TRENDS IN FINANCIAL REPORTING

Address of

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Washington, D. C.

before the

Nineteenth Annual Conference of Accountants

University of Tulsa

April 29, 1965

The title I have taken for this discussion could be interpreted as an intention to survey a long history.[1/] For example, a recent news item reported important new discoveries in the Near East of records of business transactions of four thousand years ago. Others might start the story with Pacioli, which would save us about 3,500 years. A more reasonable beginning might be early reports of the railroads; and in the industrial group the first report of the United States Steel Corporation in 1902 affords a solid starting point.

About this time three American teachers of accounting produced important contributions to the then sparse literature on the subject. In "The Philosophy of Accounts" Sprague observed that "the whole purpose of the business-struggle is increase of wealth, that is increase of proprietorship." Sprague used the term Economic Accounts to cover the income and expense accounts. He summed up one of our most important accounting problems in a single brief paragraph:

> "173. Unless care is taken to include in the economic entries of a period all that properly belongs in it and to exclude all that pertains to any other period before or after, we may greatly distort the presentation of facts so as to render it valueless; the period which has been adverse may appear prosperous at the expense of one which is actually more successful. The question must always be askt: Is there any residual asset or liability at the beginning or at the end of the period which has not been taken into account?" 2/

Hatfield's "Modern Accounting" published in 1909 carried a subtitle "Its Principles and Some of Its Problems." In his preface the author

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1/ The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

2/ Sprague, Charles E., "The Philosophy of Accounts," first published in 1907, reprinted in 1917 by The Ronald Press Company, pp. 59 and 61.

recognizes that advancement had been made in accounting practice but he deplored "a most embarrassing confusion in terminology" and the serious "uncertainty as to the correct principle to follow in many cases." So he concluded that:

> "In some cases it is possible to differentiate certain usages as bad, some methods as involving incorrect principles. But this is not always true and when in doubt there is no ultimate arbiter to whom appeal can confidently be made. In this dilemma it has, therefore, seemed advisable to show the existing variations rather than to attempt to formulate rigid rules. The comparative study of accounting practice will, perhaps, be a greater service to accounting science than a more dogmatic treatise." 3/

Some observers of the situation today would say little progress has been made since this was written.

Cole, in the preface to the revised and enlarged edition of his book "Accounts - Their Construction and Interpretation for Businessmen and Students of Affairs," first published in 1908, said that "accounting is nothing but sublimated common sense applied to finding and telling the truth about business." After some unflattering remarks about courts and lawyers, Cole said that:

> "To-day a legal decision not overruled may be found on each side of almost every accounting problem. The discussion of principles in this book, therefore, is based on fundamental analyses through common sense, and does not attempt to follow the mazes of contradictory policy in complex concrete cases." 4/

Fifty years after this was written we still have somewhat violent differences of opinion over a number of important accounting matters and we have some difficulty in determining just who has the monopoly on "common sense."

3/ Hatfield, Henry Rand, "Modern Accounting," D. Appleton and Company, p. vi.

4/ Cole, William Morse, "Accounts - Their Construction and Interpretation," Rev. and Enld. Ed., Houghton Mifflin Company, 1915, p. vi.

However, there are many indications today of trends toward improvements in financial reporting. These trends can be noted in the activities of governmental agencies and accounting and other professional societies as well as in actions of companies acting individually and in groups.

At the SEC the past year has been an eventful one in this respect. In May 1964 a proxy rule 5/ under the Securities Exchange Act of 1934 was amended to provide some specific guidelines for the content of financial statements for fiscal years ending on or after June 30, 1964, to be included in reports furnished to security holders in connection with the solicitation of proxies by the issuer. In brief, the rule now requires that any material differences between the financial statements sent to security holders and those filed with the SEC shall be reconciled or explained and with a few exceptions that the statements sent to security holders shall be certified. An example of such a reconciliation is the adoption of the practice by most of the steel companies, which present their income statements on an object or natural classification of expenses in the reports to shareholders, of stating the amounts for cost of goods sold and selling, general and administrative expense in a footnote which provides the reconciliation with the presentation in the 10-K reports. By so doing, the demands of followers of two schools of thought are satisfied.

We are studying the reports as they come in to determine what further action may be needed to insure compliance, but already a trend toward improvement is noticeable. It is hoped that the wide publicity

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5/ Rule 14a-3.

that the amendment has received and the educational efforts of the professional societies will result in close conformance to the requirements within a reasonable time, particularly since the companies that have issued reports which contain serious deficiencies are a small minority. A very helpful instructional article was published in Richard Lytle's department in the January 1965 issue of The Journal of Accountancy.

Although most companies have been issuing adequate reports, a wide variety of deficiencies has been observed in the minority group. The amendment is intended to correct such matters as the omission of the income statement, omission of sales and cost of sales, differences in the principles of consolidation and discrepancies in income and balance sheet figures in the two sets of financial statements. For example, in an annual report to stockholders noted recently, in the income statements there were discrepancies in cost of sales, gross profit and various other captions, and no amount was identified as net income. In the balance sheet the reader had to do the arithmetic to arrive at totals for current assets and current liabilities. Further comparison with the financial statements filed with the Commission disclosed that the very nominal credit balance in "surplus" was the difference between a large capital surplus and a slightly smaller operating deficit. This was all bolstered by the inclusion of a substantial appraisal increase in plant which of course does not appear in the SEC filing.

Another major event in 1964 for the SEC, and one which it is expected will have an important effect on financial reporting, was the enactment by Congress of the Securities Acts Amendments of 1964. As you probably know,

the registration and reporting requirements of the 1934 Act were extended by these amendments to the unlisted securities of companies having more than $1,000,000 in assets and 750 stockholders. While many of these companies were already filing under the Section 15(d) requirements of the Act, an estimated 1,100 companies will be required to file reports for the first time for their fiscal years ending after June 30, 1964. Since these companies have 120 days after the close of their fiscal year in which to file, the flood will start within just a few days as the fiscal year companies were given a blanket extension of time to April 30 in which to register. On July 1, 1966, the stockholder limit drops to 500 and an estimated additional 800 companies will come under the requirements of the Act.

Bringing these new companies under the Act will have a two-fold impact on financial reporting. First, with respect to the 1,900 companies being added to the approximately 5,000 which are already required to file financial statements in accordance with SEC standards, the general quality of the financial reports of the new companies is expected to be improved. Second, the newly covered companies which also solicit proxies will be subject to the proxy requirements as previously discussed, and thus better and more informative reports will be submitted to the stockholders. Incidentally, another rule has been proposed which will apply substantially the same reporting requirements to companies that do not solicit proxies.

With respect to reports of most banks and unlisted insurance companies, the responsibility under the 1964 amendments has been vested in agencies other than the SEC--for insurance companies under certain

conditions to their state regulatory commissions, and for banks to the Comptroller of the Currency, the Federal Reserve Board or the Federal Deposit Insurance Corporation as appropriate. These requirements should have a salutary effect on financial reporting in these fields, both of which have been the subject of much discussion and criticism in recent years. The recently issued reporting instructions of the FRB and the FDIC are somewhat comparable to the SEC's financial statement requirements.[6/] Although certification by independent public accountants is not required of the banks, the rules as adopted encourage it. Some large New York City banks have published reports to stockholders for 1964 containing certified financial statements. One of these reports contains an excellent explanation of the changes made in the bank's accounting in order to permit certification.[7/]

Another area of financial reporting to which the 1934 Act was extended pertains to foreign companies whose unlisted securities are sold in this country. However, Congress gave the Commission considerable discretion with respect to exemptions, and a study is now being made to determine an appropriate course of action. Financial reporting in foreign countries reflects differences from U. S. standards ranging from relatively minor variations in Canada, Mexico, and the United Kingdom to extreme variations in many other countries. Many of the variations will pose a problem of compliance with our requirements if some exemptions

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6/ Regulation S-X.

7/ Manufacturers Hanover Trust Company.

from these requirements are not granted. An extension of the effective date of the Act to November 1965 for these companies to permit further study of these and other problems has been granted.

Heretofore, for foreign filings under the 1933 Act we have required conformance to our auditing standards but have recognized the differences in accounting practices and have required conformance with or reconciliation to our standards. However, for reporting under the 1934 Act, minimal requirements were specified in the reporting forms promulgated in 1935 in order to accommodate companies then listed on national securities exchanges. These forms are still in use and thus do not make reference to our accounting regulation which was adopted in 1940. However, revision of these reporting requirements under the 1934 Act is now under consideration.

There are several major differences between foreign auditing and accounting practices and U. S. standards which we must consider. In many countries physical inventory-taking is not observed by the auditors and receivables are not confirmed by direct correspondence with the debtors. Standards pertaining to the independence of the auditors in most foreign countries are different from ours. Secret reserves, usually established by the understatement of inventory values or overstatement of liabilities, are used in some nations while fixed assets may be valued at higher than cost in many countries, often on the basis of a government decree. The practice of preparing consolidated financial statements is a new development in some countries. Our practice of recording stock dividends at fair market value of the stock issued is not followed in most foreign

countries. This has been a problem for some companies which have registered securities under the Securities Act of 1933.

A timely study of the differences between foreign and U. S. practices is the recently published book of the AICPA, "Professional Accounting in 25 Countries." Further studies are being made by committees of the Institute, the Financial Analysts Federation, the National Association of Securities Dealers, and others. Although we have cited several important differences, there are many signs of a general trend toward improvements of financial reporting in the foreign countries. The professional accounting organizations are becoming stronger and are exerting more influence for better standards and practices in many countries. The London Stock Exchange last summer issued additional reporting standards for listed companies. The Canadian Chartered Accountants have up-dated and strengthened their disclosure bulletin.[8/] In March of this year a special committee in Ontario recommended that "the financial disclosure requirements of Ontario legislation should now be revised to meet the present needs of the investor in Ontario."[9/] In Germany, comprehensive legislation, which if adopted will require improved auditing and accounting practices, is in process.

As progress is achieved in individual countries, is it too much to hope that there will be a movement toward international uniformity of auditing and accounting standards? A few years ago Jacob Kraayenhof, a former president of the Netherlands Institute of Accountants, in

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8/ Bulletin No. 20, July 1964, "Standards of Disclosure in Financial Statements," The Canadian Institute of Chartered Accountants.

9/ Province of Ontario - Report of the Attorney General's Committee on Securities Legislation in Ontario, March 1965.

discussing this matter at an annual meeting of the American Institute asked the question: "What good reasons can be given, other things being equal, for adopting different principles in various countries as to the valuation of stocks, as to methods of depreciation, as to whether or not reserves are concealed in the accounts or whether provisions are to be made for deferred taxes? As things stand this list could be extended indefinitely."

In support of his belief that more international uniformity is needed, he stated:

> "The international flow of capital for financing and participating creates increasing interest in the soundness of financial presentations and intelligibility of the explanatory notes. Many investors, not least those in the United States, buy shares of foreign corporations. Foreign subsidiaries of international concerns must produce financial statements for inclusion in the annual accounts of the parent company. The accounting principles used for amalgamation purposes often differ greatly from those underlying the official annual accounts of the subsidiaries." 10/

Today, as foreign trade and international investments and mergers continue to increase, his reasoning seems even more cogent. It is pertinent to observe that we are concerned with the flow of investments in both directions.

Another action of the SEC which extends the accountant's responsibility in the area of financial reporting is the adoption of a revised reporting and compliance form used under the Investment Company Act of 1940. In this report the accountant, in addition to certifying the financial statements, is required to express an opinion as to the fair presentation of information in many other items; e.g., asset coverage

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10/ The Journal of Accountancy, January 1960.

of senior securities and portfolio turnover rates, and in connection with certain other items to state that he has seen nothing to indicate that the company's answers are incorrect. This procedure provides assurance of reliable and more adequate financial data throughout the report. Similar extension of the accountant's attest function has been developed by other federal agencies.

In fact, for the Federal Government as a whole there has been a definite trend toward the reliance on the accountant's attest function through the increased use of independent audits in recent years. An informal survey[11/] reported in The Journal of Accountancy that 38,000 audits are stimulated or used by just 26 Federal agencies each year as compared to about half that number five years ago. SEC was the biggest user, with 11,825 annually. Other major users were Housing and Home Finance Agency (8,000); Interior Department (5,000); Renegotiation Board (4,000); Small Business Administration (2,250); Rural Electrification Administration (1,730); Federal Home Loan Bank Board (1,725); and Farm Credit Administration (1,500). The conclusions of the article were stated as follows:

> "There is every reason to believe that the Federal experience with independent auditors will result in a continuing increase in this work in the decade ahead . . .
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> "The result has been a happy one for the agencies involved, and has assisted in sound financial control over public funds. It is an area in which independent auditors can make a really meaningful contribution to the public interest."

I believe we can also conclude that such major use of independent audit reports will be a strong influence in the improvement of financial

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11/ Lyman Bryan, "Washington Background," October 1964.

reporting in general. Another step in this direction is the law enacted by Congress in 1964 which requires annual independent audits of the more than fifty Federally chartered private corporations. 12/

We noted above that the standards of independence in many foreign countries vary considerably from ours. In the past there has been much discussion in accounting literature of the difference in the view on independence between the Commission and the profession in the United States. This difference, if it existed, arose largely from the point of interest or the approach to the problem. The profession has placed primary emphasis in its rules on the concept that independence and professional responsibility are a state of mind founded upon character and integrity; whereas the Commission imputes these traits to all accountants who are entitled to practice under the laws applicable to them and, in its rule, has dealt with relationships which we consider either disqualify or tend to disqualify an accountant in this respect as regards a particular client. In a revision of Article 1 of its code of ethics in 1964, the AICPA included provisions regarding disqualifying relationships which are similar to our Rules 2-01 (b) and (c) of Regulation S-X as quoted below:

> "(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

12/ The Journal of Accountancy, October 1964.

"(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Although we are in substantial agreement with the Institute as to the tests of independence, and situations involving a lack of independence have declined, we still encounter some cases where we consider the tests are not met.

The Commission issued an opinion[13/] in 1962 in which it was held that an accountant, and his accounting firm, are not independent with respect to an issuer where the accountant acted as legal counsel for the issuer during the period covered by the financial statements certified by the accounting firm of which he was a partner. The opinion included the following statements:

"Though owing a public responsibility, an attorney in acting as the client's advisor, defender, advocate and confidant enters into a personal relationship in which his principal concern is with the interests and rights of his client. The requirement of the Act of certification by an independent accountant, on the other hand, is intended to secure for the benefit of public investors the detached objectivity of a disinterested person. The certifying accountant must be one who is in no way connected with the business or its management and who does not have any relationship that might affect the independence which at times may require him to voice public criticisms of his client's accounting practices.

"In our opinion, the partner's relationship as attorney for the registrant here during the same period covered by his firm's certification disqualified him and the firm of which he was a partner from certifying registrant's financial statements as independent accountants."

13/ In the Matter of American Finance Company, Inc., 40 SEC 1043 (March 19, 1962).

Just recently we had an inquiry from a lawyer as to whether financial statements certified by him would be accepted by the Commission in view of the fact that the accountancy law of his state contains a provision permitting an attorney to perform the services of an accountant. We cited the above noted opinion regarding the dual role of accountant-attorney and also stated that an accountant's certificate filed with the Commission must be signed by a practicing accountant who is professionally qualified as well as properly registered and in good standing as an accountant in accordance with the laws of his place of residence or principal office.

In another recent situation arising under the 1964 amendments the various partners of a small accounting firm, all of whom were close relatives, had a number of minor relationships with a prospective registrant or its affiliates, including a small loan made by a semi-retired partner to one of the affiliates. Because of the number of the relationships with the prospective registrant and the close family ties of the partners, we required that all of the relationships be terminated in order that the accounting firm could be deemed independent in certifying the financial statements to be filed with the Commission.

Because so many companies soon will be filing reports with the Commission for the first time and presumably many accountants will have their first contact with the Commission as a result, consideration of the independence question is particularly important. All registrants and accountants who have any doubts on this score should take steps to resolve them as early as possible.

The professional accountants and analysts organizations are engaged in continuous efforts to improve financial reporting and have made several important contributions just in recent months.

A particularly noteworthy contribution by the American Institute was in a large measure the result of the great ability and dedicated effort of Paul Grady. I refer to the recently published Accounting Research Study, "Inventory of Generally Accepted Accounting Principles for Business Enterprises." While the study does not introduce or advocate any new accounting principles, nor was it intended to, it may well contribute to such efforts in the future by virtue of the extensive codification of existing standards and practices and the authorities in support of them. One of the criticisms of the present state of the art that we often hear is that no one really knows what all the current principles and practices are and without such knowledge it is difficult to consider new ideas or principles or the possibility of narrowing the differences in practices. This study meets that criticism and provides a comprehensive base for further efforts toward improving financial reporting.

Incidentally, I understand that the Accounting Principles Board is currently engaged in studying its Opinions and the prior Accounting Research and Terminology Bulletins to determine whether any of them should be revised or modified to keep abreast of the changing needs for financial data. This action was directed to meet the requirements of the Special Bulletin of the Council of the Institute issued in October 1964 regarding "Disclosure of Departures from Opinions of Accounting Principles Board." The requirement in this Bulletin that departures from the Board's Opinions

be disclosed in the accountant's report, if he concludes that the departure has substantial authoritative support, should tend to reduce the departures and to provide better disclosure on the remaining ones. The provision that failure to disclose such departures would be deemed to be substandard reporting that would be considered by the Practice Review Committee provides a degree of persuasiveness that should encourage cooperation of the members and thereby lead to elimination of many of the alternative practices now observed.

We are noting improvements in financial reporting as a result of the issuance of the Accounting Principles Board Opinion No. 3 entitled "The Statement of Source and Application of Funds," which also dealt with the use of the term "cash flow." More companies are including this statement in their reports and thus are providing the stockholders with helpful supplementary information. The use of "cash flow" also seems to be decreasing and the data appears less confusing when considered with the funds statement. However, we still see some questionable usage of "cash flow" and related terms, especially in their reduction to a per-share basis, such as the inclusion in one report of a tabulation of a price-cash flow ratio for several years, or in another report an attractive bar chart which emphasizes per-share amounts of cash flow.

In connection with per-share data I might add that there are indications that too much emphasis is being placed on the single figure of "earnings per share" without sufficient prominence being given to other pertinent information. In registration statements filed with the SEC prior to 1951 a summary of earnings was required administratively but a

computation of earnings per share was generally not required except in cases where the securities were considered very speculative or there was a significant variation in earnings from year to year. However, there was much evidence that the calculation was being made erroneously in many cases.

When the form used by most companies for registration under the 1933 Act was revised in 1951 a requirement for the summary of earnings was included and provision was made for the computation when common stock was registered. This action was taken in recognition of the wide-spread use of the per-share figures by financial analysts, reporting services and the financial press generally. At the same time this put us in a better position to determine that the figures were computed consistently and fairly for the purpose intended. In addition, the following instruction to the summary of earnings was included:

> "Appropriate footnotes to the summary, including references to other parts of the prospectus, shall be furnished whenever necessary to reflect information or explanations of material significance to investors in appraising the results shown."

If the summary included material extraordinary debits or credits, a determination was made in each case as to whether earnings per share should be presented to show amounts per share before or after such items, or separately.

The danger of reliance on a single figure has long been recognized even though often disregarded. In 1940 Warren W. Nissley warned against the investor's "blind use of a single" dollar per share "amount as his basis of estimating future earnings " He also stated, "He should at

least determine the portion thereof applicable to unusual transactions and make proper allowance for the effect of such transactions.[14/]

The American Institute had also issued warnings in the same vein in 1941 and 1947, and in 1958 issued Accounting Research Bulletin No. 49 on "Earnings Per Share" with the following advice:

> "2. The Committee has previously considered certain aspects of this matter 2/ and now reaffirms its earlier conclusions that:
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> (a) It is, in many cases, undesirable to give major prominence to a single figure of earnings per share;
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> (b) Any computation of earnings per share for a given period should be related to the amount designated in the income statement as net income for such period; and
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> (c) Where material extraordinary charges or credits have been excluded from the determination of net income, the per-share amount of such charges and credits should be reported separately and simultaneously.
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> 2/ Accounting Research Bulletin No. 43, Restatement and Revision of Accounting Research Bulletins (1953), Chapter 3, par. 14. Also see Chapter 2(b), par. 4."

It seems clear that too much emphasis has been placed in some media on the single figure of earnings per share. Investment decisions should not be based on one figure even if it is computed correctly. The company's prospects should be considered in light of all pertinent data--within the company, in comparable companies, and in the economy as a whole. Many other factors, such as the quality of management, the type and extent of research programs, or advertising efforts, affect the prospects of a company but cannot be reduced to a dollar basis. Nevertheless, they may

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14/ Corporate Financial Statements - Proceedings of the Accounting Institute, 1940, Columbia University Press, p. 100.

be more important in analysis of the company than a single earnings per share figure.

Recently Thomas D. Flynn, current president of AICPA, in an address commented on this matter as follows: "The small to medium investor, however, would quite naturally like to have some rule-of-thumb which he could apply to all companies without taking the time to scrutinize underlying data. So he tends to base judgments on what appears to be the solid, precise figure of net income per share. But it is just not possible to encompass all the complexities and variables of a business, particularly one of any size, in a single figure, especially for a single year, and for this reason CPAs have for some time been pointing out the limitations inherent in an unsophisticated use of earnings-per-share." At another point he stated: "I should like to point out that any limitations of the earnings-per-share figure apply even more to cash-flow-per-share."[15/]

The Institute's research study on "Reporting the Financial Effects of Price-Level Changes" has made a great effort to clarify the issues in this important problem for management and investors. The problem has been more pressing in many foreign countries where inflation has been severe and, as we have seen, the practice of adjusting fixed asset values for price-level changes is accepted in several of them. Ralph C. Jones, who has studied the problem for many years, stated that there was a long-term trend in this country toward recognition of the problem when he spoke on the subject at the annual meeting of the American Accounting

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15/ An address before The New York Society of Security Analysts, January 27, 1965.

Association in 1963. The Institute study's conclusion that the effects of price-level changes should be disclosed as supplementary data is a more reasonable approach to the problem than that taken in the 1920's when the practice of reporting appraisal values on the balance sheet was widespread. Then the appraisal surplus was often transferred to earned surplus on the instalment plan or the income statement reported depreciation on the cost basis. This accounting is recognized today as inconsistent.

Despite the recommendations of a number of studies, disclosure along the lines suggested has been scanty and the debate goes on. Mr. Grady in his study states that in his view ". . . reporting the financial effects of price-level changes, in addition to historical statements, is essential to a fair and comprehensive presentation of financial position and results of operations . . ."[16/]

In his new book published in the same month as the inventory, Eric L. Kohler comments on the pressures for revaluation and observes that "Only a few professional accountants have developed any enthusiasm over ~~this~~ price-level adjustments ~~/the AICPA/ report,~~"[17/] and concludes his criticism by asking ". . . can one be expected to believe that management, in a free economy, would deliberately discard the competitive advantage accruing from a low-cost investment in fixed assets?"[18/]

16/ Grady, op. cit., p. 370.

17/ Kohler, Eric L., "Accounting for Management," Prentice-Hall, Inc., 1965, p. 263.

18/ Ibid., p. 265.

Support for expressing historical costs in terms of current dollars is often confused with arguments in support of appraisals or other determination of value as a basis for reporting rather than historical cost. A recent case in which a Federal court found persons guilty of violating the fraud provisions of the Securities Act of 1933 is an example of old tricks being warmed up and used over again by a new generation of unscrupulous promoters. The indictment charged, among other things, that the defendants falsely represented to investors that a corporation had 125,000 acres of timber concessions in a foreign country valued at more than $9,000,000 and that another corporation had diamond and gold concessions in a foreign country for a net worth of over $107,000,000.[19/]

These exaggerated claims of value are reminiscent of the facts brought out in an opinion of the Commission in 1940.[20/] In this earlier case the Commission found that $9,000,000 stated as cost of timberlands, which sales literature represented as having a value of $156,652,000, was false. The accountants in this case said in their certificate that it was not possible to make any determination of value of the assets and consequently they could not express an opinion on the balance sheet. Some of us recall these old cases when we review current filings which seem to be making an effort to turn the clock back.

The Institute's current study of accounting for pension costs should aid in clarifying reporting problems in this area where we note a considerable lack of uniformity and questionable consistency from year to

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19/ SEC Litigation Release No. 3158, February 19, 1965.

20/ In the Matter of Resources Corporation International, 7 SEC 689 (July 10, 1940).

year. It has long been our position that the accrual basis is the appropriate basis for accounting for pension costs. This was stated in the Commission's Annual Report to Congress in 1947 as follows:

> "The Commission has come to feel that serious consideration should be given to the proposition that even under voluntary plans in which there is no strict legal liability to continue pension payments a corporate management expecting to remain in business and enjoy good labor relations would not--if in fact it could--abandon a pension plan, and therefore a realistic approach is to recognize the liability. However, in the absence of a clear-cut legal liability the Commission has not as yet, as a matter of policy, insisted upon the showing of an actuarially determined liability for the accruing pensions. Instead a clear footnote explanation is accepted."

The Institute also indicated preference for a full accrual basis in Accounting Research Bulletin No. 47 published in 1956, but only the minimum accounting and disclosure required by the Bulletin is observed by many companies. It seems something of a paradox that accountants will give a clean certificate when an item as important as pension provisions is reported on the cash basis. As the number of pension plans increases and their costs become more significant, it is difficult to see any valid reason why the costs should not be recorded on a more orderly basis through a regular accrual method of accounting.

The Financial Analysts Federation has been very active in efforts to improve financial reporting. This organization has established a practice of awarding annually "Citations for Corporate Reporting" in four or five industries each year to encourage improvement throughout the business world. In 1964 the awards were made in the chemical, electrical equipment and steel industries, and in the life insurance and savings and loan fields.

The following significant statement was included in the annual report of the Federation for 1963-64: "The Sub-committee members found generally that there has been real improvement in the annual reports of the companies (and industries) which were studied this year; in fact, in the case of the Chemicals especially, the differences in excellence among the top several companies' annual reports was small." At the same time, however, the report listed a number of areas in which financial reporting should be improved, particularly in certain industries. For the electrical equipment manufacturing industry the suggestions were:

1. Include statistical summary of salient operating data and other corporate information specifically designed for the professional investor and for industry trade associations, government groups, and other interested parties.

2. Attempt to issue annual reports sooner after the end of the accounting year than has been the practice.

3. Provide detailed information on source and application of funds, in the form of a statistical summary.

4. Improve discussion of sales trends, cost influences, and similar matters, providing shareowner and analyst a better understanding of company performance.

5. Cite possible impact of new products and facilities, pricing and related matters on company's relative performance in coming intervals.

Suggested areas for improvement in the steel industry were:

1. Data on shipments by type of product or market, which is given to American Iron and Steel Institute.

2. Figures on ingot capacity and operating rates for industry and individual companies.

3. Information on nonsteel-making activities.

4. Data on expenditures for maintenance and repairs, which is supplied the SEC.

5. Information on pension charges--particularly in regard to unfunded costs of past services.

6. Disclosure of selling, general, and administrative expenses.

7. Data on sinking fund requirements and on the nature of operating reserves.

8. Method of depreciation used.

Adoption of these suggestions should bring about further improvements and similar recommendations could be made to other industries. The Federation had previously, in 1962, sponsored a very comprehensive study of this type by Dr. Corliss D. Anderson of Northwestern University, which was based on surveys in sixteen industries and which contained many suggestions for improving corporate reporting.

Many actions of individual companies or company groups are contributing to improved financial reporting. The current survey by the American Petroleum Institute directed at identifying the accounting practices followed in the oil industry and stating the reasons in support of each practice may be noted here.

While we have dealt with many areas where we see trends toward improved financial reporting, this is not to say that all of the problems have disappeared. Much of our time is still occupied with problems. We cited a need previously for better reporting on pension costs. Another problem that we encounter frequently is the lack of clarity in reporting under what we call the special item treatment for non-recurring gains or losses. There has long been a tendency to treat non-recurring losses as direct charges to surplus and to treat such gains as special item credits on the income statements. More recently we have noted several

cases in which special item treatment was accorded to items of cost which would have been more appropriately charged in some cases to regular operating expense, deferred in other cases to a later period, or in some cases treated as an appropriation of surplus.

Costs related to relocation of plants or to reorganization of operations, particularly in connection with the closing of a plant or the phasing out of unprofitable product lines, are of a type which is often reported in a manner which suggests that the substantial item charged to surplus in reports to stockholders, and treated as a special item after the determination of income for the year in reports to the SEC in accordance with our regulations, includes elements which should have been recognized as operating charges in current and prior years and other portions which include provisions for general contingencies and premature write-off of costs relating to future periods. In either situation the operating experience of the company for a period of years is reported as better than the facts support. Examples of such conglomerate and puzzling charges are:

> "The company has provided for closing-down costs, severance pay, moving expenses and new plant starting-up costs in the estimated amount of $_____;"
>
> "Provision for loss on disposal of properties and expenses relative to plant relocation $_____;"
>
> "Losses or expenses incurred or anticipated in connection with relocation and closing of processing and marketing facilities $_____;
>
> "$_____ has been charged to retained earnings for possible losses inherent in rehabilitating foreign manufacturing operations;"

"Provision for losses to be incurred as a result of the reorganization of certain retail operations, less estimated future tax reductions."

The wide divergences in practice in reporting "special items" indicates a need for some "narrowing of differences" in this particular accounting practice, possibly by a reconsideration of the whole subject of the relative merits of the "all-inclusive income" statement as contrasted to the "current operating performance" type of statement. Encouragement for such a reexamination is found in the Inventory of Generally Accepted Accounting Principles for Business Enterprises.[21/]

Any survey of accounting principles can only conclude that change is almost constant and likely to continue and that alternative methods of implementing generally accepted accounting principles will persist. An inventory, whether limited to some major items as was done in the SEC's response to the request of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce of the House of Representatives[22/] or are of the detail of the Grady inventory, serves to emphasize the need for continuing study looking toward the elimination of unjustified differences in accounting. This requires patience, for reconciliation of opposing views on controversial matters of principle when agreement as to the facts sometimes seems impossible is not easy to accomplish. But we must continue to work at it.

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21/ See pages 301-302.

22/ Memorandum prepared by the Office of the Chief Accountant, Securities and Exchange Commission, in Response to Request of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, on H.R. 6789 and H.R. 6793.