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Recommended Citation

Haskins & Sells Selected Papers, 1967, p. 038-048

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# The Meaning and Significance of Financial Statements

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*Presented before the National Association of Accountants, Portland, Oregon, Chapter—September 1967*

EACH DAY brings new evidence to those of us in public accounting that a great lack of understanding exists in many quarters of the meaning and significance of financial statements issued by companies organized for profit.

This should not come as any surprise to us, but it becomes increasingly apparent that we must do all in our power to promote proper appreciation of the function of these statements and of the role of the accounting profession in relation to them.

Much of the misunderstanding we encounter derives from the unfortunate impression of "precision" conveyed to the layman's eye by the very format and appearance of the statements themselves. When items are carried out "down to pennies," the layman thinks this implies absolute precision, and the mere fact that both sides of the balance sheet "come out even" tends to work an almost hypnotic effect on him.

The most serious misconceptions, however, arise from a failure to grasp the purpose of the statements, the process by which they have evolved to their present form, and the limitations from which they necessarily suffer.

## LIMITATIONS OF FINANCIAL STATEMENTS

First of all, I think we should make it clear that financial statements issued by a company are designed to depict its economic progress—or lack of progress.

Its financial statements should portray its progress in as meaningful a way as the interested parties can devise. These interested parties include not only management itself, but stockholders, financial analysts, credit grantors, and (in some cases) regulatory authorities as well.

But no matter how skillful a job is done to make statements meaningful, they will always be subject to misunderstanding and misinterpretation unless their inherent limitations are recognized.

What are some of these limitations?

The first we might cite is that of the time period covered, which for

general financial statements, as presented in annual reports, is usually one year; if a longer period is presented it is usually in units of one year.

Obviously, there has to be some kind of periodic reporting, but the fact remains that reports covering only a year can never present a comprehensive picture of a business entity. George O. May once said: "The reporting of business income for short-term periods would be indefensible if it were not indispensable."

The shorter the period covered in any statement, the less meaningful it will be. In a broad sense, the only true picture of the economic progress of an enterprise would be one that covered its entire life history.

One factor with which business must contend is the rate of speed at which technological obsolescence is moving today and the influence this has on current planning.

In the field of electronics, for example, a company is hard put to determine whether the money it spends today on research and development really represents an asset that will be recovered in the future. Maybe it will; but all it takes is for one competitor to come out ahead of it with a superior product, and those expenditures for research and development can become worthless pretty fast. Only time can tell.

Events are moving so rapidly in this field that one manufacturer I know has said: "If the product works, it's obsolete." Once a product has been developed, its successor is probably well on the way, either in his own shop or in that of one of his rivals.

We could go down the list of industries today and see the same kind of challenge in virtually every one—and particularly in fields like transportation and textiles. What happened to the buggy builders and the horsewhip makers when the auto came along is basically no different from what has happened and is happening to those whose piston planes or jet planes don't meet the demands of the marketplace.

At any given moment, the implications of technological obsolescence are something like the iceberg—only a small portion is visible above the surface. A going concern, however, has to grapple purposefully with the problem, making the expenditures it considers warranted and accounting for them in the light of its best judgment of what the future will bring.

Because of the manifest uncertainties beclouding the future, however, managements should tend to be conservative in their accounting for expenditures of this kind. If they are not sure of a product's acceptance,

they should "expense." This is a prudent course of action, but interestingly enough it may not reveal the "true" picture at any given moment—since the full story can never be known until events have run their course.

Another clear limitation on our financial statements is the fact that they are expressed in units of currency that have fluctuating buying power. Fortunately, we are not experiencing the severe inflationary pressures suffered by so many other countries, but we nonetheless know that today's dollar will not necessarily buy what it did ten years ago.

Dollars set aside today for replacement of a machine ten years from now may simply prove insufficient for purposes of keeping the concern "going" when those dollars are needed, and yet this is the accepted basis of recordation.

One of the most severe limitations upon statements—and one that strikes most sharply at their ability to depict the progress of a firm "accurately"—is their inherent inability to convey any comprehensive evaluation of the quality of management itself, of the "people" conducting its affairs.

A company may have the finest products in the world, undisputed market penetration, and all the other necessary ingredients for progress and continuity, but its future collapse may already be in the cards because of some inherent weakness in its management team, which no outsider can detect and which surely is not presently apparent through scrutiny of its financial statements. Moreover, this weakness may not be known even to the management itself.

Even if present management is highly effective, it may be impossible to evaluate the likelihood of continuing effectiveness over the years ahead. Are competent personnel being groomed to take over from the present team? And even if they appear to be competent, how can we ever know for sure until they actually take charge? What appears today to be a company with brilliant prospects for the future might easily decline with astounding rapidity if its future managers proved unable to carry it along.

## EVALUATION THROUGH THE BALANCE SHEET

Having sketched out some of the over-all limitations affecting financial statements in general, let us take a look at the balance sheet, in particular, to see the pitfalls anyone faces in attempting to derive "precise" information from it.

In the first place, few of those who use financial statements realize the extent to which the balance sheet is an evaluation of the future, rather than a reflection of the present.

The amount recorded for receivables, for example, must represent not simply what a firm knows it ought to be receiving, but what it thinks can actually be collected. A myriad of unpredictable events can alter the probabilities for collection drastically, and sometimes overnight.

By the same token, inventories on hand in various stages are meaningless except in terms of the company's ability to sell them at a profit. The evaluation the company makes today of the potential for its products may be completely invalidated by sudden changes in demand at the marketplace. Yet the figures it records today can only represent its best assessment of the future.

Similarly, the usefulness of a given item of property may change unexpectedly. A perfectly fine piece of machinery may be capable of turning out products for the next twenty years. But if those products are no longer saleable, then the usefulness of the equipment has been impaired so far as its owners are concerned.

Unexpected developments and events that cannot possibly be measured may render reserves for such items as insurance and warranties completely inadequate. When an automobile company issues five-year warranties for the vehicles it sells, how can it possibly anticipate the true extent of the expenditures it may have to make to fulfill its warranties? The most it can do is to estimate; but the effect of inadequate estimates on its figures could be very substantial indeed.

Incidentally, I should point out that the examples cited deal only with depreciation of values affecting the balance sheet, rather than with appreciation of those values. Present practice generally precludes the recognition of appreciation, although there are those who have suggested that property should be revalued every year. So far as I am aware, however, the only periodic recognition being given to appreciation occurs with investment trusts, some of which follow the practice of annually stating at market value the securities they hold in their portfolios.

**Economic Progress or Retrogression**

In assessing the extent to which a company's financial statements depict its economic progress, keeping in mind the limitations we have cited, it becomes essential to make a judgment on certain special aspects

of management's approach to its problems and on its grasp of the challenges it may face.

For example, we must make a judgment on whether or not management has the tendency to be conservative or non-conservative in assessing its future. This is a subtle psychological factor that can have direct bearing on accounting.

One company preparing to launch a new product will characteristically exude confidence over its prospects. It just "knows" it has a hit; it could not bring itself to admit the possibility of failure. So it will almost instinctively capitalize the expenditures it incurred in developing its new item.

But another company, in the same line of business, may be characterized by an extreme conservatism or caution every time it brings out something new. It just never knows for sure; perhaps experience has shown this to be the best policy. And its conservatism will find expression in its accounts; it will expense the costs incurred for the new product, because it just does not know in its own heart whether or not they will ever pay off.

An outsider must also attempt to satisfy himself on another point: Does the management of this company really know the dangers it faces from technological obsolescence? Does it have "peripheral vision"?

As in every other walk of life, a business enterprise can very easily fail to see the forest for the trees. Swept up in the day-to-day routine of production and sales, it may be completely oblivious to threats looming on its horizon. A head-in-the-sands approach has spelled the doom of many a company in the past, and readers of today's financial statements should realize how easily the past can repeat itself.

And we must ask this further question: Does management really know what its competitors are doing? It may think it does, but if its assessments are inaccurate—if it is proceeding on the basis of inadequate knowledge—the seeds of its collapse may already have been planted. But this is something that can never be apparent from its financial statements.

## WHO IS THE AUTHOR?

Having seen some of the many imponderables affecting the usefulness of statements, we are, I think, in a better position to place in proper perspective one of the most vexing of all the questions that arise: Whose

really are the financial statements, after all? Are they those of management or those of the independent CPA who audits them?

Of course, all of us who are professionally concerned with the problem know the answer: They are the statements of management, of the company, issued by those who have the responsibility for the stewardship of its affairs—its officers and directors.

But I think the layman can only be expected to understand the full reasons for this answer if we are careful to explain to him the kinds of imponderables that must be weighed in preparing statements.

When he realizes the extent and complexity of the inherent and manifold uncertainties faced by a company—and the effects these can have on its figures—then I think he will appreciate that only the company itself could possibly author the statements. Who else could have the required in-depth knowledge of its affairs, its problems and its opportunities, to make a meaningful appraisal of the effect these uncertainties may have?

Certainly not the independent CPA. To be sure, he brings to bear on these statements the full force of his technical expertise in accounting and auditing and of his professional objectivity. But he can never begin to know as much about the company as does management itself.

## THE DEBATE OVER ACCOUNTING PRINCIPLES

Once the layman understands the range of problems faced by management as it makes an honest, conscientious effort to present meaningful financial statements, I think he may be in a better position to appreciate the great debate of our day over accounting principles: the issue of "accounting uniformity" or "one-way and one-way only" versus what may loosely be called "controlled flexibility."

He can then ask himself which of the two courses better serves the common goal of all concerned—management, investors, creditors, and all the other interested parties.

In discussing with laymen this question of a "one-way and one-way only" approach versus that of controlled flexibility, possibly some simple illustrations may serve to point up some of the problems.

Suppose you and I happen to buy new automobiles on the very same day. They are identical cars, and we'll each keep them for three years, driving 12,000 miles a year, for a total of 36,000 miles.

Since these basic factors are identical, when it comes to recording depreciation shouldn't we both use straight-line depreciation, with exactly the same useful lives?

Under the "one-way-only" approach to accounting, we presumably would—but let's take a look at some points no reasonable man could afford to overlook, if he knew them.

You take superb care of your car, garage it nightly the whole year through, never slip up on periodic servicing and inspections, and at the end of the three years you will be trading in a practically brand-new machine.

But the care I take of my car is exactly the opposite of yours. I hardly ever bother to use my garage; the car is covered with snow all winter, bakes in the summer's heat, and is neglected at every stage of the way. I always forget periodic servicing and the only time I really pay attention to the poor creature is when it just can't take the abuse any longer.

So you will end up with a highly saleable item, with plenty of performance left in it, and I'll have nothing left but a piece of junk. Would it really make any sense to impose a uniform rule of thumb in a case like this where the facts behind the scenes have such a material effect?

Once the layman grasps this point, he generally has little difficulty applying it to corporate problems. For example, consider the case of two manufacturers purchasing two identical machine tools. One may have a team of experienced, efficient operators and expert maintenance men. The other—perhaps operating under conditions where his biggest problem is to train help—may be lucky if he can keep his machine going at all. So what are the useful lives of those two machines going to be?

As I suggested at the outset of my remarks, misunderstanding of the purpose, meaning, and significance of financial statements is widespread. And I think we must expect confusion to increase rather than diminish, unless those of us who understand accounting—whether in public practice or in private practice—bend our best efforts to explain the kinds of problems I have outlined here today so that laymen can grasp them properly.

I have no fear for our success in clearing away the basic areas of confusion, provided we recognize those areas that any layman—and this includes many corporation presidents—finds difficult to comprehend, and provided we talk in terms he will not consider esoteric and mystifying.

Then I think we can rely on the good judgment of all concerned to decide for themselves whether one-way principles and procedures would really result in more-meaningful financial statements.

**Comparability**

But to make these decisions, I think the layman must be fully aware of the pivotal influence exercised on financial statements by the different philosophies of management prevailing as between one company and another. He will need to recognize how different the figures of a company guided by a conservative approach may be from those a company would issue if its approach were less conservative.

He must appreciate the impact of such factors as differing methods of operations and varying standards of maintenance and repair.

And he must understand how the broad economic problems confronting a company—its marketing alternatives, its development challenges, and its competitive threats—can influence the content of its financial statements.

With this understanding, the layman will be able to see that, even if a "one-way-only" approach were adopted for a given aspect of accounting, the various limitations I have cited would preclude true "comparability" anyway.

As an example of what I mean, let us return to our simple illustration of depreciation on our automobiles. At present, we have a choice of using either straight-line depreciation or some form of accelerated depreciation. But suppose our choice were taken away and one of the two became mandatory for use under all circumstances. Even then, comparability as between our two vehicles would obviously be impossible because of the inherent differences in condition that I described.

Now, at this point I must make it clear that I personally believe we now have too wide a range of generally accepted accounting principles from which to choose. I firmly believe we should bend our best efforts towards narrowing this range. And I hope we can achieve this on the basis of reasoned understanding and voluntary co-operation among all the parties concerned—not through the imposition of uniformity by "fiat," whether governmental or otherwise.

But in narrowing the range of options, it is essential that we retain enough flexibility so that businessmen won't feel they are being placed in a strait jacket. After all, in the other aspects of business operations—

whether it be market development, research, sales, or whatever—management is not tied down to a "one-way-only" approach to handling its affairs. And I see no reason why in this one area—financial reporting—management should find its alternatives sharply limited.

## Flexibility

Why is this need for controlled flexibility so fundamentally important? I think it derives from one immutable factor: the persistence of unpredictable change in the world of business. This very day, events are undoubtedly occurring that will lead in one way or another to transformations in the patterns of financing, production, sales, and distribution which you and I have no way of anticipating. The one fact we can be sure of is that there will be changes which will ultimately affect the course of accounting and reporting. Since we cannot anticipate the changes, how can we foresee their consequences?

Incidentally, this problem of changing conditions was well stated back in 1930—almost 40 years ago—in a speech by J. M. B. Hoxsey of the New York Stock Exchange, from which Andrew Barr of the SEC quoted in a talk just this year. Here is what Mr. Hoxsey said:

> Men change, methods change, social, financial, industrial and commercial practices change. These changes have affected accounting in the past, they should affect it in the present and they will continue to affect it in the future. We can foresee that future only dimly and so our planning for it must be subject to correction as the need for correction occurs....

Despite this need to retain flexibility, however, we clearly must get on with our task of narrowing the differences in accounting principles, and in doing so I think we face one very clear challenge and opportunity—one to which we should address ourselves forthwith.

## Challenge

This challenge is the very practical, down-to-earth one of defining the criteria by which a choice can be made among alternative principles in a given case. Thus, with depreciation, once again, it seems to me that we ought to be able to spell out the conditions and circumstances under which the use of straight-line depreciation would be appropriate. Similarly, we

should be able to establish the criteria that would make some form of accelerated depreciation the proper method to use in a given case.

If we can set up our specifications in this way, across the board for the full range of accounting, then I think the task of narrowing the range of choices will move ahead more swiftly.

Even then, however, there will still remain the problem of helping the reader of a given financial statement to understand what accounting principles were selected in preparing it. In this connection, I think we should be grateful to Dr. Reed Storey of the American Institute for reminding us of an important point of history.

In his thoughtful study, *The Search for Accounting Principles,* he recalls that in 1934 the Institute's committee on co-operation with stock exchanges suggested that each listed company, after selecting the methods of accounting appropriate to its own situation, should prepare a detailed description of them for the benefit of stock exchanges and shareholders.

This suggestion was never implemented, and I think Dr. Storey's comment is very interesting. He says:

> The suggestion was a good one, and since complete uniformity of accounting method among companies is neither achievable nor desirable, a detailed description of the methods followed by a company in preparing its financial statements would always be useful. This step should become a part of any program for improvement of financial accounting and reporting....

I feel we should give serious thought to Dr. Storey's suggestion and examine the idea with a view to finding some way in which it might be adopted by corporate management.

## CONCLUSION

In conclusion, I think we ought never to lose sight of one salient fact as we go about dealing with our problems of accounting and financial reporting: Despite the asserted deficiencies, the United States today produces the finest financial statements to be found anywhere in the world.

In saying this, I certainly do not mean to underestimate the tasks we presently face. But no one can deny that today's 22 million shareholders are receiving far more informative reports than did the six and a half million shareholders of only 15 years ago.

By 1992—so the New York Stock Exchange tells us—we may well

have as many as 50 million shareholders. Let us hope that they will be receiving even more information, but, more important, that they will also have a much more sophisticated understanding of the true meaning and significance of their financial statements.

This enhanced understanding will surely contribute to maintaining investor confidence in corporate management. And, as Robert Trueblood, a past-president of the AICPA, has pointed out, the process of capital accumulation by which "our whole system of 'people's capitalism' " operates "is predicated on confidence in corporate financial reports."