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Sin of Perfectionism

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THE SIN OF PERFECTIONISM

ADDRESS

of

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before the

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These tragic days, when so large a part of the world is being destroyed, to talk of governmental regulation of corporate accounting may, to some of you, recall the poet's line about "lecturing on navigation while the ship is going down," or Anatole France's comment that "we should conceive a positive pity for our economists arguing with one another about the cost of the furniture in a burning house."

But those of you who are in that mood should also recall President Roosevelt's recent remarks when he signed the Investment Company Act and the Investment Advisers Act. "These Acts," he said, "give the Securities and Exchange Commission power to regulate investment trusts and investment counselors. They mark another milestone in this Administration's vigorous program . . . to protect the investor. As the pressure of international affairs increases, we are ready for the emergency because of our fight to put our domestic affairs on a true democratic basis. We are cleaning house, putting our financial machinery in good order. This program is essential, not only because it results in necessary reforms, but for the much more important reason that it will enable us to absorb the shock of any crisis."

I

There could be no single more deadly blow to the protection afforded to investors by the SEC than a successful attack on its accomplishments in the field of corporate accounting. Without the SEC supervision of accounts, regulation of the issuance of utility securities under the Public Utility Holding Company Act of 1935 would be meaningless and the Securities Act of 1933 would be a joke.

It is for that reason that I want to discuss the assault on the accountancy work of the SEC, launched by John M. Hancock, of Lehman Brothers, on April 26, 1940, in a speech entitled "Responsibility on the Part of the Public Accountant and His Client." There he referred to what he called "the Securities Acts and their administration," and, noting that annual corporate reports to stockholders are not within the scrutiny of the SEC under those Acts, said that "a better job is being done in the unregulated field, than in the field covered by regulation." Admitting the need and value of auditors' reports, he spoke of "the trend of development in this field over the last six years" which seemed to him "to have placed a false emphasis upon the need and value" of such reports. Mentioning the days when monkish "mental gymnasts" theorized as to how many angels could stand on the point of a needle, he said, "In these days the same kind of mind -- possessing plenty of intelligence but lacking in judgment -- seems to be busy in developing all sorts of precise practices for improving accounting methods and results." "I think," he remarked, "the current drift is towards an undue emphasis upon the accuracy of accounting for corporate reports." And he doubted whether "there is any warrant for devoting working time to a consideration of many of the finely spun arguments striving for absolute accuracy of annual reports." The "attempt to get so precise . . . is not worthwhile," he commented; and asserted that "there is no sound usefulness in the extreme precision and extended presentation now being demanded." And he emphasized "the impossibility of absolute factual accuracy in accountants' reports."

Observe what Mr. Hancock has done: He has pictured the SEC as consisting of intelligent but academic theorists and impossibilists --

monkish "mental gymnasts" -- striving, foolishly, in a necessarily imperfect world, for absolute perfection.

I want to discuss that ridiculous picture and to demonstrate its falsity for these reasons: First, it is being paraded about the country by a small group of ultra-conservative investment bankers who are engaged in an effort to have the Securities Act gutted by amending it in such a way that the SEC would be powerless to prevent the sale of certain large security issues -- even if the registration statements were clearly false and misleading. Second, such a picture, if it were believed to be accurate, would discredit the important work which the SEC, in cooperation with such organizations as yours, has done in gradually raising the standards of corporate accounting and in establishing some relatively uniform procedures in order that investors, and the public generally, will be better informed as to what corporate managements are doing with the assets of investors entrusted to their care.

In sharply disagreeing on the subject of corporate accounting with Mr. Hancock and with those investment bankers who accept his views, I am distinctly not to be understood as expressing any personal animus towards him or them on the part of the SEC or myself. In a democracy, all men, of course are entitled freely to criticize any aspect of government. And such criticism should not provoke anger in those government officials who are criticized. Freedom to reply to the criticism, however, is the privilege of those officials. And a reply, by one on the SEC, to adverse comments by an investment banker must not be interpreted as an expression of hostility towards the critic in particular or investment bankers as a group. The SEC has always recognized that the investment

bankers perform a vital function in our economy: They supply one of the means by which the savings of our citizens are converted into labor-producing plant expansion; without the investment bankers, America could not have grown as it did, and could not continue to grow. But a recognition of those facts, and respect for Mr. Hancock in particular as an able investment banker, do not require that I refrain from saying -- without any rancor -- that I have little respect for the kind of attitude he has expressed with respect to corporate accounting and its regulation by the SEC. That attitude can be illuminated by observing a similar attitude in another field:

Time was, not so long ago, when a physician, engaged in making an educated guess as to what was wrong with a patient and as to his future health, relied chiefly on the appearance of the patient, his pulse, his temperature, a glance at his tongue and throat, and on the physician's trained judgment, based on his background of previous experience. Today, most physicians also employ a multitude of laboratory tests. Suppose now that a critic of modern medical practice came before you and said: "What's the use of all this expensive laboratory hocus-pocus? It's sheer nonsense to expect absolute exactitude in medicine, and these newfangled gadgets can't produce it. Nor will their use make everybody well. A doctor must exercise judgment; and judgment based solely on laboratory tests is no substitute for the good old ways. Many patients were cured before there were any medical laboratories. Let's scrap them and go back to the old, simple, observational methods."

Such remarks are an instance of dangerous uncompromising thinking. They present a false antithesis. They divide the subject of

medical practice up into two distinct hemispheres: first, one in which doctors make their educated guesses as to a patient's present and future health without modern laboratory aids and second, one in which those aids and *nothing else* are employed. It erroneously depicts two and only two alternatives. Of course, today no physician in his senses relies solely on laboratory techniques. He uses judgment based upon both the old and the new methods.

But the critic stupidly insists on either the old or the new. And he rejects the new because (1) it alone is insufficient (as every doctor knows) and (2) it does not bring perfection in doctors' educated guessing (which no doctor or intelligent patient expects).

Such a critic dogmatically employs what may be called "either-or" thinking, an approach which is wholly fallacious with respect to most subjects -- including accountancy -- since it unwisely confines attention to one of two possible methods. Usually, there is not such a limited choice -- as if between black or white. There is a spectrum of choices; or, rather there are choices between several possible blendings of methods, old and new. Frequently, the new does not displace the old but supplements and improves it.

What we need is "both-and" thinking which says, "We want *some* of this *and* also *some* of that," which does not pit the "purely" good against the "purely" evil, but makes nicer discriminations and differentiations. You will note that science employs graduated scales of value. It does not portray heat *versus* cold, but speaks rather of 20 degrees or 60 degrees or 100 degrees of temperature.

We should beware of the dogmatic "either-or" man. He is, in most instances, a kind of perfectionist; and perfectionists are dangerous people who often stultify progress and prevent desirable change. *The sin of perfectionism is that it mutilates life by demanding the impossible.*

Perhaps I should be a little more explicit. There are, I suggest, two kinds of perfectionists. The *positive* perfectionist is a man who insists that men must live up to his ideals even if they are impossible of attainment. He demands the impossible in conduct. He is impatient with anything short of absolute perfection. But, in his favor it should be noted that he is usually aggressive - forward moving - in his search for perfection.

There is, also, the *negative* perfectionist. He is against all change because it will not bring perfection. Unless a proposed forward step will produce the "absolutely" perfect, he opposes it. He prefers whatever exists, no matter how bad, unless it can be supplanted by a flawless substitute. He is a passive resister. He usually tries to defeat a particular change by mistakenly charging that its proponents claim perfection. He erroneously reports them as saying, "This new device will have no defects." He ignores their qualifying adverbs, puts in their mouths words which they never uttered, and ascribes to them attitudes which they never entertained. He somehow induces himself to believe that they are 100% percenters, all-or-nothing fanatics, wild-eyed advocates of the impossible.

II

The speech of Mr. Hancock is an excellent specimen of that kind of absolutist or negative perfectionist approach in its most pronounced form. You will recall how, in favorably contrasting (1) unregulated accounting with (2) accounting when regulated by the SEC, he characterized the latter as involving an impossible striving for "extreme precision" and for "absolute factual accuracy."

You see, at once, the tactics of the negative perfectionist: Mr. Hancock has loaded the dice in favor of unregulated corporate accounting. He describes, as the one and only alternative, a kind of regulation which seeks to require the "extreme" and the "absolute." If that description were correct, there could be but one verdict; regulated accounting under the Securities Act would be ridiculous. If the choices were, in truth, restricted to the two presented by Mr. Hancock, no sane man would fail to elect in favor of unregulated accounting -- in favor either of the repeal of most of the Securities Act or the condemnation of those who have administered it.

But that picture is absurd. The Securities Act does not contemplate anything so impossible as "absolute accuracy" or "extreme precision" in accounting. Nor does the SEC seek to obtain it. As you are well aware, its aims are far more restrained. It strives for improvements in accounting standards, admitting freely that perfection is unattainable. That the SEC does not deal in "absolutes" or "extremes" is well known to most of the accounting profession which, I am glad to say, has cheerfully cooperated with us in striving to improve corporate accounting -- and without aiming to reach the moon of perfectionism.

Neither the SEC nor the accountants discard all the old techniques (necessarily involving judgment), nor assume that all the new and improved accounting standards -- which are gradually being evolved -- will ever exclude all error and produce absolute precision and infallibility. But you and the SEC believe that accounting must be constantly reexamined, and that revisions of procedures must be made again and again, in order that the profession may serve the current needs of the investing public with all practicable efficiency. To my mind, our cooperative program has not over-emphasized the need and value of your reports as auditors; and I believe the improvements which have been made have been salutary.

Mr. Hancock deplores "the kind of attacks which have been made upon management and upon auditors during recent years." If he means *unfair* attacks, I concur. If he means severe criticism of some managements and auditors based upon such cases as McKesson & Robbins or some of the cases recently reported in our investment trust studies, then he is surely wrong. I hope that, in that respect, I have misunderstood him. But I do go along with him in objecting to those who have tried to put business, as a whole, "in the dog house." It is just because I think that indiscriminate efforts to over-populate the kennels with businessmen should be avoided that I trust that, by the cooperation of honest practical businessmen, accountants and government, we can make life so hard for the crooks that honest businessmen may not unfairly be accused because of the misdeeds of their dishonest fellows.

As the heart of Mr. Hancock's attack on SEC regulation of accounting is to be found in his commendation of the unregulated annual corporate reports to stockholders, it is of interest to note that the New York

Herald Tribune -- a most conservative newspaper -- said, on August 22, 1940, of those unregulated reports: "While a number of corporations have realized the wisdom of publishing informative, detailed reports of their operations, complete with comparisons and share earnings, there are still too many companies which believe that the function of the report is to obfuscate rather than to elucidate."

That statement is amply confirmed by the exhaustive studies conducted by the SEC of malpractices by certain investment trusts. In our report to Congress on the accounting methods of those companies we said, in part:

"With this large industry almost completely unregulated and unsupervised, information concerning these abuses and some protection against them might have been afforded the investing public had there been in general use a sound and recognized body of uniform accounting principles and practices. The Commission's study of the accounting practices of investment companies has disclosed, however, that during the period studied there was almost completely lacking in the investment company industry any such recognized body of uniform accounting principles and practices. Instead, there reigned such diversity and confusion, that accountancy sometimes was transformed into an instrumentality by which abuses were both perpetrated and concealed rather than exposed. It is clear that the managements of many investment companies, free from almost any restraint, favored those accounting practices in connection with their companies

which were not in accordance with sound accounting principles, but rather according to whatever designs seemed to the managements best fitted to promote their immediate objectives, and the adaptability of one method or another to the accomplishment of these ends. So great was the variety of accounting practices in use among the various companies that the terse terminology of the stockholders' report became either unintelligible or definitely misleading. The few short words which traditionally comprise the vocabulary of income statement and balance sheet - "income," "profit," "capital," "surplus" -- were invested with such varied and conflicting significance that they afforded no true measure of the performance of the individual company, and rendered almost impossible accurate comparisons between companies.

"For example, at least four different methods were available to investment companies in computing the cost of securities disposed of from a block which had been acquired at different times and prices. Frequently, the use of one or another of these methods would result in the recording of a "profit" on the sale, while use of the others would have produced a loss. In consequence, it frequently occurred that a company which reported substantial earnings fundamentally had a position no better than another company which reported a loss, due to the use of varying criteria of cost measurement. Moreover, from one year to the next, behind apparently identical earnings reported by a company might lie very different results caused by a shift from one method of determining cost to another. In the same manner, and with like effect,

securities carried in the portfolios of investment companies were valued in accordance with four distinct standards, each of which affected investment and profit accounts differently.

"Reports to stockholders were found to be deficient in numerous respects. Some were deficient in their failure to reveal the basis of computation of profits or losses upon sales of securities . . . In others there was a deception arising from the failure to qualify the amounts of profits and losses when portfolio securities had been disposed of after a write-down. . . Likewise, trading losses were considerably understated. . . . By a failure in some instances to publish adequate analysis, reserve accounts became instrumentalities for covering up realized losses and for the distortion of trading results. Similarly inadequate analyses of surplus accounts in published reports led to the concealment of substantial realized losses. . . .

"Accountants' certificates which accompanied statements sent to stockholders were often characterized by equivocal phrases and material omissions. The statements themselves appear to have been more often inscrutable than informative. . . The conclusion seems unavoidable that large numbers of stockholders were led to repose confidence in reports which would otherwise have aroused their suspicion, by the very presence in these reports of the names and certificates of certified public accountants. Although this may have resulted in some measure from the failure of the public to apprehend the limited nature of the accountants' engagement or from the fact that those limits were not made known, the

study discloses that, even within the scope of their contractual duties, the work of many accountants was replete with faults, both of omission and commission, which contributed materially to the end result. It is a commonplace, to which the present study gives point and substance, that protection which does not protect is more dangerous than none at all."

It is gratifying to note that Mr. Hancock's eloquence did not persuade his own business associates. For Mr. Arthur Bunker of Lehman Corporation (affiliated with Mr. Hancock's banking house) in the summer of this year -- a few months after Mr. Hancock's attack on the accounting provisions of the Securities Act and their administration by the SEC -- joined with other leaders of the investment trust industry and with the SEC in recommending the Bill which, in August -- without a single dissenting vote in either house of Congress -- became the Investment Company Act of 1940. That Act contains provisions which go beyond the Securities Act of 1933 in conferring upon the SEC powers to regulate the shockingly sub-standard accounting practices which had occurred in parts of that industry. The business spokesmen for that industry recognized that the establishment, by SEC regulation under legislation, of decent accounting standards was essential to protect honest managements from unfair competition by dishonest managements. They did not accept Mr. Hancock's views that legislation of that kind "hampers or prevents . . . sound healthy business life."

And they did not agree with him that annual corporate reports to stockholders, not subject to SEC scrutiny, show that in

corporate accountancy "a better job is being done in the unregulated field than in the field covered by regulation" or that "the tendency for law or regulation is to set up either unworkable standards or low standards . . ." For the Investment Company Act specifically gives the SEC jurisdiction over the annual reports of investment companies to their stockholders.

To Mr. E. F. Connely, President of the IBA, such governmental scrutiny is "espionage." That, of course, is mere name-calling. It could be employed to damn any necessary governmental scrutiny; Shall we say, for instance, that government bank examiners, inspecting a bank, are engaged in "espionage," and shall we, accordingly, abolish government bank examinations? At any rate, many of the investment bankers, who sponsored the Investment Company Act of 1940 and who are also leading members of Mr. Connely's IBA, plainly did not accept his philosophy.

Investment companies, however, comprise only a small fragment of our corporations. The reports of most corporations to shareholders have for the most part been subject neither to scrutiny by a governmental agency, nor to specific statutory requirements. Many, in the 1920's and early '30's, used the "dance card" report -- a ten-item balance sheet, and possibly a few kind words by the president. A reasonably detailed income statement was a rarity. The critics of the time, many of whom were accountants, were by no means oblivious to these shortcomings. The condemnation by W. Z. Ripley* has become classic. You may say that such examples are of a long past area. By no means. True, there has been some improvement -- and particularly so because, after the passage of the Securities Acts,

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* Main Street and Wall Street (1926)

many accountants have refused to certify annual statements unless in substantial conformity to the annual report forms filed with the S.E.C. But many areas of information are still omitted from the reports sent to stockholders. The far flung industrial empire of parent, subsidiaries, and intervening holding companies is still reflected, for the most part only in the form of consolidated statements. The balance sheet of the parent, the only entity in which its stockholders have a direct interest, is seldom made available, even when there are large minorities or heavy debts in the subsidiaries -- all ranking ahead of the parent's creditors. When consolidation is not complete, separate statements, even for important unconsolidated subsidiaries, are the exception. Often nothing is said as to the relation between the earnings and dividends of subsidiaries or as to the increase or decrease in the parent's equity. Sometimes not even the extent of the minority interest is separately shown. In one case at least, the balance sheet was for one group of companies -- the income statement for another. Can these be examples of information unnecessary for an investor? I think not.

A study we have made of reports sent to stockholders shows many cases of deficiencies in vital information. What profit is it to the investor to know that the lump sum of cost of goods sold (including, without a breakdown, selling, general and administrative expenses) is so much or, indeed, merely that the difference between these expenses and net sales, both undisclosed, is such and such an amount? Much better than nothing, perhaps,

but is it comparable in adequacy and informativeness with the reasonably itemized statement of income and expenses, required in reports to the S. E. C., and found more and more frequently in the annual reports of the progressive companies?

In the course of our consideration of particular cases, accountants on our staff have again and again told us that there was no single well-settled practice in a given field. Indeed, in some cases there has been a wide divergence in the views of various members of the staff as to the proper practice to be followed. Adoption of one or the other would have resulted in wide differences in the amount of reported income and assets. The organization and operation on your part of a research department is also evidence of diversity in practice. Many of our footnotes are designed to require a disclosure, in reports to the SEC, of the accounting policies followed in a particular field. Yet a comparison of the unregulated annual reports sent to stockholders with the filings with the S. E. C. (10-K reports) clearly shows that most of these footnotes are omitted from the former. So long as wide divergence in practice exists, can such omissions be justified? Or is it to be concluded that it is unimportant to an investor how income is computed -- so long perhaps as the result of the computation is shown?

Under the Securities Exchange Act of 1934, the Commission has power with respect to proxies of corporations, the securities of which are listed on a national exchange. Pursuant to that provision, we require the furnishing of certain information as a basis for the solicitation of

proxies; and, if financial statements are called for, there is a tendency to assimilate the annual stockholders' report and the proxy statement. In that indirect way, we do have some effect on the annual reports of listed corporations. Under the Securities Act of 1933, however, we have virtually no direct or indirect power over such annual reports. The obligation to file statements with us has had, to be sure, the collateral effect of placing the unregulated report to stockholders on the defensive, if it differs substantially. But that is not a very effective method. The Investment Company Act goes further, as I have pointed out, with respect to investment companies.

There is a provision in the Trust Indenture Act which opens up an almost new field for conveying information to security holders: A corporate borrower, subject to that Act, is required to file reports with our Commission comparable to those required of listed companies under the Exchange Act. But the Trust Indenture Act goes beyond that point. It requires the borrower to transmit to each security holder such summaries of those reports as may be required by rules and regulations issued by the Commission. The recipients of these reports are not stockholders --- but bondholders or debentureholders. This is a partial recognition of the principle to which the Supreme Court last year adverted, in *Pepper v. Litton*, 308 U. S. 295, that the officers of a corporation owe fiduciary obligations to "the corporation, its stockholders and creditors." We are confronted under that Act with these problems: Of what should these summaries, sent to bondholders, consist? Should they approach a prospectus in scope? Or the brevity of

the average stockholders' report? Being designed for bondholders, as distinguished from stockholders, what special features and what differences, if any, from annual stockholders' reports should be introduced? These questions are not yet decided. Before they are, we shall again, as we have in the past, seek your counsel and explore your suggestions. But I have no doubt that the result at which we will arrive will give the bondholders much greater accounting detail than Mr. Hancock thinks they should have.

In Mr. Hancock's paper he referred frequently to an alleged suggestion that corporate accounting could and should eliminate the exercises of judgment on the part of accountants, and enable investors to make unerring judgments as to future corporate earnings and as to the future market value of corporate securities. He characterized such a proposal as "sheer nonsense." Now no one connected with the SEC has ever made such a ridiculous suggestion. I agree that such a notion, to use Mr. Hancock's phrase, is "sheer nonsense." If science cannot predict next week's weather with any degree of accuracy, how can any intelligent person believe it possible to predict, with exactitude, future corporate earnings -- which are a function of innumerable unknowable variables?

Since, however, in October 1939, I made a speech, "Accounting for Investors," in which I discussed the possibility of improved accounting as an aid to somewhat better educated guessing about future corporate earnings, and since, so far as I know, no one else in the SEC has as extensively discussed the subject of the relation of accounting to earning forecasts, it is fairly obvious that Mr. Hancock was referring to that speech of mine. It is true that I there suggested that accounting for investors -- which I differentiated from accounting for other purposes -- should give considerably more emphasis to those aspects of the corporation's history bearing on its past earnings and their causes so as to furnish somewhat more assistance to the investor than he can now obtain in forming a judgment as to the company's future earnings. But I went on, at considerable length, in that speech to point out that by no possibility could any corporate accounts reflect the numerous factors -- many of them unknowable by anyone -- which an investor would need to know if it were ever to be possible for him to form anything like a precise judgment as to a company's future earning power or the market value of his securities. Time and again I stressed the impossibility of an accurate prediction as to such matters.

That speech of mine was published in The Journal of Accountancy for October 1939, and I shall therefore not repeat it here in detail. Those of you who have read it will recall that my main theme was that more consideration of the kind of information which is valuable to investors might

be given in the preparation of those accounting reports designed for the use of investors. I said that the investor must be made aware that not only are the principles of accounting not fixed and certain, but that the facts to which they are applied are often matters about which reasonable men can differ since, frequently, those facts rest upon human -- and therefore fallible -- judgment; that the arithmetical form employed by accountants is a convenience which often expresses something that is but, at best, a conjecture about conjectures; that the investor should not be deceived as to the inherent uncertainties which lie back of the prim and neat arithmetical facade of the accountant's report. I pointed out that, while the primary value to investors of the accountant's report was to aid them in conjecturing the future net earnings of the corporation, they must recognize that no one can "determine" future earnings. "All that we can do," I remarked, "is to conjecture, to surmise -- to guess. And that is true not only because 'net earnings' is a relatively vague term -- involving, as it does, fallible judgments as to depreciation, bad debts and other items -- but, far more important because the past is no infallible guide to the future -- except to an Omniscient Being, who knows all the events of the past and correctly interprets their meaning for the future. No man either knows all past events or is able thus to interpret them; no man can, therefore, with surety, predict the future. . . Factors which are inherently impossible to weigh and measure and therefore to estimate in advance may, . . upset a well-thought out business forecast. . . In an era where change, not permanence, is the norm, where the one certainty

is that there is no certainty, we capitalize earnings which have been stable in the past as if they were sure to be stable forever more. We thus project the impermanent present into an imaginary permanent future . . .The truth is that profits are subject to hundreds of incalculables which neither accountants, nor anyone else, can foresee. *Future earning power, and therefore 'value,' are, I repeat, a prediction, a guess. But that guess should be an educated guess.* When I say that, I do not mean, of course, that, because complete certainty in accounting is lacking, there is or must be complete uncertainty. The accountant's performance lies between those polar extremes. . . We are but mortal, and contingency is the essence of mortality. Only in the grave do we escape it. Almost all thinking is based on mere probabilities, not on guarantees. . . To ask for complete and absolute exactitude, at all points in accounting, is absurd."

And I concluded that part of my remarks thus: "The accountant. . . supplies *some* of the materials for, some of the ingredients of, the investor's judgment. The ingredients he supplies should, therefore, be as pure as possible; *but the investor's judgment (or that of his advisers) cannot be compounded solely of those ingredients, nor can the accountant be asked to do the work of the investment analyst.* It is, accordingly, essential to emphasize the importance of good accounting, but a mistake to overemphasize it to the exclusion of many other factors. *I distinctly do not mean that the accountant is to forecast future earnings.* I do not mean that he should give greater recognition to the fact that the principal interest

of the investor and his advisers is future prospects -- earnings. In sum, I do not mean that the present financial statements should be replaced by earnings forecasts. But I do mean that financial statements intended for investors should be designed with a view to their ultimate use in appraising earnings prospects. That should be the focus of the accountant's attention in preparing reports for investors."

Now those remarks on the importance of the income account to investors were not entirely unorthodox, excepting, perhaps, in their cautiousness. For your own American Institute of Accountants had said five years earlier that "the real value of the assets of any large business is dependent mainly on the earning capacity of the enterprise," and also said: "It is probably fairly well recognized by intelligent investors today that earning capacity is the fact of crucial importance in the valuation of an industrial enterprise, and that therefore the income account is usually far more important than the balance sheet."*

And on April 26, 1940 -- the very same day and at the same meeting at which Mr. Hancock delivered his paper -- Mr. Bowlby, a partner of the well-known accounting firm of Barrow, Wade, Guthrie & Co., after referring to and generally approving my October 1939 speech, said: "It may be accepted as the present philosophy of investment that earning power is the major factor. However, investment judgments are not formed on past results, except as those results throw light upon what may happen in the

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* Audit of Corporate Accounts (1934) pp. 6, 10.

future. Hence, it is essential that financial statements disclose such information, regarding past events under known economic conditions, as will enable a prospective investor to form intelligent conclusions with respect to future trends. Probably no great portion of the investing public can make an intelligent forecast, but those who can are entitled to the information. Hence, a principal objective of financial statements is to disclose the reasonably prospective net earning power of the enterprise." I suggest that you contrast those remarks with Mr. Hancock's assertion that "it seems futile to think of an annual report as giving *any* adequate basis for appraising the future value of securities."

The uninformed reader of Mr. Hancock's paper would conclude that we on the SEC believe that the investor should rely, to quote him again, "upon details of accounting almost to the utter neglect of other factors." Of course, that is not true. No one believes more emphatically than I -- and I have said so, in public and private, many times -- *that when one invests in a corporation he is inescapably investing in management;* that management involves the exercise of judgment and discretion; and that the qualities of good or bad management include many intangibles which cannot possibly be recorded in figures.

Mr. Hancock, subsequently, made much the same point. But because of the impossibility of catching, in the net of efficient accountancy, *all* the facts bearing on the future of a corporate enterprise, he concludes that it is silly to use accountancy as *one* of the aids in surmising

a corporation's future. He is guilty of a well-known fallacy -- the confusion (to use high-brow terminology) of a "necessary" with a "sufficient" condition: Thus, while it is true that men cannot live without salt, that is not the equivalent of saying that men can live by salt alone. Similarly, while good accounting is indispensable, it is not, alone, sufficient. And so, that accounting can never be precise, that it unavoidably involves judgment factors, that it alone cannot be a guide to predicting future earning power and that, indeed, there is no unfailing method of predicting future earnings or future market values -- all that does not at all compel the conclusion that accounting for investors cannot be so revised as to give to the investor *some* more help than accounting has heretofore given in affording him *part* of the data upon which he can base a *guess* as to future earnings and market values.

Of course, there are no infallible means for arriving at precise judgments as to such matters. But we must do the best we can with the best knowledge we can obtain. "Every year, if not every day, we have to wager our salvation upon some prophecy based upon imperfect knowledge," said Mr. Justice Holmes. Surely, if the past history of a company's earnings are told with approximate accuracy and the telling shows that the earnings have heretofore been very bad, that narrative is *some* help in forecasting the future earnings. And the same is true as to a narrative showing a very handsome earning history.

The point is that it is unsound to reason in any field that, because perfection is not possible, and because increased information will not furnish a foundation for completely guaranteed judgments, therefore attempts to procure as much more adequate and useful information as is available -- within the limits permitted by the nature of the subject matter -- is useless or nonsensical. It is well to bear in mind these wise words of Aristotle: "We must not look for the same degree of accuracy in all subjects; we must be content in each class of subjects with accuracy of such a kind as the subject matter allows, and to such extent as is proper to the inquiry. . . An educated person will expect accuracy in each subject only so far as the nature of the subject allows."

The history of thought in every field contains instance after instance of just such objections to procuring more accurate information as have been voiced by Mr. Hancock. He referred to the Middle Ages. But, in the Middle Ages, men were burned at the stake for wanting to learn more about arithmetic, astronomy, and dozens of other subjects.

Galen's writings on human anatomy were derived from studies of the insides of monkeys. When Vesalius subsequently began dissection of the human body in order to discover what it was like and how it differed from a monkey's interior, he was charged with impiously trying to upset the established rules of anatomy. As Andrew D. White tells the story, the cry that went up against Vesalius "has been the same in all ages -- the cry for what is called 'sound learning'. . . The idea has always been that the older studies are 'safe.'" Certain men, one might say -- thinking of Galen and Vesalius's critics -- have a fondness for "monkey business."

As to vast areas of experience, the human race is ignorant and will always remain largely so. There are factors in the universe as to which, because of our limited equipment, we shall always, almost surely, remain in darkness. Chance will always play an important part in human affairs. Comparatively little of the future will, I think, ever be precisely predictable. But because our ignorance is and must be large, that is no reason why we should wallow in it, no reason why we should diminish our efforts to reduce - the unknowable, the unforeseeable, - so far as possible.

It has been said that the better is the enemy of the best. Sometimes that is true. But it is no less true that the all-or-nothing men, those who will have nothing but the unattainably perfect, are the foes of improvement. If all men had insisted that either they must fly with the skill of birds or not fly at all, aviation would be non-existent.

Negative perfectionism has often retarded the use of inventions. Robert Fulton's steamboat was called "Fulton's Folly." DeForest's efforts to launch the wireless telephone were laughed at by the Western Electric Co. Not so very long ago the chief engineers of a leading telephone company scoffed, before the American Institute of Engineers, at the automatic telephone.

Paradoxically, the calm acceptance of unavoidable imperfection improves effectiveness. For such an admission rids us of an impossible task and enables us to face the environment unburdened by a feeling of the

necessity to stretch our aims beyond their practically possible scope. By conceding the immense amount of our inescapable ignorance, we become more alert in detecting facts. To the extent that one goes to sleep in a dream of attainable perfection, he becomes the victim of uncertainties and imperfections which he ignores and which he therefore fails to allow for. The courageous attitude of accepting as inescapable the existence of uncertainties and imperfections, makes one's world picture more complex; life is disclosed as far more precarious and difficult to conciliate. But such an attitude usually drives men to learn more about what was previously undetected, thereby reducing the area of the unknown and uncontrollable. It is indeed a paradox that, insofar as we become mindful that life is bound to be less perfect than we might like it to be, we tend to improve it. We should never have had steam engines if men had been content with dream engines. Airplanes were not invented by believers in wishing rugs.

III

Please do not misunderstand me. I am not for a moment charging Mr. Hancock with deliberately and intentionally distorting the views of the SEC. He is an honest man. But I surmise that what happened to him was something like this: As I've indicated, he joined a campaign to have the Securities Act disembowelled. Now if the SEC in its administration were demanding perfection, if it were made up of academic extremists, then Mr. Hancock would have had an excellent argument in favor of such an amendment. He, therefore, doubtless wanted to show that such was the case. Presumably, when he came to write his April 1940 paper, he vaguely remembered what I had said in October 1939. If I had said what, in his paper, he ascribed to me, it would prove his point. And so this is what I surmise:

Wishful memory came to his assistance. No doubt he honestly believed

that I (or someone in the SEC) had made the absurd statements which he erroneously imputed to us. He was, I suspect, so carried away by the music of his own rhetoric that he neglected to check up on the accuracy of his reporting.

Every lawyer knows that honest witnesses sometimes remember past events in accordance with their desires. The courts have observed that "men are prone to see what they want to see;" that "our sympathies and our prejudices bias our memories;" that "very honest persons often deceive themselves without being aware of it;" that, when a person has a deep interest, "his interest will, even if he wants to be truthful, impress upon his memory with much greater distinctness those things which make in his favor than it will those which make against him;" that "our memories are easy and oftentimes unconscious slaves to our will"; and that "the interest of a perfectly creditable and innocent witness may, and often does, color his recollection and mold his impressions, sometimes even insensibly to himself." It is also a fact that Mr. Hancock was inciting to war on the SEC and was perhaps influenced by the precept that men do not follow an uncertain call to battle.

Let us look now at the central thesis of Mr. Hancock's criticism of the Securities Act: He points to the fact that most corporate managements are honest. With that the SEC heartily agrees. He goes on to say that there have been some "notorious exceptions" but that the "good human qualities" of "integrity, probity, ability and judgment" of corporate management cannot be "injected into a situation where they do not exist through the operation of any Act of Congress or regulation based thereon." He says that he "has little belief in the power of law to make men honest."

Again you will perceive a false picture made up of sharp blacks and whites: Of course, laws cannot make all men honest. But that does not

mean that one must go to the other extreme and say, "Therefore, let us abolish all laws prescribing standards of honesty." Of course, regulation is no substitute for good faith. There are thieves and murderers in the world despite the fact that for many years there have been laws against theft and murder. Should we, therefore, repeal the laws against theft and murder? Surely not. Laws have their effects, partly because fear of punishment for a violation of the laws acts as a deterrent and -- far more important -- because, after a while, the existence of the standards of minimum morality enacted into law creates habits and customs so strong that most men will not break with those habits and customs, will not even contemplate doing so, because they accept their operations as they do the air they breathe.

As I said, Mr. Hancock is a *"negative perfectionist"*: If a law is not sure to be 100% effective, then, he feels, the law is not good enough and should not be enacted, or, if it is already enacted, should be repealed.

Mr. Hancock goes on to say that it is unthinkable to him that any body of sensible men "will say as their deliberate judgment that the present Securities Acts and their administration are *in all respects* reasonable." Again I am in accord with him -- as far as he goes. For you will note the perfectionist phrase, *"in all respects."* I defy anybody to find any statute or any administration of any statute or any human institution which is "in all respects" reasonable. I do not believe that, at any foreseeable time, there will be a world in which that will be possible. Human institutions are, as their name indicates, human, and therefore necessarily fallible.

The members of the SEC recognize that, because they are human, and are called upon to act, they are bound to make some mistakes.

They would not want you to believe otherwise. For they are devoted to democracy. *And only under a dictatorship is it a dogma that those who hold office can never err.* *

The SEC Commissioners take only this to their credit: They do their conscientious best to avoid mistakes. When they find that they have erred, they admit it and change their ways. In April 1940, Mr. Brownell, counsel for Morgan Stanley & Co., in arguing before us, in the Dayton Power case, that one of our own rules was invalid and that we should reverse ourselves, said that he knew, from experience, that we could consider his argument "with the same disinterestedness as the Supreme Court."

Mr. Hancock reports that he is "impatient over the attempt to improve everything at once." If he means instantaneous improvement, I share his views. But I deplore his intimation that a fanatical passion for impractical instantaneous improvement of everything is characteristic of the SEC. If the SEC were so daft, why is it that the Investment Company Act of 1940, at the express request of the business men in that industry, conferred upon the SEC far more discretionary power than the SEC requested? *That added discretion, in other words, was thrust upon us by those businessmen.* Did not that fact -- plus the fact that those businessmen vigorously urged the enactment of that statute this year and did all they could to avoid postponement of its enactment until next year -- go to show that they were willing to trust to the good horse sense of the present personnel of the SEC?

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* Without claiming to be "good", we do share something of the attitude expressed by the poet MacNeice:

"And to the good who know how wide the gulf, how deep
Between Ideal and Real, who being good have felt
The final temptation to withdraw sit down and weep,
We pray the power *to take upon themselves the guilt*
Of human action, though still as ready to confess
The imperfection of what can and must be built,
The wish and power to act, forgive, and bless."

And did not those facts, too, serve to answer the recent remarks of Mr. E. F. Connely, that the federal government is endeavoring to over-regulate transactions in securities? For it is a notable fact, as I have said, that some of the principal members of his own Association were among those who, a few weeks ago, successfully urged Congress to pass the Investment Company Act. Obviously they did not accept Mr. Connely's thesis that such regulation paralyzes free private enterprise and promotes totalitarianism. They knew that the pre-regulation exploitation of thousands of middle-class investors might constitute a prelude to totalitarianism; that, if such exploitation continued, there would be grave danger of so angering the great middle class that it would be likely to turn to some dictator who, falsely promising to save the middle class, would destroy it, and, with it, democracy and capitalism. The truth is that the major function of the SEC laws and the SEC is conservative -- to aid the conservation of our American profit system under our democratic form of government.

I repeat, we on the SEC are not perfectionists or panacea-mongers. We are firm believers in sensible and intelligent working compromises. I wrote a whole book on that subject, published two years ago, in which I said this: All compromises are not evil or foolish. Life is full of compromises. Walking is a compromise between falling down and standing up. . . Most dealings between human beings in daily life involve innumerable compromises; civilization is built on mutual yieldings and concessions. There are good and bad compromises. Some deserve applause and others condemnation. And so with objections to "half way measures" and "gradualness." Life could not go on without them. Sleep is a half-way measure. When one uses brakes on a steep hill he is practicing gradualness. To avoid gluttony or drunkenness is to be gradual and half-way.

But, although the SEC does not believe in perfection or in trying to improve everything at once, it does believe in constant sensible efforts at improvement. I had always thought that was the American way of life. I had always thought that the great progress which this country has made over the years was largely a result of the fact that we have never been satisfied. We have constantly driven ahead to make things better and to make better things. That applies to manufacturers, doctors, scientists, lawyers, and to government as well. There is no question but that it applies to accountants and auditors. We are not perfectionists, but we are "improvists."

While we on the SEC are devoted to gradualness and intelligent compromises, we are definitely not appeasers. We go along with those who believe that there are some fundamental principles which must not be compromised. The British people are valiantly demonstrating that attitude today. They have cast off their former false leaders who believed it possible to compromise concerning the minimal decencies of life with an absolutist whose purported compromises are but deceptive means for achieving a victory by which he can work out his own absolutism that abolishes all free choice for the average man.

Such absolutism is abhorrent to Americans. We do not want dictators, nor even an elected government, to manage all the affairs of life. Large areas of industry need no governmental regulation. And, even where regulation is needed, it should not be all of the same pattern. It should vary according to the peculiar characteristics of the particular regulated industry. In some industries, it should take the form of governmental consultation and cooperation. In others, some form of industrial self-regulation, with residual governmental supervision, is sufficient. In others, experience shows that varying degrees of more drastic regulation are necessary.

Rigid and inflexible uniformity in the field of accounting would be nonsensical. And Mr. Hancock, in attacking it, is knocking down a straw man. Perhaps I can explain the difference between his point of view and that of the average investor: He is an important investment banker. He personally knows many industrial leaders, and, without too much difficulty, he can obtain personal access to those he does not already know. He can talk personally to them about their business and form a first-hand judgment of their abilities. In so far as he can trust the information he gets, he is able to place himself in a splendid position to know about the future of business or the future of any particular enterprise. In short, he is in a most enviable position - a position not available to most investors who want to find out about various enterprises. He can place an enormous amount of emphasis, in his analysis of a particular situation, on management -- because he knows management personally. But the average investor who is not in that position, must place his reliance on the *record* of management rather than on the *personality* of management. And for the fair presentation of that record, the investor must rely to a considerable extent on you accountants. The investor may miss many factors which Mr. Hancock can discover, but, if you give the investor or his investment analyst enough details, he will find out at least whether or not the record is a good record or a bad record and how it compares with other records in the same industry. That is especially true, if the investor can feel confident that accounting practices and principles are relatively standardized and that the accountant who has reviewed the data is completely independent and reasonably curious.

To Mr. Hancock the unregulated annual report to stockholders is apparently good enough. But Mr. Hancock's perspective can hardly be said to be that of the average investor. He is much more fortunate.

He lives in an environment which, for most investors, is nonexistent. He needs to have much less down on paper than the average stockholder. But it is difficult to believe that important investment advisory services, like Poors, Moody's, or Standard Statistics would want to go back to relying on the meagre accounting data contained in the average report to stockholders. In fact, I cannot imagine that even the analytical staff of the investment trust sponsored by Mr. Hancock's own firm would want to be obliged to rely solely on that information. Of course I would admit that the average stockholder must find detailed balance sheets and income accounts -- especially when there are a lot of footnotes -- pretty heavy going. But I fail to find there even a weak argument against the inclusion of such details. After all, the influence of the informed investor and the investment adviser, availing himself of fuller information, is quickly felt in the market place.* Artificial market prices based on needlessly inadequate information -- so ruinous to the mass of investors in the past -- are today made almost impossible, as to registered securities, by the use of detailed and more adequate information. I am sure that you accountants will not at all agree with Mr. Connely that "investors today actually receive in understandable form less pertinent information than before the enactment of the Securities Act of 1933."

And so, to repeat, I feel that we on the SEC and you in the accounting profession can take pride in our constant efforts to improve the standards of corporate reporting. I feel confident, that we have already made a contribution so substantial that, even if the Securities

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* As to benefit to investors, through investment analysts, of the work of the SEC, see Graham and Dodd *Security Analysis* (2d ed. 1940). pp 49, 50, 53, 146, 229, 280, 286, 406, 420, 426, 446, 456, 598, 600, 609, 656.

laws were to become a dead letter, corporate reporting would never again shrink to its former status. The stature of your profession has grown immeasurably in the past few years. Your increasing independence is the envy of other professions. Neither you nor we will ever attain perfection, but I anticipate that we will spend a good many more years on our joint effort to improve the quality and value of information to security holders.

What we want for investors is the best available data practically obtainable. That they procure it may make life duller for some persons. As Abe Martin said, "Nobuddy kin talk half as interestin' as the feller that ain't hampered by facts or infermashun."

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