inventory price declines”;
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> “After provision of $4,500,000 for inventory decline;”
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> “After special reserve appropriation totaling $525,000”;
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> “After reserve appropriations” (no amount shown);
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> “After $6,000,000 provision for contingencies”;
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> “After giving effect to $13,798,474 restoration of reserves”;
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> “Includes reserve credit of $190,705”;
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> “Includes $100,233 transferred from reserves”;
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> “After giving effect to $6,255,341 gain on sale of property”;
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> “Includes $1,896,317 profit on sale of capital assets”;
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> “After $441,000 for anticipated losses under retirement plan”.

On other days the following footnotes appeared:

> “After $350,000 inventory reserve”;
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> “After an appropriation of $1,126,186 for research and advertising”;
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> “Includes credit adjustment of $224,445”;
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> “After giving effect to $564,996 recovery of prior year’s loss on dredging contract”;
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> “Exclusive of $1,050,000 restoration of contingency reserve. Including this reserve.net was equal to $5.17 [instead of $3.78] a share”;

> "Includes $200,000 transfer from reserve for plant reconversion";
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> "After deducting $600,000 provision for possible inventory losses and for replacement of plant facilities, etc.";
>
> "After deducting $300,000 for plant and equipment replacements";
>
> "Before appropriation of $1,800,000 for replacement of facilities at current cost. After deducting this reserve the common share earnings were equal to $5.35 [instead of $6.06]";
>
> "Profit before provision for depletion and income taxes" (no amounts shown);
>
> "After provision of $278,093 for employees' profit-sharing and retirement";
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> "Includes $110,319 profit on sale of treasury stock."

It seems apparent that in this Digest of Earnings the Wall Street Journal, like Barron's, is attempting to "call its readers' attention to non-recurring items, explaining their true significance" so that, as stated in the Barron's article, "investment analysts, bankers and some others [may] check income accounts carefully to determine for themselves whether each item in it, and those not in it, would alter the actual net income." [Underscoring supplied.]

Surely this is a constructive purpose and a necessary function of financial publications if the information conveyed to its readers through financial statements is incomplete or incomprehensible.

The extent to which this purpose is accomplished seems considerably limited, however, for it will be noted that no two footnotes are worded exactly alike. For example one refers to "inventory price decline," another to "possible inventory price declines" and still another simply to "inventory reserve." How is one to know from these explanations whether the inventory loss reserved against has actually taken place in the current accounting period, or definitely is to be expected in a subsequent accounting period or is merely an indefinite contingency? Also several of the notes refer to appropriations or provisions without stating any amount and others combine two types of items in one amount.

Furthermore, no mention is made in those notes of items which may have been carried direct to surplus. And is the reader to understand that the absence of footnotes with respect to a particular company indicates that no unusual circumstances exist?

But why should it be necessary for readers of income statements to satisfy themselves as to whether they reflect "the actual net income"? It is management's responsibility to prepare such statements so that there can be no doubt as to the net income and it is the function of independent accountants to determine whether management has done so. If the statements are prepared in accordance with generally accepted accounting principles there should be no question on this point.

But what are the generally accepted accounting principles underlying the preparation of income or profit and loss statements?

In Accounting Research Bulletin No. 9,* issued by the American Institute of Accountants' Committee on Accounting Procedure in May 1941, the "income account" or "statement" is defined as:

> "An account or statement which shows the principal elements, positive and negative, in the derivation of income or loss, the claims against income, and the resulting net income or loss of the accounting unit."

This definition, which coincides with Rule 5-03 of this Commission's Regulation S-X, promulgated about a year before the issuance of Bulletin 9, seems to describe pretty clearly the composition of the income statement. And I should expect that the final item on such a statement would be <u>the</u> net income for the period covered by the statement.

However, the Accounting Procedure Committee's Bulletins 28, 31, 32 and 33 contravene Bulletin 9 and our Rule 5-03 in that they permit the showing on the income statement of items having no part in the determination of net income.

It seems to me that under these circumstances the principles underlying the preparation of income statements are at best contradictory and, insofar as the determination of "the actual net income" is concerned, are non-existent.

Notwithstanding this unsatisfactory situation, some of the published income statements to which I have referred were prepared in a manner which complied with the foregoing definition contained in Bulletin 9 and the provisions of Rule 5-03 of Regulation S-X and others failed to comply therewith, yet the independent accountants' certificates applicable to a large majority of both types of these statements contained the usual statement in the opinion paragraph that "In our opinion the * * * statements of profit and loss and surplus present fairly * * * the results of operations for the year in conformity with generally accepted accounting principles ***."

And in some of those few instances where exception was taken to certain principles applied in the income statement it was difficult to determine what the certifying accountant considered the applicable generally accepted accounting principles to be.

For example the following paragraphs appeared in the certificate pertaining to the financial statements for 1947 of a large industrial company:

> "During the year, a reserve for property replacement and/or excessive cost of new facilities was provided by a charge to operations of $2,000,000. While provision for such

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* This bulletin was identified as a "Special" bulletin and is entitled "Report of Committee on Terminology."

reserves by charges to income has not yet been recognized as technically conforming to accepted accounting principles, we, nevertheless, believe the charge to be justified in view of the Company's relatively large plant investment and the economic conditions existing during the year 1947.

"In our opinion, subject to the comments in the preceding paragraph, the * * * statements of income and surplus present fairly * * * the consolidated results of operations of the Company * * * for the year, in conformity with generally accepted accounting principles * * *.

In a certificate which was applicable to the accounts for 1947 of another large industrial company <u>the</u> <u>same</u> <u>accounting</u> <u>firm</u> stated that:

"The Corporation included in its costs and expenses, and as a deduction in determining net income for the year 1947, a special provision for depreciation of $3,500,000 based on greatly increased construction and property replacement costs, this being in addition to the amount computed on the basis of cost in accordance with generally accepted accounting principles on which the provisions for depreciation have heretofore been made." * * *

"In our opinion, subject to the exception noted in the preceding paragraph, the * * * statements of profit and loss and surplus present fairly * * * the consolidated results of their operations for the year in conformity with generally accepted accounting principles * * *."

It is indeed unfortunate that a great number of the income statements currently being made public are so equivocal as to require explanation or clarification beyond that contained in the statements themselves. Does this situation not indicate the necessity for the establishment of more definite and more substantive accounting principles governing the determination of net income and the preparation of income statements; principles which truly may be said to be <u>the</u> generally accepted accounting principles and from which departure may be concurred in by the certifying accountant only at the risk of impairment of professional standing?

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It should be understood that the views I have expressed are not necessarily those of the Commission, except, of course, to the extent that reference has been made to published opinions, rules and regulations.