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"THE RELATION OF ACCOUNTING STATEMENTS AND REPORTS TO SECURITY ISSUES"

ADDRESS

Of

WILLIAM W. WERNTZ

Chief Accountant, *Securities and Exchange Commission*

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THE RELATION OF ACCOUNTING STATEMENTS AND
REPORTS TO SECURITY ISSUES

The ingredients of a matured investment judgment are not always susceptible of exact determination. Indeed, the operative facts which cause an investor to sell or buy or hold are often extraneous to the business itself. Judgment or perhaps merely a guess as to the future of particular industries may often be far more of a motivating factor in reaching an investment decision than the conclusions drawn from an analysis of the record already made by that industry or by a particular company in that industry. Similarly, in choosing between two companies in the same industry the selective factor may often be not the comparative statistical performance, but rather a judgment or a guess as to such possibilities as a shift in industrial centers or the birth and death rate of effective competition. However important these intangibles may be, sound investment judgment cannot be reached from them alone. They must be grounded against a solid table of historical information, if satisfactory results are to be obtained. It is largely this factual foundation which is sought in the registration statement and prospectus required by the Securities Act.

Roughly speaking, the registration statement or prospectus when filed consists of financial statements and of narrative information about certain major topics which the statutes and the Commission have selected as most frequently significant. The information so given is documented by copies of the company's instruments of organization and important contracts. It would be a vain struggle to attempt to allocate importance between these types of information, for the significance and informative value of each is increased by the others.

Before proceeding further, I should like to call attention to the change that has taken place in the emphasis attached by investors to varying types of statements. As recently as fifteen years ago a very eminent accountant assigned to the balance sheet, a statement of financial position, the most important place among the many kinds of financial statements that confronted the man in business. Almost continuously since then there has been an increase in the significance attached by experienced investors to statements which reflect the rate and direction and nature of change. Without detracting from the informative value of the balance sheet there has come a realization that knowledge of the road and scenery between year ends is essential. This new emphasis is not limited to the income sheet but includes I think analyses of surplus and reserves on the one hand and of major asset groups on the other. There is evident also a heartening tendency in many fields to explore the utility, as a means of providing information to prospective investors, of such seldom seen statements as the analysis of cash receipts and disbursements or the application of funds statement, or a historical summary of profits and their disposition. Various statistical and analytical presentations have also appeared. These need neither discussion or praise to evidence the points I have in mind, that new forms and adaptations are possible and that accountants are searching for them.

This trend, I think, emphasizes the importance of the particular problems that I wish to discuss this afternoon.

Inevitably, in a discussion of financial statements for investors there arise the twin problems of accuracy and intelligibility. The first of these, accuracy, has in itself two meanings. Opinion and judgment play so large a part in the recording of transactions and the preparation of financial statements that absolute accuracy, in a mathematical sense, is impossible.

In order to report on the condition of a business at a given point of time, the past must be separated from the future, assets must be distinguished from expenses. Since in reality the past and the future are incapable of clear separation, the attempt to distinguish between expenditures which still promise benefits and those which do not is a matter of difficulty. The decisions that must be made involve a good deal of judgment, its cumulated effect being reflected in the surplus and reserve accounts.

Even more subject to error is the attempt to single out a small segment of the flow of business and reflect in statements the results of that period's operations apart from the whole. In such an effort the relative degree of the error is magnified by the brevity of the period. These difficulties lead some to the conclusion that the uncertainties of the balance sheet and income statement amounts are such as to render them meaningless. Although judgment and opinion do play a large part in the construction of financial statements, nevertheless I believe that, within limits, accuracy compatible with their purpose can be obtained. The development of recognized ways of thinking about financial and business events and of sound accounting principles to be followed reduces progressively not only the margin of error in recording transactions and reflecting conditions but also the possibility, which is just as dangerous, of misinterpretation by those who read the financial statements but who have not a first-hand knowledge of the business. Without implying any straightjacketing of progress or of thought, it seems to me that by this development the field of alternative and inconsistent methods can be and is being materially reduced. If in those instances where judgment must necessarily play an important role in the application of accepted principles, there is high fidelity to the interests of fair play, then I think relative if not absolute accuracy is obtainable. Nor does the narrowing of the field of uncertainty imply an inflexibility in thought that would prevent adaptation of statements to meet the needs of a particular business. This principal of flexibility is already embodied in our forms under the Securities Act and Exchange Act in the language "The registrant may file financial statements and schedules in such form, order and using such generally accepted terminology as will best indicate their significance and character in the light of the instructions."

However well adapted to their purposes, accounting principles can be no more accurate than the facts to which they are applied. Unless the event-recording function of the accounting system produces reliable results and is immune to the introduction of fictitious and misdescribed transactions, summary statements and analyses can produce only illusory results. We have had a number of cases in which this very fault has appeared. In each of them the Commission has firmly taken the position that the reporting company itself is charged with the responsibility of producing an accurate account of itself. Duties so important as these cannot be left for their entire performance to an annual check-up by an outsider. Such a check-up may be considered an essential under present conditions, but it is not a substitute. Without doubt, the first essential to the presentation of satisfactory financial statements is an internal accounting system that produces adequate, reliable and informative records. Only if the modern publicly owned business has such records available can the second step, their interpretation and presentation in appropriately summarized statements of condition and of operations, be successfully completed. If the principles to be followed in those statements are selected and applied with due care and regard for the interests of those who are expected to rely upon them, the financial information necessary for the formation of an intelligent investment judgment will be at hand.

This raises the problem of how to present financial information to investors in an intelligible and useful fashion. The conscientious draftsman faces a dilemma. Too much detail will often conceal rather than reveal the significant information or lack of it. The fault of too little is patent. Moreover, prospective investors, even if institutional investors and experts be excluded, differ in the significance they attach to particular information. In the same way, businesses, individually, are not always so homogeneous as the usual groupings such as utilities, manufacturers and investment trusts imply. Administratively, as you know, we have selected the procedure of prescribing reasonably detailed breakdown, disclosure of the more important accounting policies, and limited collateral information. The niceties of color and emphasis, the tailoring to prevent misleading inferences or omissions--these are left to the draftsman. We have prescribed, so to speak, the ingredients but not their precise mixture.

The attitude of some issuers toward this problem is varied, occasionally it is amusing. Some feel that the quickest way is to include a complete, and apparently unedited, record of everything, and the statements become so clogged with minutiae as to be ineffective. Others cast their statements in a matrix of technical and legal verbiage that transforms the obvious into a riddle. Others object strenuously to further particularization of our requirements but continue to adhere rigidly to the letter of the requirements, construe them narrowly, and interpret the absence of a specific requirement as a prohibition. Each of these approaches seems to me to deny the ability or the willingness to approach the problem of full and fair disclosure with the same methods and the same spirit employed in meeting other business problems.

But these are generalities. They characterize the atmosphere in which work is done rather than suggest or criticize solutions of particular problems. Even the large majority who conscientiously attempt to present comprehensive and dependable statements find the goal of intelligibility not easily obtained.

I use the term “intelligibility” to avoid the word “simplicity”, for the latter is often so misapplied as to be synonomous with “inadequacy”. The old ten-caption balance sheet and one-figure income statement may have been simple, but they were also, I think, obviously inadequate. The scope and variety of business that is commonly conducted by a single large company defies reduction to a handful of figures spread over a page or two. When to this are added the complexities springing from an interrelated family of companies, often themselves having outside creditors and stockholders, the impossibility of intelligible presentation in a page or two is obvious.

I am reminded of a conversation I recently had with the president of a very large enterprise. In discussing the complexities of the particular inter-company structure he was frank to admit that he could no longer recall why most of the companies had been created or what they now contributed to the organization.

Within a given company the strange manner in which securities are sometimes created, with ambiguous, conflicting and overlapping rights, makes simplicity and brevity illusive. The spectacle, for example, of several issues of preferred stocks with perhaps an income bond or two is not unknown. Nor is the existence of a stock (I will not call it preferred) which has been sold for $40 and is entitled to $2 prior dividends per year, but which has a par value of $10 and a redemption value of $45. In contrast to these cases there are, of course, many businesses which in structure and operation are such that adequate financial information can be presented in short space.

But whether the business facts demand brief or extensive treatment, much can be done toward making the financial presentation both simple and intelligible. With your permission I should like to enumerate a number of the more promising areas.

As I mentioned above, much can be done in the way of making uniform the principles followed in the preparation of the statements. Accounting statements are intended to convey information. In this sense accounting is a language. Therefore, sufficient similarities must be obtained between the financial statements of comparable companies to enable the reader to make comparisons without first having in hand a separate dictionary and grammar book for each of the companies. Like a language, the utility of accounting increases as its principles and definitions become standardized.

Next, there is the use of language as clear and unambiguous as the art of the draftsman can make it. Most of you can probably recall footnotes and explanations that were paragons of ambiguity and confusion. I would like, however, to quote one to you: in explaining the basis of inventory valuation it was stated: "The fixed prices are those below which the corporation has not bought light native cowhides, upper leather and crude rubber since 1920, with the exception of the period from November 1931 to April 1933." Abstruse and obscure language is not, of course, employed only by accountants or in financial statements. You may recall an opinion by Harold Neff of the Commission's staff as to the description needed in a prospectus of the provisions of a trust indenture permitting the issuance of further securities. The actual description ran to several thousand words including definitions. It was couched in legal language with a generous sprinkling of accounting phrases and concepts. Mr. Neff's proposed solution was compressed to less than two hundred and fifty words without loss of the essence of the provisions.

Next, there is the question of repetition of identical or substantially similar material. In many cases where several sets of financial statements are filed much of the required explanatory information is pertinent to captions in several balance sheets, schedules or other statements. The easy way is to repeat. A more workmanlike method is the judicious use of cross references. Perhaps the most satisfactory method in many cases would be to draft an integrated statement covering these matters as a sort of additional financial statement to accompany the usual balance sheet, profit and loss statement and related schedules. Precise references would then serve as a link to the financial statements with no loss of utility, with much saving of space, and, I think, with the result of obtaining an integrated, readable document. This same treatment could be extended to care for situations in which no single, clear-cut accounting principle had been recognized. In such cases, the necessary explanation of the substantive factors motivating the choice made between alternative principles could be set forth once for all, and references thereto included wherever appropriate.

Finally, there is the possibility of developing new forms of statements with the special interests of investors in mind.

These are but a few of the methods which you will recognize as aids in making your statements intelligible, or, if you will, simple in the true meaning of the word. Brevity, an equally desirable objective, must be thought of as a relative term, dependent for meaning on the underlying conditions and on the purposes to which the final product is to be put. Moreover, those who are familiar with the business can best apply these guides so as to achieve our mutual objective -- the presentation of comprehensive and dependable statements that are intelligible to the investor.

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