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Present-day Problems Affecting the Presentation and Interpretation of Financial Statements*

By Arthur Andersen

Since the beginning of the twentieth century, a little more than one generation ago, many volumes of extraordinary events have been written into the history of mankind. The world has seen wars, earthquakes, floods, famine, revolutions—and on the other hand has made great progress in the development and use of machinery and power. All these things have been primary events. They have caused many further changes of a secondary nature which eventually may even more powerfully affect the history of the world. Among these are profound changes in international boundaries and relationships; changes in the social policies and government of various nations; extreme disruptions in the economic and financial field; a tremendous growth of new industries; and the modification of industrial operations by reason of the trend toward larger and more widely owned units of production. In all recorded history there has probably never been another period of time so crowded with swiftly moving events of such a vital nature.

It may be said that business, which is the mainspring of human living in the modern community, has felt the impact of all of these factors and has been forced to adapt itself rapidly to new and ever changing conditions. In this country especially the rate of change has been great, for here individual freedom and initiative and individual reward have given an incentive to new developments of every sort. Corporations have increased in size and in complexity of organization, operations and finance. Completely new industries have started from nothing and have grown to tremendous size, such as those engaged in the production of motor vehicles, electrical power, electrical products, radios and airplanes. At the same time all business has been increasingly subject to the elements of greater social control and mounting and burdensome taxation. Another problem has been the development of a completely new technique of finding the capital required for this industrial expansion. A further complication lies in the fact that the period of the world war changed the United States from a debtor to a creditor nation, with a suddenly

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new position in the matters of international trade and financial relationships. More recently new problems have arisen, as the deflation period necessitated changes in methods and even changes in the application of principles which had been considered entirely sound during the period of expansion. The latest problems are those caused by political changes which have definitely applied the principles of a broad social control over all industry.

These changes in the conditions and structure of business have multiplied the problems of accountancy. Where industry is concerned with matters of production, accounting is concerned with determination of all the elements of cost, extending from the broad bases of accounting policies as to depreciation, maintenance and distribution of overhead down to the details of expense classifications, inventory controls and what not. Where industry has the broad problem of sales, accounting has many problems of sales classifications, of branch sales accounting, of territory analyses, of profits by classes of product, of selling costs, etc. Even more vital are the accounting problems in the field of finance, in which the problems of taxation, of bank credit, of long-term borrowing, of preparation of annual statements for publication, etc., call for the development of a specialized technique. As important general problems, accounting must deal with the matters of adequate reports to executive and administrative heads, with questions of budgetary control, with the effectiveness of the system of internal check, with the organization of the accounting department, etc. In other words, accounting penetrates into every phase of business operation, for the two purposes of, first, providing the bases for the establishing of broad principles of operation and, second, the detailed control over and recording of all results of operations.

Thus, while accountancy may be said to be an integral part of business, in another sense it stands beside industry as a counsellor and guide. In the one function it keeps pace with the requirements of industry in matters of current operation, but in the other function it must anticipate and interpret for industry the effects of the many economic and technological changes which have been taking place with bewildering rapidity.

When businesses were small and personally controlled, both these functions of accountancy were underdeveloped and little recognized. But the changes of the past half century have lifted accounting to the status of a profession. Actually it is the youngest and most immature of all professions, and it is handicapped in its status, not only by this lack of tradition, but also by the necessity of being practical as well as technical. The older professions attain a dignity based upon the cumulative technique of hundreds of years and upon the maintenance of a fair degree of mystery. Accountancy has thus far accumulated little technique, for it is still in the process of steady development of fundamental principles. It can not attain any high degree of mystery, for its methods and principles must be practical and understandable and in step with the progress of industry and people. It can not function merely as a code of fixed rules, for it is constantly modified by the principles which are developed as a composite of the best and most enlightened business experience.

Because accountancy is a profession rather than just another kind of business, it must assume responsibilities which go far beyond those imposed by the business function alone, for it has long been recognized that the published financial statements of corporations are clothed with a public interest and that the accountant has a responsibility to the public as well as to his client. This responsibility is based on social premises; it exists regardless of legislation, which serves only to focus attention upon it. In the past decade this factor of the public interest has been of increasing importance, due to the tremendous spread of security holding by the public, the trend away from ownership operation of businesses and, recently, the economic slump and financial ruin which affected so many people.

Great portions of the public feel that they have been insufficiently informed or even misled in reference to past security issues, not alone by those in the management and control of industry and finance, but also by the public accountants, who have not fully met their professional responsibility. This opinion is not entirely justified, and the situation can not be lightly dismissed as due to misunderstanding or animus. That the opinion exists indicates that the profession is faced by very definite problems, the answers to which lie either in the province of education of both client and public or in the correction of certain methods which, by force of circumstances, have existed to date.

Specifically, it appears that the following problems exist:

1. The problem of providing more informative reports for the investing public.

2. The problem of educating the public as to the meaning and fundamental limitations of accounting statements.
3. The problem of simplifying accounting statements.
4. The problem of more rapidly and accurately adjusting accounting policies to changing economic conditions.

These problems are not new. They have been with us for many years. But today they appear in the form of a direct challenge which must be met by definite answers.

A considerable part of the criticism that corporation statements are not sufficiently informative is due to failure on the part of the investing public to understand accounting phraseology. What is clear to the technician may not be clear to the layman. Yet this is true in any profession. No one expects a doctor, a lawyer or an engineer to have a vocabulary entirely free from necessary technical terms or to be capable of explaining extremely complicated principles to the man in the street. An attempt at extreme simplicity of expression may be either impossible or misleading, and the accounting complexity of a modern business is at least as great as the complexity of our social laws, or of electrical and mechanical devices. It may be that the real answer to this problem is not one of "writing down" to the understanding of the general public, but, instead, a necessity on the part of the public to acquire some understanding of the principles which must be applied in safeguarding its wealth and interests.

A second rather general criticism is that many of the values and amounts shown by financial statements lack exactness. This also is due to the fact that the public generally is ignorant of the principles and factors involved. The man in the street can not see why an item of $2,000,000 of plant assets in a balance-sheet is not an absolute statement of value, true today, tomorrow and next year. To him accounting, if it means anything definite, means only a mathematical computation which is either right or wrong. If he buys a $1,000 mortgage bond which, according to the balance-sheet, is backed by $3,000 of plant assets, he blames the accountant if, some years later, he realizes only $300 in liquidation. He believes the original statement of asset values must have been in error. He can not credit the fact that there are different bases for valuation in a going business and in a liquidated business or in the same going business under different economic cycles.

The correction of the misunderstanding which underlies this criticism must be founded upon a program for education of the layman. He must learn that the accountant is not an appraiser, but that his duty is to report the basis of stating the value of assets in the balance-sheet. He must understand that a balance-sheet is not a statement of liquidating values, that many factors must be given weight in the valuation of securities, and that book value is of little significance unless considered in conjunction with the income account. He must realize that the determination of the values at which assets of a corporation are stated in its accounts is a function of the board of directors. It is the function of the accountant to describe the basis of stating such values. There have occurred errors due to faulty judgment or due to a lack of knowledge of all essential facts or perhaps to undue optimism. There are even errors due to an excess of conservatism. Yet corporate management is no more superhuman than the rest of the human race. During the period of expansion it was almost impossible to resist the idea that there had been definite economic changes which warranted a changed estimate of property values. The business world commonly felt that the values of both tangibles and intangibles might in large part be based upon earnings and upon the high price levels in existence at the time. This view naturally resulted in many an overstatement of values—as such values are now determined in the light of reduced earnings and deflated prices. Perhaps in the current period management may be subject to the error of undue pessimism and may determine values at so low a level as to damage the equities of security holders by understatement. The accountant should be particularly concerned with write-downs which result in an obvious understatement of values. Such a practice is fully as objectionable as the practice of the writing up of values which prevailed in the years prior to 1930. Its immediate effect is an overstatement of future earnings, and dividends paid out of such earnings may in part represent a return of capital rather than a return on capital.

A third criticism is that financial statements are misleading because they fail to reveal clearly facts of which the accountant is fully aware. This criticism has frequently been directed at the accountant's statement of qualifications and disclosures. Broadly speaking, a qualification constitutes a statement of the accountant's reservation short of his full endorsement of a financial statement; a disclosure is the presentation of a material fact on a financial statement. Qualifications are objectionable; they tend to obscure the clear-cut presentation of facts and to destroy confidence in the statements to which they are attached. Unfortunately, it is impossible in many instances for the accountant to state the actual monetary effect on the financial statement of a qualification or to state all material facts in terms of figures. Where the basic causes for the need of a qualification or of an involved explanation of facts can be removed by appropriate action of the board of directors such action should be taken. The accountant is powerless to act on his own initiative. He can not make adjustments of the accounts except by authority of his client. He can not and should not attempt to dictate the policies of a corporation, but he may and should use all means in his power to induce his client to adopt policies and to make those adjustments which will permit the presentation of the published accounts without material reservation. There is today a noticeable willingness on the part of corporation management to make adjustments which will lead to the elimination of qualifications from the financial statements, a trend that is greatly in the interest of the investing public.

The need for more informative financial statements can not be met by the addition of undigested and non-essential details. Intelligent presentation of financial statements requires a nice balance between clarity and detail. A balance-sheet consisting of naked figures is not informative, nor is a balance-sheet burdened with pages of footnotes informative.

The latter type of statement has been one of the unfortunate results of an excess of caution on the part of those who are subject to the statutory liability imposed by the securities act of 1933. It has become common practice to view the financial statements as a vehicle for protection against such liabilities. This is not constructive. Fundamentally the financial statements are a vehicle for conveying information. If they are truly informative and if they are predicated upon a reasonable examination in conformity with duty and custom, the question of statutory liability will be answered automatically. When confronted with the necessity for a decision on a difficult question of policy respect to financial statements the accountant should search his conscience rather than the statutes.

While accountants must strive toward more informative reports and statements, within the scope of their own work, and must in every possible way seek to further the knowledge of the general public in regard to the meaning of financial statements, a significant portion of the responsibility also falls upon the shoulders of management. The education of the public may be made easier as progress is made along the line of simplification of statements and reports. The statements will be complicated if the corporation facts and conditions are complicated, and they in turn are shaped by the acts, policies and decisions of management.

The audited financial statements of corporations are not inherently complicated. They sometimes become complicated because they must reflect the completed or uncompleted results of transactions which are so intricate that no simple explanation is possible or because of the necessity of explaining a company's departure from recognized accounting practices. Neither of these causes is within the control of the public accountant. He may and should counsel his client as to the advantages of simplicity and as to the wisdom of adhering to recognized accounting practices, but the responsibility for taking definite corrective measures rests with the management, including the board of directors. It has been my observation that during recent years there has been a sincere and effective effort on the part of many boards of directors to bring the accounting policies of their corporations into line with recognized accounting principles and to improve the standard of corporate accounting.

There is also a distinct trend toward simplification of corporate structures and intercorporate relations, but the efforts of management in this direction, particularly as to those corporations whose business is national in scope, are handicapped by the conflicting laws of the several states—laws which are to a large extent responsible for the holding-company system.

The financial statements of a corporation are seldom really informative to the reader who does not possess a knowledge of the accounting policies governing their preparation. This is particularly true in comparing the statements of two or more companies in the same industry. In my opinion, the lack of information as to such policies is one of the real deficiencies in corporate accounting. A statement of the major accounting policies of a corporation has an importance equal to that of the financial statements themselves, since neither is complete without the other. A corporation's published financial statements should be accompanied by a concise statement of its major accounting policies, such as those relating to the annual provisions for depreciation and depletion, valuation of inventories and plant properties, amortization of discount and consolidation of subsidiaries.

Since it is the duty of the directors of a corporation to pass upon the major policies governing its administration, the major accounting policies should receive the same scrutiny that is given to matters which are directly concerned with the administration of production and distribution. The accounting policies are important because of their bearing on the preparation and presentation of the company's financial statements. These statements form one of the means by which management may control the details of operations. They serve as a guide to aid the directors in determining the results of management policies and, in their published form, are almost the only source of information available to the investing public by which they may judge for themselves the success of the enterprise. Every board of directors should insist that its members be furnished periodically with a statement of the company's accounting policies and should insist that all major accounting policies be submitted to them for formal approval.

It may be said that accounting policies may, to some extent, be shaped by the broad economic beliefs of the management and the board of directors. It will probably come to be increasingly necessary that corporate managements adopt a long-range viewpoint, that their plans be laid in advance to enable them to attain certain definite objectives. Managements that rely upon and follow principles which look only to what is immediately expedient without regard to any long-range objectives can not hope to achieve a lasting success. At the present time it is possible to hold three distinct general opinions: first, that the country will shortly see a secondary reaction, during which the levels of commodity prices and industrial activity will fall far below current levels; second, that the present level may be relatively permanent, representing a reasonable and normal recovery from the extreme depth of the depression; third, that the present level is far below the normal, and that there are periods of prosperity ahead equal to or more pronounced than those which prevailed in the past. Obviously, no man, be he an economist or a financier, can look ahead and foretell with certainty which of these theories is the correct one, but it is equally obvious that the general and accounting policies of the management of an enterprise will be vitally affected by the school of thought to which it belongs.

In considering the problems of providing more informative financial statements and of simplifying those statements, it is well to remember the fundamental limitations in the scope of an accountant's work. An accountant is just what the name implies—one who is skilled in the construction, presentation, examination and interpretation of accounts. It is his function to determine facts; to determine whether or not the accounts have been kept in accordance with recognized principles and whether or not those principles have been applied on a consistent basis; to verify the propriety of the distribution of items as between capital and income; and to satisfy himself that the financial statements provide an adequate disclosure of material facts pertinent thereto.

The accountant is not an appraiser nor is he an engineer. He is not qualified to determine plant values, adequacy of depreciation, investment values, condition or value of merchandise or similar matters. As to such matters he must confine himself to the determination of those facts which are within the scope of his recognized qualifications and to render his opinion within those limits. Thus the limitation of the accountant's responsibility as to the verification of the inventory is in good practice set forth in a parenthetical phrase such as "(Quantities and condition determined by the company—priced at the lower of cost or market)." This means that the accountant has not verified and does not take responsibility for the determination of either the inventory quantities or condition but that he has satisfied himself as to the clerical accuracy and the basis of pricing. The accountant ordinarily should not take responsibility for the determination of quantities, because in many industries this would require specialized knowledge outside the field of accounting, and in most cases the expense of an independent verification is prohibitive. The accountant can not determine the condition of the inventory, because he does not have the special knowledge which would qualify him to undertake such work.

Again, the accountant is not a lawyer and is not qualified to interpret the legal effect of charter provisions, contracts, titles to property and other legal agreements. He should, however, have a sufficient knowledge of law to recognize legal problems which have a bearing on the accounts.

Finally, a public accountant is not a forecaster. It is not within his proper functions to predict the future results from operations of a business nor to forecast the condition of a company's affairs at a future date. His opinions should be, and are commonly understood to be, based on his knowledge of facts and conditions existing at the time when his work is performed. This limitation should always be carefully observed in the preparation of pro-forma statements used with public financing. Pro-forma balance-sheets giving effect to the application of proceeds from the sale of securities are on the border line between fact and fancy and should be avoided, except in those cases where the exact effect of the financing can be determined in advance. The same principle applies to the preparation of pro-forma income accounts. The once widespread practice of eliminating so-called non-recurring charges falls within the field of forecasting and is, therefore, objectionable.

A considerable part of the public criticism against statements which prove uninformative because they are so complicated has arisen in relation to the reports on the affairs of holding companies and their subsidiaries. Accountants have long recognized the limitations of consolidated statements but have been inclined to emphasize their importance without reference to their deficiencies. There are certain points of limitation, however, which if not recognized by accountants will serve to mislead the public. Thus, from a purely mathematical or technical viewpoint it is possible to add two and two and get four. But the sum of two apples and two oranges is not a definite four. So in accounting it is possible to sum up various factors to result in a consolidated statement, which, however, is only a fiction. The consolidated statement may not have a practical or applicable meaning in that its component parts are subject to the statutory restrictions of different states or countries, its apparent earned surplus may not be available for dividends, its stated asset valuations may represent the application of several different policies, etc.

In determining its policy as to the consolidation of accounts in the company's annual report, the board of directors of a holding company or any corporation owning subsidiary companies should be guided by the sound principle that the financial statements should be presented in that form which will most clearly reflect the financial position of the companies and the results of their operations. If this principle be conscientiously applied, the consolidated accounts will, in many instances, be accompanied by separate statements of the accounts of the parent company. This policy is now followed by the more progressive holding companies and there are indications that the practice will become more general in the near future.

Moreover, the current economic conditions have introduced other factors, such as the devaluation of various national currencies, which may prevent any practical interpretation of the apparent results. A generation ago foreign exchange rates moved between the rather narrow limits of the gold points. Since the world war foreign trade has been faced with widely fluctuating rates of foreign exchange, a condition which has been greatly aggravated during recent years by the rise of nationalism accompanied by changing standards of value, deflation of currencies (including our own), government control of foreign exchange and other artificial devices. Some countries have established restrictions on the transfer of funds abroad which are so severe as to make the official exchange quotations meaningless. Under these conditions the consolidation of the accounts of domestic companies with the accounts of corporations kept in terms of foreign currencies does not appear clearly to reflect the facts. Certainly there is no sound basis for including in the consolidated income account of a corporation the earnings of foreign subsidiaries in countries such as Germany, whose strict regulation of the transfer of funds abroad is an effective bar to the conversion of those earnings into American dollars.

The problems inherent in the preparation, presentation and interpretation of financial statements thus arise from multiple sources: first, the lack of accounting knowledge on the part of the public; second, the complications introduced by the nature of business and the attitudes and policies of management; third, the limitations imposed upon the accountancy profession, both as to the scope of its authority and its relationships with client and public; and fourth, the lack of precise and uniform principles within the profession. The accountant is an interpreter, but he must be also an educator. He discharges a vital business function and at the same time is charged with ethical and moral responsibilities of a high social order. He has the problem of his own education and adjustment during a period of rapidly changing world conditions—a period in which the decisions and principles of today may be proven faulty tomorrow, by a changed operating condition, a new legal requirement or a different economic cycle. Because he is integral with industry and society, he must strive to preserve an intelligent balance between the necessary principles and technicalities of his profession and the practical aspects and necessities of industry.

It is perhaps easier to make progress along the lines of correction of professional technique than to discharge the more intangible functions of industry advisor and educator, yet there are still many weaknesses within the working factors of the professional functions.

It is not uncommon for accountants to be too technical—to accept figures as an end in themselves rather than as an interpretation of practical conditions. They are sometimes inclined to follow an orthodox form for setting up balance-sheets, in complete disregard of special conditions which may exist. This is particularly true in cases where the corporation is in the process of reorganization under section 77B of the national bankruptcy act. Another example of this failing sometimes occurs in preparation of earnings statements. It is obvious that in the ordinary course of business some items technically applicable to the operations of one year will be entered in the accounts during a later period. Overlapping items of this character which arise in the ordinary course of business should be absorbed in the income account of the period in which they are taken into the accounts and should not, except in extraordinary circumstances, be treated as adjustments of earned surplus. Obviously where overlapping charges or credits are substantial in amount they should be set forth as special items in the income account so that their effect on the operating results may be readily observed. The practice of making direct surplus adjustments for items of this character is in the nature of a bookkeeping approach that may easily lead to serious misrepresentation. In good practice the earned surplus account should be virtually closed except for dividends and the balance of the net profit-and-loss account for the year.

It is equally important that the general and surplus reserves should not be used for the purpose of equalizing earnings of a corporation over a period of years. The practice of equalizing earnings is directly contrary to recognized accounting principles. The proper function of accounts is to record and report, as nearly as may be, the actual results of business transactions. If the nature of a business is such that its earnings fluctuate from year to year, it is nothing less than direct misrepresentation arbitrarily to equalize them between years through the medium of what has been known as a reserve for "contingencies." There is no reason why most reserves can not be specifically identified in the balance-sheet as liabilities, as reductions of assets or as permanent or temporary appropriations of surplus. The changes in these reserves are of considerable importance in the analysis and interpretation of corporate earnings and should be reported in the financial statements.

On the other hand, it is sometimes possible for the accountant to deviate too far from technical conventions and thus to lose sight of fundamental principles because of the urgency of some particular situation. Thus the accounting treatment of losses arising from a reduction of recorded values of assets of the corporation is too often decided upon the basis of expediency. As a matter of accounting principle such losses should be charged first against earned surplus, and only after earned surplus has been consumed should they be charged against capital surplus. Earned surplus should be the cumulative result of all income, losses and distributions.

Another current problem which is of technical interest occurs in the treatment of debt discount. Recent months have witnessed an increasing number of refunding operations through which corporations have taken advantage of the present low cost of money. It is characteristic of many of these operations that the new securities refund prior issues which in the ordinary course of business would not mature for a number of years, and in most cases there is a reduction in interest rates resulting in a substantial saving in annual interest charges. The problem arises as to the proper disposition of the unamortized discount and expense on the bonds retired and the premiums paid incident to their redemption. It is, of course, conservative practice to write off such discount on the premium against earned surplus at the date of refinancing. But there are many instances in which this procedure can not be justified from an economic or business point of view.

Debt discount is properly chargeable against earnings of the debtor corporation over the period of years in which it has the use of money represented by the debt. To insist that all bond discount and premium applicable to refunded issues should be written off against earned surplus at the time of the refinancing would, in some instances, have the practical effect of preventing a refinancing which, if carried out, would effect a real reduction in the cost of money to the corporation and would be highly desirable on other grounds. After all, these costs may properly be spread over the years for which it can definitely be ascertained that an actual saving has been effected in the cost of money. In these cases, therefore, the unamortized bond discount and expense applicable to the issue retired and the premium paid in connection with such retirement should be amortized over the period of years ending with the maturity of the refunded bonds. The debt discount and expense applicable to the new issue should be amortized over the life thereof. This procedure would appear to be fundamentally sound as it limits the spread of the amortized discount and premium applicable to the refunded issue to those years which, as can be definitely determined in advance, will receive the benefit of the lower cost of money as a result of the refinancing.

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We are living in an interesting period, enlivened by changes of far-reaching effect. Our own profession has shared generously in this experience. The past few years have probably brought about more changes in accounting practices in respect to published reports than were experienced during the preceding generation. Most of these changes have been beneficial and no well informed person would deny the need for them.

However, accountants must be alert to preserve the gains which have been made. The time is not far distant, perhaps, when reviving industry and optimism and increased profits may serve to abate the public outcry against uninformative reports which was so loud two or three years ago. While no one may question the effectiveness of most of the reform measures which have been adopted, there is always the tendency for a healthy body to discard the precautions which have served to create that new vitality.

Permanent improvement in accounting practices and methods of corporate reporting can not be brought about by legislation or by government regulation. The regulations laid down by a governmental bureau serve a good purpose but can never successfully take the place of individual initiative, intelligence and courage. If any real progress is to be made toward continued improvement in corporation reporting, it must flow from the efforts of those charged with the direct responsibility of determining the policies of corporations. As professional accountants we can contribute to this progress by emphasizing the advantages of adhering to sound business principles, by seeking to establish more firmly the standards for accounting practice, and by having the moral courage to cling to those standards.