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By George O. May

Perhaps some of you may think that the choice of title suggests an unbecoming levity on my part. I have, however, never been one of those who thought that serious subjects should be discussed only in austere language and portentous tone. In fact, I have thought that reformers were usually more successful if they avoided that austerity which often suggests complacency if not self-righteousness, and adopted a little more of the humor which is akin to a sense of proportion and a sympathetic understanding.

If I am to appear before you today in what might be called the rôle of an Emily Post in the field of financial accounting, I should first show some qualification to do so. While I have never entertained at the high financial table and seldom been even a guest, I have been employed by some of the best financial families when they were giving parties and for some years I have had the honor of being retained as a consultant by the body which, thanks very largely to the efforts of my good friend, Mr. Hoxsey, has come to be recognized as unquestionably the greatest non-professional authority on the etiquette of financial accounting, the New York Stock Exchange.

I have naturally noted with considerable interest, perhaps some concern, the changes in table manners and habits that have resulted in the last few years from the influence of Washington.

Until about three hundred years ago, the only implements provided at the table for the consumption of food were the knife and one form of spoon. About three hundred years ago, early in the seventeenth century, the fork was added to the equipment. That is true at least in regard to those of British origin. Those of you who have Italian ancestors may take pride in the thought that they probably used the fork considerably earlier, because the fork, like double-entry bookkeeping, came out of Italy.

During the last three hundred years the art of the silversmith has provided us with a large variety of knives, forks and spoons, so that we have now some table implement that is adaptable to almost any kind of food, although etiquette still seems to me to

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require the use of a fork in some cases in which a spoon or knife could profitably be employed.

Now, I have a feeling that until comparatively recently, anyhow, we have remained, in the field of financial accounting, rather in the knife-and-spoon age. I think that in the field of industrial accounting, accounting as an instrument of control, far greater progress has been made. If I may continue my analogy without inviting a jibe at the nature of the process by which accounts are prepared for publication, the equipment of the kitchen has improved more than the equipment at the table. I am wondering whether now we can not do something to bring about an improvement in the table equipment similar to that which has been brought about in the kitchen equipment by coöperation between accountants and the business-machine companies.

The Securities and Exchange Commission is taking an active part in this matter. Up to now, one must recognize, I think, that its efforts have led to an increase in bulk rather than in the efficiency or the elegance of the accounting information that is given to the investor. Those of you who are accustomed to the simpler and more direct language of the old prospectus may look with some concern on the modern prospectus with an over-ornamentation of cross-references and footnotes, just as those who have come to know the beauty and simplicity of the early Georgian silver in England, find their aesthetic sense offended by the rococo ornamentation of the later eighteenth century silver.

But, as a matter of history, it is a fact that the first movement towards the improvement of the English silver about 1700 was an increase in bulk. The silversmiths started putting more real silver into the articles that they supplied to the public, and after they had done that they found it was possible to simplify the ornamentation and perfect the designs so that they produced something that was both more solid, more effective and more beautiful than anything that had been known before. I am wondering if it is too much to hope that just as the finest English silver grew out of a currency crisis in 1697, we may ultimately get the finest financial accounts that we have had as a result of the depression of 1932.

The subject, then, that I really want to talk to you about today (dropping analogies, which should never be pressed too far) is the inefficiency, if not the danger, entailed in the use of accounts for purposes for which they were not designed, and for which they are not appropriate. Since our time is short, I am going to narrow it down to the question of accounts in annual reports and accounts in prospectuses, and in order to keep the subject still more clearly within our time limits, I am going to confine myself to the consideration of income figures, which are, I think, by common consent usually the most important piece of information contained in an annual report or prospectus of a going concern.

It seems to me it should be obvious that it is not possible to get one form of account or one statement which will serve equally well the purposes of regulation, taxation, annual reporting and a security issue. Yet this does not seem to be at all generally appreciated. We find people regarding an annual report as if it were a prospectus, and we have people complaining if a statement in the prospectus does not conform with the statement prepared under a very technical tax law, and suggesting that it must be misleading, if it does not.

When you think of all the complexities of modern business, it seems to me a matter of surprise that accounts can be prepared, comparatively simple accounts, that are as useful as those accounts are today for even a single purpose, and that it is altogether unreasonable to expect the same account to serve a variety of purposes. Accounts should be prepared with the purpose for which they are to be used clearly in view.

Now, starting from that point, we must consider what is the difference between the purpose of an annual report and the purpose of a prospectus. The purpose of an annual report is historical. It should be considered a report by the managers of the property to the owners. A prospectus is a representation made in connection with an offer to sell. An annual report is a single chapter in a continuous history, to be read in conjunction with all the previous chapters. A statement of earnings in a prospectus is a section taken out of the history of the company designed to be self-sufficient and self-contained, and designed also to throw light on the earning capacity of the business. Its importance is not historical; its importance lies in the implications as to the future which may be drawn from it. Incidentally, if I may digress for a moment, it is one of the great defects of the present legislation, as I see it, that by requiring so many statements to be published it destroys the implications which could fairly be drawn if they were made voluntarily.

If you voluntarily put a statement into a prospectus, you may fairly be charged with responsibility for the implications that would naturally be drawn from it. You are not entitled to make the statement if you know that people will inevitably draw inferences from it that the actual facts do not justify. If you put the same statement in because the statute requires it, the statement does not carry the same implication, and, I repeat, a prospectus is important for the implications that people draw from it, not for the historical record it presents, purely as history.

The sharp distinction between the nature of an annual report and a prospectus has, I think, become blurred in recent years. I may perhaps have contributed in some small measure to misconceptions on that point, and if so, I am glad now to do something to repair my fault. I have said in the past, and I still feel, that those companies which list their securities and endeavor thereby to get the benefit of a broader market for their stockholders, should recognize an obligation to publish more information than they would otherwise feel obligated to give, so that the potential traders may have some basis upon which to trade. I should, however, be very sorry if the idea were allowed to prevail that the primary purpose of an annual report was to give information to speculators.

I think the first duty is to the continuing stockholders. Certainly, I should not like to have our executives generally act as if they thought Maynard Keynes was right when he spoke of this country as one in which industry was conducted as a side-show of a casino.

I think the misconception in regard to the nature of an annual report is reflected in the act of 1934 and encouraged by it, particularly by section 18, which imposes certain liabilities on directors and others for statements made in annual reports. That section may have led to greater care in making statements in annual reports, but I think it has also had the effect of making statements in reports more guarded and more carefully qualified, and I think it has had the definite result of making the statements which appear in the prospectus less helpful to investors than those which they formerly received.

I do not wish to attempt at this time to discuss the merits of the securities legislation as a whole. It has achieved valuable results in many ways, and if I criticize it in some respects, I should not be regarded as condemning it as a whole. I do feel that it has very definitely led to the presentation of accounts in prospectuses which are not appropriate for the purpose, usually accompanied by footnotes which explain the inappropriateness of the figures which are being given.

As an illustration, the form of statement in regard to earnings which we used to have, in what I suppose I should call the bad old days, was, "The earnings of the company for the past five years have been as follows:"

What do we get now? Probably something like this: "The following figures are taken from the income statements which appear in the offering prospectus and must be read in conjunction therewith and with the footnotes and explanations attached thereto." And if you turn to the prospectus, as likely as not you will find an explanation that in some or all years the accounts reflect certain adjustments which had nothing whatever to do with the earnings of those years, implying that those figures, therefore, are not appropriate for the prospectus. No doubt, there will be an explanation of just what those adjustments were, and any investor who happens to be an accountant—I purposely put it that way, not any accountant who happens to be an investor—can perhaps make up a reasonably appropriate statement for himself, but as a means of enlightening the small investor this is not a very effective method.

You may feel, as I confess I do, a certain regret that the accounts to which you and we put our names that appear in prospectuses today, are not as illuminating as those which we used to put out in the old days. Even if that is true, it does not necessarily mean that the act has had a bad effect. Nearly all legislation is in the nature of a leveling process, and if you view with regret the leveling down of the standards you have created, you must realize that may be only a small price to pay if the act has resulted in a much greater leveling up of the standard of the less satisfactory prospectuses that used to be issued.

At the same time, I think you and we should endeavor to see that this leveling process shall be achieved as far as possible by raising low standards and with no more lowering of the highest standards than is unavoidable, and I think that we can rely on the coöperation of the commission in doing this.

It is unnecessary to explain to you gentlemen why accounts, as they appear in annual reports, are largely historical, largely conventional, and why estimate and opinion enter so much into their preparation. Thanks to the stock exchange and the securities commission, I think financial people now generally recognize not only that that is so, but why it must be so.

And, of course, estimates can not always be right; sometimes they are found to be wrong to a considerable extent, and if they are wrong the error, when it is discovered, has to be corrected. Personally, I believe that it is wise for executives always to aim to have a margin of conservatism in their estimates, and, if so, that means that they will normally be bringing into the accounts of later years those margins as the actual requirements become known. Personally, I also think that adjustments of this kind should as a rule be reflected in the current income account, and not through the surplus account. But whichever way it is done in the report, when you come to a prospectus those adjustments ought to be thrown into the years to which, in retrospect, they are recognized as belonging. That used to be the practice until regulation came upon us.

When you ask an executive, now, to adjust, for the purposes of a prospectus, accounts that have appeared in an annual report, he is reluctant to do so because he says that will imply that the original report was wrong and invite action under section 18. It is all very well to tell him of the difference in the import of the prospectus; he will reply, "Well, will any one of the innumerable courts in which action may be brought recognize that distinction, and even if they will, are you equally sure that possible complainants will recognize it and not subject us to a lot of unnecessary expense?"

Now it is not possible to give assurances on that point—in fact it finds some support in rulings of the staff of the commission; therefore he is likely to take the line of least resistance and put out the accounts exactly in the form in which they appeared in the previous report, accompanied by explanations, such as I have indicated, of the reasons for the inappropriateness.

I think if we are going to get any real improvement in the accounts which appear in prospectuses that are issued, if we are to get anything like a return to the sort of useful information which we used to give, we must first get some action from the commission that will allay those fears and apprehensions. I think it would be a very valuable thing if the commission would explicitly recognize the essential difference between an annual report and a prospectus, and would state categorically that in its opinion the adjustment for the purposes of a prospectus of accounts that have been issued in an annual report carries no implication whatever that the original report was erroneous. If we could do that, then we would get back to the old practice of adjusting figures that have appeared in the reports, so as to make them appropriate for a prospectus.

After all, a report, as I said, is just another chapter in the history of the company, and everything in the accounts which form part of the report is affected by what has been done in the past, by the form of the company's organization, and all those things. In the prospectus the position is quite different.

I don't want to bother you with details, but I should like to recall a single case, not mentioning any names, that attracted my attention, which has the additional interest that it was the prospectus of a railroad which is subject to the Interstate Commerce Commission. That company published in a prospectus an income account for ten years and a profit-and-loss or surplus account.

Now, as you looked at the profit-and-loss or surplus account, you found in the later years large charges for what are called delayed debits or, in other words, charges which related to prior years. It is practically certain that a substantial part of those debits ought to have been charged against the earlier years in the ten-year period covered by the income account, and that, if you were making up one income account for the whole ten years, those charges would have been made against it, with the result that the income for the ten years would have been very much less than the aggregate of the figures shown in the income account for the ten separate years. And though the accounts were presented as required by law and the publication of the profit-and-loss account supplied the information necessary to show why the income account was not really appropriate for a prospectus, the form of presentation was distinctly unhelpful to the investor.

That is a case where we get accounts designed originally by the Interstate Commerce Commission for purposes of regulation, then adopted in the annual report and finally employed in the prospectus, two removes away from their original purpose. You can not make accounts serve as many purposes as that and serve them adequately.

Indeed, returning to the title of the address, I think you can eat peas with a knife with a great deal more comfort and success, and less danger, than you can use accounts for one purpose that have been prepared for an entirely different purpose, as, for instance, to determine the present financial worth of a business from a balance-sheet that has been prepared to show what has become of the money which has gone into it, which is the historical purpose of a balance-sheet.

I am sorry there is no representative of the commission here, because I think we can not do very much in this field without the coöperation of the commission, but I do express the hope that those of you who are concerned with the issue of securities, and most of you are, will constantly bear in mind this difference between the prospectus and the annual report; that you will use your influence to bring about recognition of that difference by the commission, and will use your influence to see that difference recognized in the statements which are submitted to the public, thereby, I am sure, improving the quality of the service which you render to investors to their benefit and ultimately, therefore, to your own.