1979

Perception of public confidence in financial reporting: A half century down the drain?

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THE PERCEPTION OF PUBLIC CONFIDENCE IN FINANCIAL REPORTING: A HALF CENTURY DOWN THE DRAIN?

By
Paul Garner, University of Alabama

The query in the title of this little piece is occasioned by a coincidence which occurred to me some weeks ago, when three items appeared in prominent business and financial publications, namely The Wall Street Journal, Business Week magazine, and the Financial Analysts Journal.

The Wall Street Journal for June 1, 1979, page 14, has the headline “Public is Losing Confidence in Accuracy of Corporate Reports, SEC Chief Warns”. In the article, Chairman Harold Williams of the Securities and Exchange Commission warned that public confidence in the accuracy of corporate financial reports is deteriorating rapidly. He further charged that “there is an enormous and growing perception and credibility gap between financial reporting and economic reality”, and he urged that accountants reduce the gap.

A few days later, in the June 4, 1979 issue of Business Week (pages 114-115) in connection with a review of an analysis made by Professor Lee Seidler, in his regularly issued publication prepared for Bear, Stearns, and Company, called “Accounting Issues”, Professor Seidler suggested that a prominent company, the SCM Corporation, used “creative accounting” in its annual report for 1978, as compared with the 1977 fiscal year. The Business Week writer said that “despite all the talk of self-policing on the part of the accounting establishment, accounting techniques can still be applied with a great deal of artistry and selectivity. It all depends on whether a company wants to teach or titillate investors.” Professor Seidler, in his detailed tabular presentation, suggested that the reported earnings per share for fiscal year 1977 of $3.70, versus fiscal year 1978, of $3.75, could possibly have been “adjusted” to $4.46 for 1977 fiscal year, versus $2 for fiscal 1978, per share. After a couple of weeks or so, the Letters to the Editor Department of Business Week for July 2, contained a letter from the Vice President for Finance of the SCM Corporation, taking issue with Professor Seidler and the reporter of Business Week magazine, with “your readers deserve more informed reporting. Had you studied our annual report, and not merely another’s account of it, I am sure that you would agree it fully discloses all material facts about our fiscal year reports.”

The third item (Contemporary) selected is found in the Financial Analysts Journal (March-April 1979) beginning on page 72, under the title of “The FASB—Eliminator of Managed Earnings?” by Professors Dean Graber and Bill Jarnagin. The article starts with “Over the years, accountants have been criticized for their ability to massage the numbers. Critics contend that managed earnings are a product of accountants’ leeway to choose among a multitude of accounting alternatives when preparing financial statements.” They quote Professor John C. Burton, former chief accountant of the Securities and Exchange Commission, “The way you keep the score determines at least in part the way you play the game.”

The coincidence referred to in the first paragraph above arises because of the fact that about the time I was reading the above three items in publications with millions of readers, I was presented with a slender volume published nearly a half a century ago (1930) by Alexander Hamilton Institute entitled “Investment and Speculation”. The author was Mr. M. S. Rukeyser, who was commented on in the Preface by the publisher’s editor-in-chief, the well-known Joseph French Johnson. Mr. Rukeyser was a prominent reporter and special writer of finance business for a number of widely read publications of that era, including the New York Tribune, The Financial Department of Vanity Fair, the New York American, and the New York Evening Journal, plus being the author of scores of other works. In addition, Mr. Rukeyser “has studied and advised 30 thousand or more individuals on their financial plans and prob-

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CALL FOR PAPERS ON ACCOUNTING HISTORY

Persons wishing to present papers on the subject of Accounting History at the annual meeting to be held in Boston, Massachusetts, August 10-13, 1980, are requested to submit two copies of each of the following:

1. an outline of their research (maximum 5 pages)
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Western Washington University
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Help

The Editor asks your assistance in providing information on accounting history meetings or other noteworthy items. Please send them along to: Notebook, Box 658, University Plaza, Atlanta, Georgia 30303.

Accounting historians will enjoy William Faulkner's use of the "ledger" (more appropriately, a daybook) in The Bear. Faulkner expands the use of an accounting record to include, biography, conversation, debate, employee evaluation and family lineage.

A. McKelly Lynch
University of North Alabama

GARNER (continued)

lems."

he lectured widely throughout the country, and spoke on the radio networks regularly. These activities are mentioned in order to indicate that he probably was a keen lay observer of the accounting and investment scene in the years immediately before the great depression, and at its beginning when the little book of 350 pages was written. He was not an accountant by profession, having studied literature, journalism, and economics at Columbia University.

In view of the fact that financial and business reporters for general readers can still make the headlines, as indicated in the three examples above, in 1979, it is a bit of curiosity that a prominent writer of a half century ago can also be quoted along substantially the same lines, even though it is natural that the phaseology may be a bit different. Therefore, after going through the 350 pages carefully, and noting all of the comments and con-

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In his work with the 30 thousand individuals, Mr. Rukeyser became a keen observer of the American people in regard to spending versus saving: "A large proportion of American families, whose objective is keeping up with the Joneses, not only spend 100% of their income, but actually exceed their income by indulging in their futile whims. Psychologically, the objection of such careless financial management is that it over emphasizes the place of money in the family economy. The thriftless are perpetually absorbed with money problems; bickerings over bills between husbands and wives; with attempts on the part of bread winners to temporize with collectors; and with the torment that comes from a deep seated consciousness that the home has built for his family is merely 'a house of cards.'"

The author then compares the economic management of the household with that of a bookie at the race track. The latter keeps two columns of figures: "One marked 'take,' which represents the income, and the other 'paid,' which represents outlays. The bookie's solvency depends on taking in more than he pays out." The conclusion is that a business enterprise, or a household, must take in more than it pays out; and this is where the theme of the book comes to the forefront, namely investments.

Finally, on the subject of spending versus saving, the advantage of compound interest should not be overlooked. If a younger person saves a dollar for his old age, instead of spending it upon "immediate gratification of a passing impulse, the wastrel takes up not one dollar, but perhaps six, for the saved dollar has within itself the capacity of repeated duplication."

In the days before social security, and the welfare appropriations, Mr. Rukeyser could write "if it were true that the world owed each of us a living, there would be no need of individual thrift. But, whether the world owes us a living or not, experience shows that no one will cash the claims of the improvident to a living. The prudent man knows that life is subject to external flux, as a famous Greek philosopher remarked long ago."

Also, in the days before the "three martini lunches", the man who is building up his good will by lavishly dispensing "$100 bills to hostesses at night clubs, is really looked down upon by his associates."

After the discussion of spending versus saving, the author begins his treatment of fields of investment, with an extensive (relatively) discussion of widely owned railroad security investments. It is at this point that Mr. Rukeyser starts to comment on accounting related subjects. He seems to conclude that railroad securities have an advantage because they must be "revealed in accordance with standardized accounting practice". They are not "subject to irregularity, tardiness, and lack of standardization, as are the reports of unregulated industrials. Frequently, industrial corporations deliberately hide earnings and assets." At the same time, "railroads must submit monthly reports on earnings and expenses." At the same time, "railroads must submit monthly reports on earnings and expenses." It was of course several years later before industrial companies began the regular practice of reporting on a quarterly (at least) basis.

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GARNER (continued)

At a later place in the same chapter the author has three paragraphs on "accounting methods of industrials". He concluded that "the most conservative industrial concerns write off intangible assets to the sum of $1." As contrasted with the General Electric Company, "whose good will and patents are unquestionably of enormous worth, and which are carried at a dollar on the balance sheet, numerous promotion companies whose good will is zero and whose patents are purely of a conjectural value, frequently set these up on the balance sheet at a high figure." In the opinion of Mr. Rukeyser, "enterprises that pursue satisfactory accounting methods set up large reserves against depreciation and obsolescence."

In another section of the same chapter, the author makes reference to the New York Stock Exchange as an outside influence in getting the companies to publish at least once a year a balance sheet and an income account. This was of course accomplished a few years later. Mr. Rukeyser paid tribute to the late E. H. Gary who had been chairman of the United States Steel Corporation. Mr. Gary was described as "a pioneer in the advocacy and practice of more enlightened accounting methods." Moreover, "Mr. Gary made it a practice to give out earnings statements at 3 o'clock on given days, after the Stock Market has closed, and he withheld advance information from directors and other insiders, putting all stock holders on a parity in respect to the time of receiving data concerning the progress of the corporation." But in general, the overall view and appraisal of Mr. Rukeyser was that "industrial corporations are still in the realm of accounting anarchy and are, for the most part, limited only by the conscience of management. Many of the very best industrial corporations go to extremes in accounting conservatism and deliberately hide earnings and assets from stockholders."

In the light of the tens of thousands of pages that have been written on the oil businesses in recent decades, the comments of Mr. Rukeyser on investments in oil companies have some curiosity interest. A half a century ago it could be written that "many a man of small means, with a vast amount of hope, has expected to find in oil stocks the vehicle that would bring him the wealth of John D. Rockefeller. Oil production is still primitive in character, even though it is undergoing important changes of method. In the present state of the art, there is a good deal of uncertainty as to how long such production will continue, and as to whether there is any oil in unproved wells. Moreover, there are numerous economic hazards, such as whether prevailing prices will enable companies to produce oil and sell it at a profit. The large oil companies have for years relied on wild cat methods to find new fields."

In a chapter on "Changing Value of Investments" the author comes to the conclusion that "even the best financial statements are statements of opinion rather than purely objective documents. In the last analysis, they represent the opinion of the directors. Their value is only relative, or comparative."

On the subject of "adequate depreciation allowance" Mr. Rukeyser urges that "a depreciation fund should be set up out of earnings to allow for the wastage. If the depreciation fund is significantly larger than the actual declining value of property, it may be carried on the liability side and really represent accumulation of net profits that the corporation, in the last analysis, owes to its own stockholders. Sometimes the item is found both on the asset side and on the liability side. When it appears exclusively on the liability side, the depreciation fund usually is composed of general assets." Following the chapter on changing value, the subject of "internal factors" is treated at length. Under this topic, an appraisal of what constitutes good management arises. The accounting implication of this is found in the sentence: "The thoughtful student, however, will look behind profit statements to ascertain whether the company has been conservative in making charges against profits and in setting up reserves against invisible foes or future profits." As a prelude to the labor difficulties of the mid 1930s, "good management signifies an ability to maintain cordial relationship with employees."

In light of the crisis situation which began in the fall of 1929, Mr. Rukeyser felt that it was necessary to discuss "methods of successful investors" in a rather long chapter. He quotes the investment philosophy of the chief executive of one of the large insurance companies to the effect that the "practice of undervaluing our securities is now a permanent feature of our investment policy." The executive looked forward "to the time in the not distant future when we will have an undisclosed margin so vast that even the present large figure will appear comparatively small."

In a down-to-the-earth chapter on "Wall Street Merchandising" there is a sub-section ten on "Juggling the Balance
Sheet". Here, we find some of the most significant appraisals of 1930 accounting matters, such as "some corporation officials deceive by padding earnings statements, that is, by carrying assets, such as inventory, at too high a figure on the balance sheet, thus giving an exaggerated notion of the alleged profits. On the other hand, some of the strongest and best companies listed give stockholders the wrong impression by understating assets and earnings. The question may be raised whether it makes much difference to the outside stockholder whether he is deceived by exaggeration or by understatement. Padding balance sheets and income accounts has been generally denounced, but the reverse process of withholding facts regarding the true nature of profits and assets has been condoned as conservative accounting. Where a company habitually hides assets and earnings, it opens itself to the suspicion that it is intentionally giving an advantage to directors, officers, and bankers who alone are privy to the secret."

Mr. Rukeyser condemns inadequacies in 1929 and 1930 corporate accounting: "As long as certain corporate balance sheets and income accounts are travesties on revealing accounts, there will be mystery markets. When a company is telling only half a truth about earnings, outsiders in times of optimism might assume that the authentic facts are four times as favorable as the published ones. Likewise, in bad periods, they might assume that the facts are twice as black as they really are. In times of panic, companies that have hitherto hid assets and earnings have shown an informal tendency in statements by officers to disclose a little more of the true position." He then discusses two named specific company examples and draws the foreboding conclusion that "unless corporations volunteer to improve their practices, the demands for legislation to enforce accounting standards on industrial corporations seems inevitable."

In presenting "the test of adequate financial information," Mr. Rukeyser quotes one of the editors of a then prominent financial magazine to the effect that "it would be a good thing if every director and executive of a successful corporation would put himself in the place of the average stockholder and ask himself the question: would I hold as much of the stock as I do were my information limited to what is contained in the annual or other report?"

The banking community then comes in for a bit of comment with the summary statement that "banks themselves are notorious offenders in the matter of hiding assets and earnings. They habitually write off large amounts as reserves against bad loans, without setting forth clearly what their practice is." But banks are not alone in such a practice: "Industrial corporations sometimes hide the ebb and flow of profit by setting up reserves against contingencies in good years, and by using them up in bad years." However, sophisticated stockholders can get the "true picture" by deducting the depleted "reserves from the reported net profit". Earnings may be hid in other ways described by Mr. Rukeyser and he cites one of the then (and now) major merchandising firms for not distinguishing clearly between operating expenses and capital expenditures.

After mentioning other cautions such as nonuniformity in depreciation charges, Mr. Rukeyser concludes his admonitions to investors and speculators with the point that "these and other subtle subsurface distinctions help explain current anomalies in market prices of shares. Some buyers have confidence in figures put out by one group and lack confidence in those published by others. The fact that many published statements are used to conceal authentic conditions rather than to reveal them helps to explain why Wall Street security buying has become metaphysical rather than scientific."

As a forecaster, Mr. Rukeyser would receive good marks in his predictions that "the ownership of American corporations will become more widely diffused, and therefore there is an increasing moral obligation on the part of corporate executives to publish better financial reports that will tend to put outsiders on a parity with insiders in respect to the changing facts about a company's condition. And, such information should be published promptly."

If one thinks about the present state of financial reporting in the United States, and compares it with the comments and conclusions of the popular writer Mr. Rukeyser of a half century ago, one may conclude that progress is indeed evident during the five decades, but he or she might well remain ambivalent as to the extent of the progress.

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Merry Christmas