"PLAIN TALK IN ACCOUNTING"

ADDRESS

OF

JAMES J. CAFFREY

Chairman, Securities and Exchange Commission

To the

AMERICAN INSTITUTE OF ACCOUNTANTS

Miami, Florida

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Mr. Chairman, Gentlemen:

I bring you greetings on behalf of the entire Commission and of myself. We wish you a pleasant and fruitful meeting. We would all like to be with you, but since that is impossible I have accepted your invitation as an ambassador to a group with which we have worked closely, amicably, and effectively for a long time.

This is my first address to a professional group of accountants; and, I understand, this is the first time a Chairman of the Securities and Exchange Commission has addressed the Institute. It is a perfect occasion for high-sounding phrases. But I would rather use it to do some plain talking. I do that because plain talk is the substance of my message to you.

I cannot afford the luxury of either a personal or professional bias on accounting problems. Although I am a lawyer I do not view accounting with the squint-eyed hostility of some lawyers. Although I like to speculate about technical accounting I have no technical ax to grind. My position requires me to bear in mind the needs of investors, to think in practical terms of the effect of regulation on company managements and on those who render professional services to companies, to make decisions based on legal considerations and to reach judgments based on accountants’ presentations. I discovered early that there were two important things I had to do: think straight and talk plain. Out of the welter of complicated legal, accounting, analytical, and other elements that enter into our deliberations the challenge is to find the issue reduced to its simplest form and to state the conclusion in the plainest way possible.
To my mind the accountants’ job is very similar. Out of the welter of raw elements that go into the making of a financial statement he must find the simplest and most sensible rules of order and he must state his conclusions in the most understandable form possible. The single, most important challenge which faces the profession is, to my mind, the challenge to talk plain.

I do not by any means underestimate the extent of that challenge.

Perhaps the most striking thing about your profession is the enormous change that has taken place in the position of the accountant. From the simple scrivener tabulating receipts and disbursements, with limited functions and limited responsibilities, he has become the processing plant through which the raw data of finance must pass before it can be compiled in the vast financial encyclopedia of our time. To the terminology of receipts and disbursements he has had to add a language to describe newer concepts; within the framework of the balance sheet and income statement he has had to find a place for items of multiple, complex, and ambiguous character. To the simple dimension of income and outgo there have been added new dimensions in which to reflect spending not yet done and receipts not yet in hand.

Further, the accountant for the large enterprise is often called on to account for the operations of an “entity” only in the bare legal sense. Within a single corporate framework there may be divisions, each one of which represents an enterprise almost independent in its organization and operation. The holding company system, as, on the other hand required the development of techniques of combination and consolidation to account for a diversity of corporate entities in reality joined in a common economic
To these difficulties have been added many others. Not only is the imagination staggered by the growing size and complexity of what the accountant must account for, but it is not always clear even for whom accountants account. The single enterprise is no longer the personal concern of one owner or a small group of owners. Its ownership is likely to be spread among vast numbers of security holders, aggregating into a welter of conflicting legal and economic interests in the single business unit. In any given situation the exercise of an accountant’s judgment may vitally affect the ownership interests of one competing group of security holders as against another.

History seems to have an endless storehouse of burdens for the accountant. His presentation must also satisfy the regulatory agencies interested in the operations of the economic enterprises for which he accounts. One group in government is charged with protection of the revenue, another with the protection of security holders, another with the protection of rate payers, another with the protection of employees, and so on. Each of these bodies may approach the balance sheet or the income statement with a different emphasis, and may read it for a different message. Nevertheless, the accountant is expected to produce one single adequate, truthful, and understandable statement.

History has thus thrust the accountant into a crucial role. Management, labor, conflicting groups of investors, potential investors, and governmental interests make vital decisions based on the story told by the accountant. Yet the accountant is no mere reporter who sits by the sidelines giving a play by play description of the business. Save in the simplest kinds of business he has been given a task which embraces interpretation as well
as mere recording; judgment as well as mere tabulating; art as well as science.

What does this add up to? Perhaps the simplest way of putting it is to say that the accountant’s position has become a position of power. In this regard history has an even hand, with power she doles out responsibility. The full measure of that responsibility is a full bible of accounting. I have neither the time nor the ability to cover that much ground. I would like to touch briefly on some problems that, with the layman in mind, strike me as basic and perpetual.

An accountant necessarily deals with terms of art. But those terms have popular meanings to the non-professionals who read and rely on accountants’ statements. While I might be ill at ease in technical arguments about the full implications of such words as “profit”, “income”, “surplus” and “depreciation”, when I read an accountant’s statement I have a very well-defined reaction to these words. I assume that their character and quality of these accounts are the same for different statements of the same or different businesses. I assume that the accountant has told me how much the business made or lost during the year and how much it can pay out without impairing the investment. I expect the statement to be complete: if it covers income and outgo I feel entitled to believe that charges and credits have not been tucked away or placed anywhere else. If there are necessary qualifications to what I read in the figures I assume that these will be flagged for me where they are most pertinent and will be stated in such a way as to permit me to appraise the statement intelligently.

These are the things a layman expects. In my opinion these expectations are the core of accounting. They are the common ground upon which the public and the
profession communicate; they are the only source of vitality for accounting concepts; they define ideals - vague and difficult as they may be - toward which the philosophy and language of accounting must move to be vigorous and meaningful. When accounting terminology loses touch with common meanings it becomes at best a verbal exercise and at worst a polite method of lieing. As necessary as it may be for the accountant to choose between alternative theories or alternative applications of theory in the course of making his statement; as multiple and as complex as may be the elements that go into the achievement of the net result, it must mean pretty much what the layman thinks it means or it has no public meaning at all.

Thus, there are necessary limitations to the art of accounting. It cannot be permitted to take the accountant so far afield that his language loses its essential touch with reality. The common man’s understandings of accountants' words are heavy anchors against drift in representation of financial facts. They must form, in all statements, for all companies, and wherever used, the essential content of accounting terminology.

Every generation brings with it those who strive for certainty, and it brings also those who insist that certainty is a will-o’-the-wisp. Of course, absolute certainty in accounting is not now, and may never be, an achieved fact. But it is nonsensical and dangerous to deny its validity as an ideal. Your profession has in the past decade made many improvements in that direction. They are palpable evidence that we can go still further.

There is a vast premium in continuing efforts to achieve certainty, comparability, and rigid independence in accounting. We must remember that an accountant’s
presentation is, to most people who read it, like a mariner’s compass in the fog. It is all they have to go by. If the guide fails they are lost. They cannot trace back the method of arriving at the statement. They do not have the skill to temper their reading with sophisticated judgments about diversities in accounting treatments. They have no choice but to assume that the accountant’s presentation means what it says and that it tells the whole truth, on the basis of an independent and thorough survey of the facts.

Full respect for the stewardship inherent in the position of the accountant requires more than conscientious performance by individual practitioners. Who is to blame if the balance sheets and income statements of the X and Y companies certified by different firms, are found to use the same language, within the scope of accepted or acceptable accounting principles, to describe different things? There may be excellent arguments to justify both presentations and both may have been conscientiously certified. However, if they use the same words to describe different things even an experienced investor who makes a comparison between them has been seriously misled by a dangerous though honest falsehood. Each statement, telling the truth in its own way, is justifiable. Put together they distort each other.

It is here that the Institute has done much in the past and can do more in the future. Individual practitioners, working alone cannot reduce their concepts to generally applicable formulas. Comparability, which is one of the vital elements of meaningful accounting, presupposes broadly applicable standards, so concise and well-defined that variability is eliminated or reduced to to an insignificant minimum.
How can we do this job best? First I think: it obvious that we must preserve and improve the close cooperation of the past between the S.E.C. and the Institute. Accounting standards cannot be improvised or manufactured in a vacuum. The Commission needs the benefit of the close touch with facts and practice which the profession gives us in talking our rules over with us. Only in that way can we be sure of vital and meaningful standards. On the other hand accountants need our continuous support. What is inevitably a part-time effort of busy members of the Institute and its committees is a full-time effort of the Commission. What, in the end, the Institute can only suggest to the profession we can require.

I cannot stress too strongly the importance of keeping and improving our cooperative relations of the past.

The American Institute of Accountants and the Securities and Exchange Commission have been partners in a common endeavor. We at the Commission who have worked with you know how much the public owes to accountants who have devoted so much of their time and effort to bring about improvement in accounting standards and accounting techniques. You have shown your deeply felt responsibility in many ways; you have given unstintingly of your time and skill in reducing ideals to workable formulas; you have been an important vehicle in transmitting the benefit of new developments to the accounting profession in general, to the businesses for which you account, and to the public which depends so vitally upon your efforts. Because of this, you are much more than an association of professional practitioners devoted to your own interests - you are a means of safe-guarding and transmitting the heritage of your art and
We at the Commission know, too, how important the Institute has been as a standard bearer in its field. So-called “Regulation” of accounting by the Commission has not meant policing a best. Because of the high ethical sense of the profession it has involved, most pertinently, a legislative job; it has meant mutual effort in the development of a rational code. Once you and we have agreed on the general acceptability of an accounting principle or practice, whether it is promulgated by you or by us, we feel reasonably sure that the profession will obey it. What in some other fields is done largely through coercion and discipline is done in the accounting field largely through voluntary adoption of, and voluntary adherence to, professional standards. We have through this valuable partnership built an enviable record of progress. We do not dare do less and the public looks to us to do more.

Lastly I wish to stress the importance of scope in any program to improve the adequacy and comparability of financial statements. Among those whose interest is served by such improvement the investors stand prime. They are, in the classical sense, the owners and creditors for whom accountants account. At the very least any program of improvement should embrace all companies in which public investors have an interest. The Commission had this in mind, among other things, when it recommended to the Congress that the Securities Exchange Act of 1934 be amended to make it applicable to some 1,000 companies - each having at least $3,000,000 in assets and 300 security holders - not now required to file financial statements with the Commission because they do not happen to have securities listed on a national securities exchange.
To the members of your group - those who know best what sound accounting means for investors and the public generally we shall look for help in framing workable and intelligent legislation. We have no unalterable, pre-conceived ideas about how the law should read, or about what the extent of its coverage should be. You gentlemen would have much to do with translating such a law into action. Your voice should be heard in the councils of deliberation.

Our direct interest in these matters is limited to businesses in whose securities there is a public interest. But you have no such limitations. Financial history seems to indicate that any business may be a candidate for development into a corporation with a wide public interest. The transition accountingwise would have been eased in many cases which have come to our attention if the guiding hand of truly independent accountants working with sound principles and procedures had been applied earlier in the life of the business. Most of you, I suspect, literally have grown up with many of your principal clients. This process will continue. Failure on your part to maintain a progressive and constructive attack on accounting problems on a broad front can only lead to a usurpation of the field by others. With proper foresight and a cooperative attack upon new problems of accounting as they arise in the future conflicting procedures will be avoided and your profession will retain the confidence of clients and investors alike.

Thank you.