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COMPARABILITY IN FINANCIAL REPORTING: THE CONCEPT
AND ITS APPLICATION TO FINANCIAL ANALYSTS

DISSERTATION

Presented in Partial Fulfillment of the Requirements for the Degree Doctor of Philosophy in the Graduate School of The Ohio State University

By

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* * * * * *

The Ohio State University
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PUBLICATIONS

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CHAPTER I

INTRODUCTION TO THE PROBLEM AND
DESCRIPTION OF THE RESEARCH STUDY

The Problem

In recent years, increasing criticism has been levied against the accounting profession by important members of the business world. Much of this criticism has been concerned directly or indirectly with the lack of comparability among financial statements published in corporate annual reports. This criticism comes from management, financial news writers, financial analysts, stock exchange officials and representatives of the S.E.C. The following comments are typical:

Accountants have high standards, but low standardization. It is as if every audit were custom-produced for a particular corporation. As a result the investor does not get adequate comparability of income accounts or balance sheets, even within the same industry.\(^1\)

In some instances it is almost as futile to try to compare the regularly published statements of two different companies as it is to add apples and pears.\(^2\)


The growing lack of accounting comparability in published financial statements of American Corporations, for which accountants must accept their share of responsibility, has caused concern to financial analysts as well as to many CPAs. It has certainly complicated our daily tasks and added to our burdens. ... The impact of differing accounting policies on corporate financial statements is already of sufficient import to warrant the close attention of the over-worked investment analyst.

Even the S.E.C. has become more critical of the lack of comparability in accounting reports, judging by the recent announcement by the S.E.C. that consideration is being given to "limited action 'which would eliminate' unjustified differences in financial statements of similar companies."^4

Members of the accounting profession have also expressed some concern over the problem of comparability in financial reporting. There are numerous articles in accounting literature which deal with comparability or closely related subjects. An examination of this literature reveals widely differing views on comparability and related issues. Accountants seem to agree that some progress is needed in narrowing the areas of difference in accounting procedures. Differing views exist, however, on such issues as the extent to which comparability


can be obtained, the sense of urgency, and the proper procedures for the narrowing process.\textsuperscript{5}

Although many accountants express concern about a lack of comparability in financial reporting, discussion of the subject has been superficial. The essential issues of comparability have not been defined. In fact, there is not even a commonly understood meaning of the term.

Typical references to comparability generally do not offer an explanation of the meaning of the term or even attempt to limit implications that might be drawn

\textsuperscript{5}George R. Catlett discusses these differing views in his article "Controversy Over Uniformity of Accounting Principles," \textit{Journal of Accountancy}, 118 (December, 1964), pp. 37-43.

Additional evidence of disagreement is found in the comment by Weldon Powell that "uniformity is not attainable. Neither is the kind of comparability that some have in mind which is tantamount to uniformity." "The Development of Accounting Principles," \textit{Journal of Accountancy}, 118 (September, 1964), p. 41.

Other articles relating directly to these issues include:


For a more comprehensive listing see the bibliography included at the end of this research paper.
from the use of the term. Some writers have added modifying adjectives and created such terms as "useful comparability" and "accounting comparability." But this has not been sufficient to clarify the meaning and implications of comparability as it applies to financial reporting.

In the absence of a professional or technical definition or concept of comparability, one must rely on a standard denotation. According to the dictionary, the word comparable means "capable of being compared." However, comparison is possible with varying degrees of sophistication, since any two objects can be compared. Unlike objects such as a horse and a man or a funds statement and an income statement can be compared. Also, similar objects can be compared even though differing amounts of information are available on each object. The financial statements of two companies can be compared even though one set of statements is fully explained, with detailed information and explanatory notes, while the

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7 Fox, op. cit., p. 46.

8 Fryor, op. cit., p. 15.

other set is highly summarized, with little detailed information and no explanatory notes.

It does not seem likely that the various references in the literature to comparability of financial statements intend to imply a broad meaning of the term. Such an interpretation does not explain the current demand for greater comparability among financial statements, since comparisons can be made between any two existing sets of financial statements. It would seem that a more restrictive meaning or concept of comparability is implied.

Need for Resolving the Issue of Comparability

The criticism by users of financial statements and the concern of accountants over the issue of comparability are probably sufficient reasons for attempting to resolve the problem. An even more compelling reason, however, is the apparent importance of the issue to both debt and equity investment decisions.

The investment in both debt and equity securities, by a large number of individual and institutional investors, is a common phenomenon in our modern economy. In the absence of unlimited funds, the investor must choose among alternative investments. This choice must be made without knowledge of the exact return that will be realized from a given investment. This uncertainty is especially applicable to investment in equity securities.
If precise rates of return could be calculated, the analyst would have to compare only the calculated rate for each potential investment. Since the lack of certainty precludes the calculation of a precise rate of return, investors are forced to make direct comparisons of the information that is available in order to determine a ranking of investment opportunities. Financial statements are regarded as the main source of information for such comparisons. The ranking of investment opportunities, on the basis of the comparison of the financial statement information of the companies being evaluated, will be meaningful only to the extent that the comparisons are valid. Resolution of the issue of comparability is necessary in ensuring that such validity exists. As pointed out in the previous section, a concept of comparability does not exist at the present time. It is necessary to establish such a concept before:

1. Communication concerning comparability can be meaningful
2. The relation of comparability to the investment decision can be fully established
3. Comparability can be fully evaluated as a desirable or undesirable aspect of financial reporting
4. The present state of comparability in financial reporting can be determined
5. The probability of achieving comparability (assuming achievement is desirable) can be evaluated
6. The procedures for achieving comparability (assuming achievement is desirable) can be established

**Research Objectives and Hypotheses**

The objectives of this research study are to develop a specific concept of comparability and to examine the effects of the application of this concept to the function of the financial analysts as users of financial statements. The hypotheses are:

**Hypothesis I**

It is possible to establish a concept of comparability which is sufficiently precise to determine its presence or absence between two sets of financial statements.

**Hypothesis II**

Comparability represents a desirable goal of financial reporting.

The primary objective of this research study is to develop a clear and precise concept of comparability. It is not the function of this study to develop a framework or foundation of accounting, to arrive at accounting postulates or principles, or to specify what types of information ought to be reported. A concept of comparability cannot, however, be developed and discussed without reference to some underlying accounting framework. Therefore, an existing framework of accounting is assumed as indicated in Chapter II.

The second objective, as indicated above, is to examine the effects of the application of the concept of
comparability to the function of the financial analysts as users of financial statements. Several factors led to the selection of the financial analysts as the specific user group for the investigation of the application of the developed concept of comparability. The financial analysts are, of course, directly concerned with the investment decision problem. They have expressed concern over the issue of comparability, typified by the quotations included at the beginning of this chapter. Also, the financial analysts probably represent the most influential and most sophisticated users of accounting data. Their advice and decisions influence the investment of millions of dollars annually.¹⁰ John L. Carey, Executive Director of the American Institute of Certified Public Accountants, pointed out in a recent article that "the increasing number and stature of the financial analysts, who have attained a great deal of influence in investment decisions, add to the pressure for even more and better information."¹¹

No attempt is made in this study to evaluate what the financial analyst should be doing in carrying out

¹⁰One writer makes the observation that "analysts may swing as much as 30 million into or out of a stock through recommendations to their firms' individual and institutional accounts. Such men can truthfully be said to be among the most powerful men in Wall Street." Charles E. Silberman, "Wall Street's Influential Analysts," Fortune, 55 (January, 1957).

his function or what accounting framework or model is most ideally suited to his needs. As in the development of the concept of comparability, an existing framework of accounting is assumed. The focus of that part of the study which relates to the financial analysts is simply to determine the function of the financial analysts as it is presently exercised and then to examine the effects of applying the concept of comparability to the evaluation techniques embodied in that function.

Research Methodology

Heavy reliance has been placed on the inductive method both in developing the concept of comparability and applying the concept to the user group decision problems. The initial stages of the research included an extensive study of the pertinent literature and actual corporate annual reports. Using this as a broad base of knowledge, a tentative concept of comparability was established. The concept was then tested through the development and analysis of a large number of hypothetical cases. Each of the cases typically consisted of two companies employing divergent accounting procedures or financial statement disclosures in a specific area of accounting. This case approach was employed to assure both the validity and all-inclusive coverage of the final concept.

In carrying out the second part of the study, the written expressions of the financial analysts in periodicals,
monographs, and books were the primary sources of information regarding the decision problems and methods of evaluation of the analysts. Once the function of the financial analyst was established, the concept of comparability was applied to determine the impact or relationship of the concept to this function. Finally, the research findings were examined for both implications and possible suggestions for future improvement in the comparability of financial statements.
CHAPTER II

CONCEPT OF COMPARABILITY AS IT APPLIES TO FINANCIAL STATEMENTS

Delineation and Scope of the Concept

Financial statements purport to present information which is useful in assessing the economic position of a company. Conceptually, the economic position of a company is a composite of the net resources over which the company has control and the prospects for increases or decreases in these net resources. From a practical standpoint, there is no single figure that represents the economic position of a company nor is there even any precise means of determining this position. This is due to a variety of measurement problems ranging from the impossibility of quantifying some determinants of economic position (such as skill) to alternative measurements which might be used in quantifying other determinants (such as net income). Since a precise computation of the economic position of a company is not obtainable, any assessment of economic position must rely on the indicators which are available to the observer. These indicators can be referred to as economic circumstances.
An economic circumstance is any identifiable indicator of economic position. An assessment of the economic position then becomes some abstraction from a large number of economic circumstances, as illustrated in the following diagram:

There is a relationship between these different categories of economic circumstances, for the nonreported internal and external circumstances would probably have an effect on the magnitude of the reported economic circumstances (derived from operations). However, at any point in time each of these categories may be given some separate consideration in assessing the total economic position of a company. The assessment of the economic position of any given company would likely vary among individuals attempting to make such an evaluation.

A decision which involves an allocation of resources among companies, such as the purchase of debt or equity securities, requires an assessment of the relative economic position of companies. Since an abstraction of the economic position of each company is highly subjective and likely to be misleading, an assessment of the relative economic position of two or more companies is
likely to be made by comparing directly the various economic circumstances of one company with the economic circumstances of other companies. This is why a concept of comparability becomes important. In order for these comparisons to be meaningful in the determination of relative economic position, the economic circumstances must be reflected on an equivalent basis among the companies being compared. The essence of the concept of comparability developed in this paper is the equivalent reflection of economic circumstances. As previously defined, an economic circumstance is any identifiable indicator of economic position. This paper, however, focuses only on the economic circumstances reported in the financial statements. It does not attempt to cover the non-reported external or internal economic circumstances.

Any item reported separately on the financial statements is a reported economic circumstance. This might be a single account as maintained in the company's general ledger, or a combination of accounts which are closely related. (For example, gross sales, discounts, returns and allowances, and sales taxes are often combined and reported as a single item.) Typical examples of separately reported items are cash, inventories, sales, long-term debt, fixed assets, depreciation, etc. Any summary figures reported on the financial statements would
also be reported economic circumstances. However, the focus of this research study is on the reporting of individual economic circumstances rather than summary economic circumstances.

The focus on individual economic circumstances was selected for two reasons. First of all, the individual economic circumstances are the basic units of the financial statements. While it might be possible to achieve comparability at a summary level of economic circumstances, it seems more logical to focus first on the basic units (individual economic circumstances). A concept of comparability which applies to the summary levels then can logically build on the concept of comparability which is applicable to the individual economic circumstances. Also, there is evidence that at least some users of financial statements are concerned about many of the individual economic circumstances such as sales, depreciation, research and development costs, long-term debt, etc. This is especially true for the financial analysts, as documented in Chapter III.

Comparability in the reporting of economic circumstances is an issue both for financial statements among different companies and for a single company over time.

\[1\text{Summary figures differ from the combination of accounts referred to above in that they represent a summary of items which are normally reported separately on the financial statements.}\]
This research study specifically focuses on the problem of intercompany comparability.

For maximum communication and understanding, comparability must be discussed in terms of a specific accounting framework of financial reporting. Such a framework is needed in order to establish what information is to be reported as well as what constitutes similarities and differences in the information among companies. For example, the reporting of the cash collected from customers by two companies might be considered to be appropriate information for a cash-flow statement but not appropriate for an earnings statement. In other words, the framework of reporting on a cash basis would properly include cash collections as a reported economic circumstance, whereas the accrual framework would not. Comparability has little meaning in the reporting of information which is inappropriate to the underlying accounting framework. Two companies might also report receivables from customers on a statement of financial position. The receivables of one company might represent installment claims, while those of the other company might represent thirty-day claims. It is the function of the accounting framework to determine whether the receivables should be considered as being similar or different economic circumstances. A concept of comparability, or at least the concept developed in this paper, cannot be applied in the absence of a specific framework.
As indicated in Chapter I, it is not the function of this research study to develop an accounting framework of financial reporting. Therefore, some framework must be assumed in focusing on the development of a concept of comparability. Because of the current demands by financial statement users for comparability among present financial statements, this research study focuses on comparability within the existing accounting framework. This focus in no way attempts to justify (or discredit) the present framework of financial reporting. It simply constitutes an effort to develop a practical concept of comparability which has potential for immediate implementation. In other words, it is the intention of the study to develop a concept aimed at what we now report as well as how we presently go about doing it. In a subsequent section, the applicability of the developed concept to another possible accounting framework will be briefly considered.

The existing framework of accounting is obviously not without loose ends. However, it is a fairly well-defined process often referred to as accrual accounting. This consists of some rather specific rules or principles for revenue recognition based largely on realization, the matching of expired costs relating to the revenue realized, and valuation of assets at unexpired acquisition cost. It is largely a system based on acquisition cost rather than specific market values, with emphasis on objectivity
and verifiable evidence. It is beyond the scope of this research study to attempt to describe fully the framework of accrual accounting as it underlies present financial reporting. The rules or principles for revenue recognition, the matching of expenses and revenues, the valuation of assets and liabilities, and the information admitted to the accounting process and reported in the financial statements are the important aspects of the framework as it relates to this research study. It is assumed that there is a sufficiently common understanding or consensus concerning this existing framework, as briefly referred to above, to serve as a basis for the development, communication, and understanding of the concept of comparability.

An important modification to this existing framework will be made in connection with the concept of comparability developed in this paper. In the existing framework of accounting, there is no adjustment made in accounting measurements for the changing purchasing power of the dollar. This study assumes that it is acquisition cost measured in terms of committed purchasing power which

2The classical description of this system is probably that found in An Introduction To Corporate Accounting Standards, by W. A. Patton and A. C. Littleton, published by the American Accounting Association, 1940.

3A recent attempt to describe this existing system resulted in a monograph in excess of 400 pages. See Paul Grady, "Inventory of Generally Accepted Accounting Principles For Business Enterprises," Accounting Research Study No. 7, American Institute of Certified Public Accountants, 1965.
should be accounted for within the framework of accrual accounting. This holds true in accounting for both un-expired costs (assets) and cost expiration (expenses). Net income then becomes the result of matching expired purchasing power against revenue for the period, and assets would be reflected largely in terms of committed purchasing power awaiting disposition. Any of the factors in the concept of comparability might be viewed broadly as modifications of the existing framework of accounting, since such a concept does not exist at the present time. However, the concept of comparability developed in this paper is considered to supplement more than modify the basic framework of accounting.

As indicated previously, the essence of the concept of comparability developed in this paper is the equivalent reflection of economic circumstances. Equivalent reflection is the reporting of similarities and differences in economic circumstances among companies as similarities and differences to the same degree. Criticism of financial reporting often seems to focus only on the reporting of similarities. Typical of such criticism are assertions that accountants should attempt to "narrow the areas of difference and inconsistency in practice," or eliminate "variations which cannot be justified by

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differences in circumstances."\(^5\) Manuel Cohen, Chairman of the S.E.C., recently indicated a similar view when he stated that the opposing sides to the argument over uniformity should "emphasize the common goal of eliminating unjustified variances in financial reporting and thereby achieve a maximum degree of comparability of financial statements of similar companies."\(^6\) There is nothing inherently wrong with the focus indicated in these statements as long as the corollary objective of reporting differences in economic circumstances as differences is also recognized. It would seem that these twin objectives are two sides of the same coin and that the clear-cut achievement of one should also lead to the achievement of the other. In other words, the elimination of unjustified differences would leave only justified differences. As indicated in the above comments, however, the emphasis in current discussions of comparability has often concentrated only on the one objective. This tends to project a one-sided concept of comparability. The concept of comparability developed in this paper is a general concept designed to accomplish both objectives.

Equivalent reflection and, therefore, comparability in the reporting of individual economic circumstances is

accomplished through equivalent statement presentations and equivalent measurements. Each of these areas involves several reporting variables as outlined below:

1. Equivalent statement presentation
   a. Statement caption
   b. Statement classification
   c. Detailed information presented

2. Equivalent measurement
   a. Valuation basis
   b. Measuring unit
   c. Economic flow approximation

Each of these variables is discussed at some length in subsequent sections of this chapter.

Equivalent Statement Presentations

Equivalent statement presentation includes the statement caption, statement classification, and detailed information variables. Uniformity is the key to the equivalent statement presentation of any given economic circumstance by two or more companies. When applied to the field of accounting, the term "uniformity" has the possibility of different connotations. The most restrictive of the dictionary definitions is the "absence of variation." \(^7\) As it applies to accounting, in connection with financial statement presentations, uniformity implies the absence of variation in the statement presentation.

variables in the reflection of a given economic circumstance by two or more companies. It does not imply that all companies must have identical economic circumstances or that different circumstances should receive identical accounting treatment. A discussion of each of the statement presentation variables should be helpful in clarifying these points.

A statement caption is the term used to identify a reported economic circumstance or category of economic circumstances in the financial statements. Statement captions represent the signaling device to indicate to the statement user where similar and dissimilar economic circumstances are being reported by two companies. The same statement caption appearing on two sets of financial statements for a reported item should be an invitation to the user to make comparisons, with the assumption that the same economic circumstance is being reported by both companies and that it is reflected on an equivalent basis. Divergent statement captions should be an indication to the statement user that different economic circumstances are being reported, e.g. cash versus accounts receivable, ordinary accounts receivable versus installment accounts receivable, or sales versus net sales. The statement user may wish to make some comparisons between different economic circumstances. But it would seem that such comparisons would be viewed by the statement user in a somewhat
different light than comparisons of similar economic circumstances. For example, while the statement user might compare the reported balance in the ordinary accounts receivable of one company to the reported balance in the installment accounts receivable of another company, he might wish to give more consideration to the difference in the conversion time than he would in comparing ordinary receivables between two companies.

Where the same caption is used in reporting different economic circumstances, the user may be misled into believing that the same economic circumstance is being reflected. Thus the user may be misled into believing that he is comparing the same economic circumstance between the two companies. The statement user would also be misled where the same caption is used in reporting the same economic circumstance by two companies but any of the other variables in the concept of comparability is not handled on the same basis by both companies in the reporting of that economic circumstance. Either of these latter two situations would constitute a false indication of the existence of comparability and would be misleading to the statement user.

Where divergent statement captions are used in reporting the same economic circumstance, equivalent
reflection is not achieved, even if the remaining reporting variables (as listed on page 20) with respect to that circumstance are on an equivalent basis. This assumes, of course, that the different captions are not commonly understood by the statement user as having the same meaning. Comparability requires the use of uniform statement captions (along with the other variables for equivalent reflection) in the reporting of a given economic circumstance among companies. The corollary requirement is that different statement captions should be used when reporting different economic circumstances or where the same economic circumstance is not reflected on an equivalent basis with respect to the other reporting variables.

Statement classification refers to the grouping of one account with another account or accounts for reporting in the financial statements, either as a single figure or as a listing of accounts leading to a given subtotal. Grouping into a single figure results in the reporting of a single economic circumstance, while a listing results in each account being reported as an economic circumstance. The first type of grouping (for reporting as a single figure) represents an undisclosed classification, while the second type of grouping (for reporting as part of a list of accounts leading to a given subtotal) represents a classification which can be observed by the user of financial statements. An undisclosed classification divergency between two companies obviously creates the
more serious problem for the financial statement user. Since any single figure reported on the financial statements becomes a reported economic circumstance, any undisclosed classification divergency between two companies in arriving at the single figure creates a distortion in the relative dollar magnitude reported for that economic circumstance. This is the only one of the three statement presentation variables which can have an effect on the dollar magnitude of a reported economic circumstance. One of the more common examples of a classification divergency which is often of the undisclosed type is found in the area of accounting for sales and excise taxes. A leading accounting firm summarizes the financial statement treatment of these taxes among companies as follows:

1. Not included in sales or expenses at all
2. Included in gross sales and deducted in arriving at net sales
3. Included in gross and net sales and in cost of sales
4. Included in gross and net sales and in operating expenses other than cost of sales

The dollar magnitude of the reported sales, net sales, cost of goods sold, and operating expenses would be affected

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by the above classification divergencies. Obviously, the magnitude of sales, net sales, cost of goods sold, and operating expenses would not all be affected by each possible classification divergency. Each possible divergency between two companies, however, would affect the magnitude of one or more of these items. Similar effects could be obtained in the statement classification of sales discounts, purchase discounts, and bad debts.

Although a divergency in the second type of grouping is apparent to the financial statement user, it can still be argued that such a divergency does not constitute equivalent reflection of the reported individual economic circumstance in question. This is due to the basic reason for the listing of economic circumstances in separate groups leading to separate subtotals. This type of listing is usually made because of the different nature of the groups. For example, a listing identified as current assets does not convey the same meaning as a listing identified as fixed assets. Therefore, the appearance of the same economic circumstance in different groups or listings between two companies can affect the meaning which a statement user attaches to that economic circumstance. Prepaid expenses is an example of an economic circumstance which is often involved in a classification divergency of this type. Prepaid expenses might also be combined with another account or accounts for reporting
as a single figure. Then, of course, a classification of the first type is involved.

In summary, equivalent reflection is not achieved where classification divergencies exist between two companies in the reporting of an economic circumstance, since either the reported magnitude or the implied meaning of the economic circumstance is typically affected. Uniformity in the statement classification of an account or accounts leading to a reported economic circumstance is necessary for the achievement of comparability. Obviously, the classification must also be consistent with the governing accounting framework.

The central focus of the concept of comparability developed in this paper is the reporting of individual economic circumstances, as indicated in the first few pages of this chapter. Yet, the concept also applies to the reporting of broader or summary levels of economic circumstances such as current assets, current liabilities, or operating expenses. A brief digression from the central focus is necessary to indicate the nature of comparability in the reporting of these broader or summary levels. The primary difference between the reporting of individual circumstances and the broader levels (categories) is summarization. This is closely related to the group-listing problem discussed above. In other words, several individual economic circumstances are viewed as belonging to the same category, i.e., all possessing the same
governing characteristic, such as the capability of being converted into cash within an operating period. The main problems in achieving comparability at this reporting level (assuming comparability is achieved at the individual level) rest solely on the three statement presentation variables. Again, uniformity is the key. The caption for the same category or summary economic circumstance between two companies must be uniform as well as the category classification of the individual economic circumstances. (In addition, the same detailed information must be presented, as discussed in the next paragraph.) This does not mean that a given category for two companies must contain identical economic circumstances (identical item constituency). For example, the current assets of one company may consist of cash and accounts receivable, while another may consist of cash and inventory. This does not violate equivalent reflection. To the extent that the same individual economic circumstances exist for two companies, however, they must be classified uniformly by the two companies in order for equivalent category reflection to be accomplished. This assumes, of course, that the uniform classification is consistent with the accounting framework. In addition, different economic circumstances should be classified in the same category by two companies if they share the governing characteristic of the category, as defined within the accounting
framework, if equivalent category reflection is to be achieved.

**Detailed information** is the third statement presentation variable. Detailed information refers to the extent to which accounts are reported separately in the financial statements as economic circumstances and to the reporting of supplemental or explanatory information. The extent to which accounts are reported separately in the financial statements is directly related to the variable of statement classifications. Any grouping of accounts for reporting as a single figure reduces the extent to which accounts are reported separately in the financial statements. However, the same classification is followed by two companies when one company has combined several accounts for reporting as a single figure (single economic circumstance), while another company has listed those same accounts separately (each account shown as a reported economic circumstance) in arriving at a subtotal for those accounts. This type of situation involves a divergency in the detail between two companies and not a divergency in classification. For example, one company might report separate figures for raw materials, work in process, and finished goods (separate economic circumstances), with a subtotal of the three; another company might group these three accounts together and report a single figure (single economic circumstance).
The classification or grouping of the three accounts is the same by both companies. However, the detailed information is different, since the one company did not report the three accounts separately.

The second aspect of detailed information is unrelated to statement classification. Examples of supplemental or explanatory information would be the reporting of the characteristics of the classes of capital stock and the reporting of the terms of long-term leases. A divergency in detailed information would not distort the dollar magnitude of the reported economic circumstances. It would, however, affect the degree of knowledge of the economic circumstances which a statement user can obtain from a set of financial statements. A difference in the reporting of detailed information does not result in equivalent reflection, and comparability is not achieved. Uniformity in the reporting of detailed information between two companies is necessary for comparability.\(^9\) This assumes, of course, that the information in question has some meaning for the statement user.

A potentially confusing point arises when a time dimension is attached to the reporting of detailed information. For example, assume that two companies report only a total for inventory in one year, but in the

\(^9\)The concept of materiality points out a practical limitation to the achievement of uniform detail among companies as discussed in a subsequent section of this chapter.
subsequent year one of the companies reports a breakdown of inventory. It might appear that comparability decreased over the two year period. However, comparability still exists with respect to the information which was reported in both years (total inventory). In other words, comparability has not decreased from the prior year.

But, it is also true that comparability is not present between the two companies with respect to the new detailed information reported by the one company.

A question could also be raised on the effect of financial statement location of detailed information. To the careful reader of financial statements, however, disclosure of the same information by two companies either in the financial statements proper or in footnotes to the financial statements would constitute equivalent reflection.

**Equivalent Measurement**

The measurement process can be viewed separately from the problem of statement presentation. The measurement process consists basically of determining the magnitudes of both the flows of costs and revenues and the resulting residuals of assets and equities. The three variables involved in equivalent measurement are the valuation basis, the measuring unit, and the approximation of economic flows.
Valuation basis refers to the financial property of an economic circumstance which is selected for measurement and reflection in the financial statements. Under a section entitled "Bases of Valuation", the Accountants' Handbook states that "cost to the accounting entity is the valuation basis traditionally emphasized by the accountant." Net liquidation value (sometimes referred to as net realizable value), reproduction cost, replacement cost, sound value, current dollar cost (sometimes referred to as adjusted cost), earning value (sometimes referred to as the present or discounted value of future earnings), and fair market value are other valuation bases which are listed and discussed in that same section.

For reference purposes in this discussion, the above listing can be considered as an all-inclusive list of potential valuation bases. The choice of the valuation basis to be used in the measurement process is determined largely by the accounting framework. For this research study, it is assumed that adjusted historical cost (acquisition cost adjusted for changes in the general price-level) is the main valuation basis.

11 Ibid., pp. 2-4.
12 This was indicated earlier in the chapter in the discussion of the accounting framework assumed for this research study. It is recognized that adjusted cost is the main valuation basis, not the only valuation basis, since it does not apply to all items (e.g. receivables, donated property, revenues received in advance, etc.).
This also has an effect on the measuring unit and the economic flows which might be recognized. (For example, it tends to exclude the recognition of value changes which have not been realized through exchange transactions.) The use of a different valuation basis by two companies in the measurement of a given economic circumstance would typically affect the magnitude of the reported circumstance and, therefore, would not result in equivalent reflection. R. J. Chambers states that no analysis of conventional accounting statements can yield sensible conclusions, insofar as those statements contain representations of different properties for different items, and employ scales for different items which vary materially in significance.\footnote{R. J. Chambers, "Measurement and Objectivity in Accounting," \textit{Accounting Review}, 39 (April, 1964), p. 267.}

In the above quotation, Chambers uses the term \textit{properties} in the same sense that the term \textit{valuation basis} is used in this research paper. Chambers' article suggests that the same property (valuation basis) should be used for the measurement of all statement items (economic circumstances). This limitation imposed by Chambers, however, is stronger than that imposed by the concept of comparability applied to the reporting of individual economic circumstances. Comparability requires uniformity between two companies in the valuation basis used in the measurement of a given (the same) economic circumstance. However, it does not preclude the use of different valuation
bases for different economic circumstances (applied uniformly between companies). It is the function of the governing accounting framework to determine the valuation basis or bases to be used in the reflection of various economic circumstances. As indicated previously, the accounting framework adopted for this research study primarily stipulates the use of adjusted cost (cost adjusted for changes in the purchasing power of the dollar). Other frameworks have been suggested, however, which would make widespread use of different valuation bases for different economic circumstances.

The measuring unit is another crucial variable in the measurement process. Chambers also refers to this problem in the above quotation. A measuring unit is the basic unit of measurement in any scale. In a scale of physical weight a unit would be the pound. In a financial scale it is a monetary unit. The dollar is the measuring unit in the financial scale used by accountants in this country. The use of a homogeneous or uniform measuring unit is necessary in the achievement of the equivalent reflection of economic circumstances. It is generally

Robert Sprouse and Maurice Moonitz discuss the possibility of using adjusted historical cost, replacement value, discounted present value, net realizable value, and market value for the measurement of different economic circumstances within the same framework of accounting. "A Tentative Set of Broad Accounting Principles For Business Enterprises," Accounting Research Study No. 3, American Institute of Certified Public Accountants, 1962.
recognized that the dollar fluctuates from year to year in terms of its purchasing power. The accounting framework assumed for this study is concerned with the measurement of purchasing power. Therefore, the dollar measuring unit must be adjusted for the changes in purchasing power from year to year. If adjustment is not made, equivalent measurements between companies is not likely to be achieved, since the unadjusted financial statement effects of fluctuations in the purchasing power of the dollar would typically not be the same for two companies. This would obviously affect the magnitude of the reported economic circumstances. As stated previously, a uniform or homogeneous measuring unit is necessary for the equivalent reflection of economic circumstances. The dollar, adjusted for purchasing power changes, which is required by the use of adjusted cost as a valuation basis, meets such a requirement.

The approximation of economic flows is the third variable in the measurement process. Economic flows consist basically of increments and expirations in the economic circumstances which are reported on the balance sheet. Not all measurements directly involve this variable. For example, the measurement of cash to be reported on the balance sheet does not typically involve any approximation of the flow of cash that occurred during the reporting period. The measurement of the
depreciation expense and the corresponding fixed assets, however, typically does involve an approximation or estimation of the applicable economic flow (utilization cost) which occurred during the reporting period. Within the existing framework of accounting assumed for this research study, the economic flows which are measured are largely acquisition cost flows and revenue flows realized from exchange transactions. These flows may occur due to single events or continuing activities. Approximations of these flows are necessary because the exact flow is not known. It would be possible to approximate these flows indirectly by determining the balance sheet economic circumstances at two points in time and computing the flow as the difference. This is often done in some areas such as accounting for small tools and insurance premiums. Within the present framework of accounting, however, the emphasis seems to be more commonly placed on a direct approximation of the flow. Conceptually, there should be little difference in the resulting measurements from either approach. From a practical viewpoint, however, significant differences can arise due to imperfect measurements. The emphasis on a direct approximation of flows is probably attributable, in part at least, to the primary importance that has been placed on the income statement in recent years.

The approximation of economic flows will affect the dollar magnitude of the reported economic circumstances.
Thus, careful attention must be given to this step in the measurement process. There are areas of accounting where no alternative approximation procedures are involved in estimating the economic flow. A determination of the salaries and wages expense and utilities expense are examples of such areas. There are other areas in accounting, however, where alternative approximation procedures exist in estimating the economic flow. It is these latter areas which would typically generate the most difficulty in achieving equivalent measurements among companies. A determination of the depreciation expense and cost of goods sold are prime examples of areas where alternatives exist in approximating economic flows. The alternative approximation procedures would include the lifo, fifo, and average methods with respect to cost of goods sold; and the straight-line, sum-of-years digits, and double declining balance methods with respect to depreciation.

At the present time, a company has almost complete freedom in selecting from the "generally accepted" alternatives available in a particular area. A given company might simply select from the "bargain counter"\(^{15}\) or perhaps conform to tax procedures. For the equivalent approximation of economic flows between two companies, however,

it is necessary for the approximation procedures selected by each company to be appropriate to their respective underlying flows. Unfortunately, a determination of the approximation procedure that is appropriate in each case can be very difficult. Uniformity typically does not provide the key to the equivalent reflection of a given economic circumstance with respect to the approximation of the underlying flow. As indicated in the discussion of the other reporting variables, uniformity between two companies is necessary for the equivalent reflection of a given economic circumstance in the statement presentation variables, as well as the valuation basis and the measuring unit. Economic flows applicable to a given (the same) economic circumstance, however, may differ markedly between two companies. Equivalent measurement and reflection of a given economic circumstance, in such a situation, would require nonuniform approximation procedures, appropriate to the underlying flow of the respective companies. This is indicated more fully in the depreciation example on a subsequent page.

The appropriateness of an approximation procedure to a given flow cannot be ascertained without obtaining some evidence pertaining to the basic nature of the flow. This problem is more concerned with implementation rather than with the basic concept of comparability. Yet, a basic concept of comparability has little value unless it
is potentially capable of being implemented. This would seem to warrant or even necessitate some discussion of the basic nature of economic flows in relation to the determination of appropriate approximation procedures.

Since the actual economic flow is unknown, some evidence must be selected as representative of the unknown flow. Unfortunately, there have been few specific guidelines established by the accounting profession in connection with this problem. One writer recently commented that

> aside from the absence of useful and accepted postulates, perhaps the most significant vacuum in the literature relating to generally accepted accounting principles is the almost total lack of criteria for the selection of specific procedures to implement the application of an acceptable principle to a given situation.¹⁶

Since the actual economic flows are unknown, any evidence selected as being representative of the flow is likely to be somewhat arbitrary. Nevertheless, some basis for estimating these unknown flows among companies must be established. The following paragraphs discuss some of the more feasible possibilities.

A concentration on the physical nature of flows probably offers the best evidence for a determination of the appropriate approximation procedure in the estimation

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of many economic flows. The utilization of productive fixed assets, for example, results in the production of saleable units. This is the purpose behind the acquisition and use of such assets. The pattern or rate of production of saleable units over several periods of time is affected by factors such as obsolescence, supersession, level of maintenance, and physical wear and tear. This pattern of production (often termed the expiration pattern) might follow an accelerated pattern, a straight-line pattern, or some other pattern. A determination of the probable nature or shape of this pattern in the production of saleable units establishes the evidence for the selection of the appropriate depreciation method. (If the sales prices are expected to vary significantly over the life of the asset, the actual physical flow might be modified somewhat by giving weighting to expected sales prices in arriving at the applicable expiration pattern.) Equivalent approximation between two companies would be achieved where the depreciation method used by each company is appropriate to the respective pattern for each company. If the expiration pattern is similar for two companies, a uniform method would be necessary for equivalent approximation. If the pattern differs between two companies, uniformity in the depreciation method could not possibly produce comparability.

A similar concentration on the flow of saleable units might be used in achieving equivalent approximations
between companies in accounting for depletion and for maintenance versus betterments. The recognition of revenue earned in connection with long-term construction contracts also might be related to the physical flow. This could be based on an architect's estimate of the physical completion. Even an estimation of the percentage of completion based on costs can be viewed as another way of arriving at the physical completion, if the pronouncements of the AICPA are followed. Audits of Construction Contracts suggests that where a contractor has used costs incurred as the basis for estimating percentage of completion, the auditor "should ascertain that the results are meaningful and a true measure of actual contract completion."\(^17\) Another section of the same publication refers to the recommendation concerning the use of costs as a basis of estimating percentage of completion found in Accounting Research Bulletin No. 45 and states that

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\text{\ldots since work performed (emphasis added) is the primary basis for income allocation, certain costs may be disregarded as a measure of performance in the early stages of a contract for the purposes of determining income allocation.}^{18}
\]

The physical flow of inventory units has been suggested by the AAA as possible evidence for the selection


\(^{18}\)Ibid., p. 15.
from alternative inventory costing procedures in allocating acquisition costs (purchase prices). Recognition of the physical element of economic flows is also found in a discussion of the measurement process by Norton Bedford. Bedford discusses physical flow in connection with the measurement of expired services in accounting for "merchandise, supplies, tools, and other short-term service resources." He classifies this as an area where "there is a physical flow of material objects, and services flow with them." He states that the objective of the formulas employed in the measurement of flows in this area is "to attach a portion of acquisition cost to each physical object, and to consider the acquisition cost of the physical object to be the utilization cost of the services in these objects." It should be emphasized that the physical flow would be useful as evidence only in estimating acquisition cost flows. It would not be useful in estimating market value changes. However, as indicated previously, the assumed framework of accounting concentrates on acquisition cost flows, not market value changes.

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21 Ibid.

22 Ibid.
There are other flows where physical evidence does not appear to be available or at least feasible to use as evidence of the unknown flows. The utilization of nonproductive fixed assets, such as a building, falls into this category. Concentration on time periods may offer the best approach in obtaining evidence of the expiration pattern for non-productive assets. This would not necessarily lead to the selection of a straight-line method of amortization. For example, a particular building might be expected to fulfill its intended purpose better in the early years of its anticipated total life of usefulness. This might be due to expectations of higher maintenance charges in later years or other expectations such as design changes which are anticipated as being necessary in order to fully utilize the building in later years. It seems likely that the possible flow patterns based on time periods would be very similar to the possible flow patterns based on the production of saleable units. Again, equivalent approximation between two companies would be achieved where the depreciation method used by each company is appropriate to the underlying flow pattern for each company.

As pointed out previously, any evidence selected for use in approximating the unknown economic flows is likely to be somewhat arbitrary. However, the types of evidence discussed above appear to be the most feasible for use within the existing framework of accounting.
There are some areas in accounting where the nature of the economic flow in connection with a given economic activity has not been resolved. The leasing of long-term assets and the acquisition of a company through exchange of shares of stock are examples. Until the basic nature of such flows has been resolved, it is not possible to determine the accounting procedures which are appropriate in any given situation where such activities occur. The resolution of these issues in accounting theory must be considered as a prerequisite to the achievement of comparability among financial statements. It is possible that some areas cannot be resolved. In problem areas where this proves to be the case, comparability becomes indeterminable. It is also possible that the nature of the economic flow relating to a given activity might be resolved, but evidence pertaining to that basic flow is not generally available. This is often true in the area of accounting for research and development costs. There is general agreement that costs should be capitalized where specific benefits are obtained to be written off over the future periods of benefit. But, obtaining evidence of benefits at the time of the expenditure appears to be impossible in many cases. Where evidence of the flow cannot be obtained, comparability becomes indeterminable. The concept of comparability does nothing to resolve these issues of determining the nature of economic
flows and ensuring that evidence is available to be used in approximating the flow. It does, however, emphasize the need for resolving these issues.

**Materiality and Subjectivity**

The practical application of comparability must be viewed in light of the problems of materiality and subjectivity. It is commonly accepted in accounting that almost any treatment of a financial statement item is permissible as long as the reported result is not misleading to the financial statement user. There is no reason to believe that any of the variables in the concept of comparability should be excluded from this practice. Immaterial deviations in these variables should not be considered as impairing comparability. In fact, materiality must be specifically considered in determining the detailed information to be reported in the financial statements. It would not be practical to require the uniform disclosure of all possible financial information on all financial statements. The relative importance of given information, such as research and development costs, may vary substantially among companies. Financial statements would become exceedingly complex and detailed if the uniform disclosure of all information were required.

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23As indicated previously in this chapter, it is the function of the accounting framework to determine what information is to be admitted to the accounting process and reported in the financial statements. The concept of
Unfortunately, there is no clear measure of materiality. The evaluation of materiality necessarily rests with the judgment of the preparer of the financial statements or the certified public accountant who examines the statements. Possibly the financial statement user may not feel assured that undisclosed financial statement information or other apparent reporting differences are immaterial. This is a problem of a lack of confidence in financial statement presentations and the judgment of the accountant, which may be justified with the present state of reporting. Improved comparability in financial reporting, along with increased liaison between accountants and financial statement users, should improve the confidence of the user in the accountant's application of the concept of materiality. Regardless of this degree of confidence, the user must assume that apparent deviations in the variables of comparability are immaterial, if he is to evaluate the economic position of two companies from the information in the financial statements. This reinforces the importance of the existence of comparability from the viewpoint of statement users.

The element of subjectivity partially overlaps that of materiality, since a determination of materiality

23 comparability then stipulates that the same information must be reported by any two companies (assuming the information is applicable to both companies) within the constraints of materiality.
can be made only by subjective judgment. Subjectivity, however, creates a much broader limitation to the application of the concept of comparability. There are many areas of accounting where subjective judgments are required in the preparation of financial statements. Such evaluations are necessary where the actual state of affairs is not known. Subjective evaluations are likely to vary among individuals; and, therefore, reported financial results will vary to the same extent.

There is an inherent conflict between attempting to achieve comparability among reported financial statement items and attempting to maximize communication of the economic position of the entities. The degree of information concerning economic position which might be presented in the financial statements can be viewed as a continuum.

zero information absolute information

The reporting of zero information needs no explanation. The reporting of absolute information implies the inclusion in the financial statements of all information which might aid in the evaluation of the economic position of the company. This is, of course, unattainable within the present framework of accounting. The important fact for this research study, however, is that as the degree of information imparted by the financial statements of
any two companies advances on this continuum, comparabilty with respect to the added individual statement items generally decreases. This is not a one-for-one relationship, however, for some increases in reported information can be made without increasing the element of subjectivity, which is the factor that causes a decrease in comparability on the continuum. It is assumed that cash is the first segment of information to be reported on this continuum. It would be possible to prepare financial statements which report only the cash balance for all companies. The determination of the cash balance can be accomplished through counting and other procedures which involve little or no subjective evaluations. But as segments of information beyond cash are reported, areas of uncertainty which require subjective judgments are soon encountered. The present framework of reporting includes many subjective evaluations or approximations of income and expense. The limitation of subjectivity could be eliminated by reducing the present scope of financial reporting. Such a reduction in the scope of reporting, however, appears to be extremely unlikely and is generally considered to be undesirable by both accountants and financial statement users. Consequently, the limitation of subjectivity on equivalent reflections and, therefore, comparability must be recognized and accepted. It is not unreasonable, however, for financial statement users to expect the variations in subjective evaluations and
approximations to represent the best judgment of the accountant or some other qualified individual and to be free from outside bias. If, for example, the subjective approximations or evaluations are influenced by federal income tax laws, comparability is not achieved within the acceptable limits of subjectivity.\(^{24}\)

The limitations imposed by the existence of subjectivity in accounting and the application of the concept of materiality, as discussed above, force the financial statement user to be satisfied with something less than absolute comparability. The concept of comparability developed in this paper, modified in light of these two limitations, can be viewed as a practical concept of comparability.

**Summary of the Concept**

The concept of comparability developed in this paper focuses on the equivalent reflection of individual economic circumstances in financial statements, within the existing accounting framework modified by adjustments for changes in the purchasing power of the dollar. The key factors in achieving equivalent reflections are equivalent statement presentations and equivalent measurements. Equivalent statement presentation by two companies with

\(^{24}\)It is interesting to note that the AAA Committee which recently prepared *A Statement of Basic Accounting Theory* included "freedom from bias" as one of the accounting standards. (American Accounting Association, 1966), p. 11.
respect to a given individual economic circumstance is achieved when:

(1) The same statement caption is used by both companies (The corollary to this is that different statement captions should be used for different economic circumstances.)

(2) The same statement classification is followed by both companies

(3) The same detailed information is given by both companies

Equivalent measurement by two companies with respect to a given individual economic circumstance is achieved when:

(1) The same valuation basis is used by both companies

(2) The same measurement unit is used by both companies

(3) The accounting procedure(s) used by both companies to approximate the underlying economic flow(s) (if applicable) is appropriate to the respective underlying flow of each company

It is recognized that equivalent reflection cannot be achieved on an absolute basis, due to the limitations of subjectivity and materiality. The concept of comparability outlined above, viewed in light of these two
limitations, can be considered as a practical concept of comparability.

**Comparability and Consistency**

The focus of this research study is on intercompany comparability. Comparability between successive financial statements of the same company is also important. The basic characteristics of comparability over time and between companies appear to be essentially the same.

Consistency is often seen as the means of obtaining comparability between two sets of financial statements of the same company. However, consistency is nothing more or less than uniformity over time. It follows from the discussion in this chapter that consistency or uniformity in the financial statement presentation variables, the valuation basis, and the measuring unit would typically be necessary in order to achieve comparability. However, consistency or uniformity in the approximation of economic flows over time would achieve comparability only where the nature of the flow did not change. Where the nature of an economic flow changed, comparability would be achieved by adopting the accounting methods of approximation which would be appropriate to the basic nature of the new flow.
A Brief Consideration of the Impact of Changing the Accounting Framework

There have been several recent attempts to develop a framework of accounting based on market values. Although it does not appear likely that such a framework will be adopted in the practice of accounting in the near future, there has been sufficient support voiced for such a framework to warrant a brief examination of its potential impact on the concept of comparability.

The statement presentation variables would not be affected by the adoption of an accounting framework based on market values. Uniformity in the statement caption, classification, and presentation of detailed information would still be required for the equivalent reflection of a given economic circumstance by two companies.

The effect with respect to the measurement variables is somewhat more complex. Obviously, the main valuation basis would be changed from adjusted cost to some type of market value (e.g. replacement cost, appraisal value, fair market value, net realizable value). The requirement for comparability, however, would again remain unchanged. Uniformity between two companies in the valuation basis used in the measurement of a given economic circumstance would be necessary for equivalent reflection and, therefore, comparability.

A uniform measuring unit would logically appear to be necessary in order that equivalent measurements
might be achieved within any framework of accounting. As stated in Accounting Research Study No. 6, "the problems created for accounting by a changing dollar remain whether the accounts are kept on a conventional basis of historical cost or on a market price (replacement-cost) basis." The need for adjustments to the dollar to achieve a uniform measuring unit between companies, however, would be reduced under a market value framework. To the extent that market values are estimated at the same point in time between two companies, the dollar measuring unit is uniform.

The approximation of economic flows is the variable most affected by the adoption of an accounting framework based on market values. This would change the types of flows which would be recognized in the measurement process. For example, greater emphasis would be placed on value changes not realized through exchange transactions. In other words, the flows that are going to be measured and reflected in the financial statements would be changed (e.g. holding gains and losses would now be measured and reflected). The basic requirement for comparability does not change, however, since the approximation procedure(s) used by two companies would

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have to be appropriate to the underlying flow of each company, in order for equivalent measurement to be achieved.

In discussions of the use of market values, there has been some tendency to emphasize the balance sheet values as opposed to the flow that occurs between two points in time. If the flow is computed as the difference in value between two points in time, the measurement variable of the approximation of economic flows loses much of its significance. The flow becomes the residual determined, not by direct approximation, but by estimates of the magnitude of the balance sheet economic circumstance at two points in time. However, this still does not change the basic concept of comparability. It simply reduces the emphasis on the variable of approximation of economic flows as part of the measurement process.

In view of the above arguments, it is obvious that the implementation of the concept of comparability would be significantly affected by the assumed accounting framework. The basic concept of comparability, however, is independent of the two accounting frameworks discussed. The equivalent reflection of a given economic circumstance between two companies is achieved when the same statement caption is used, the same classification is followed, the same detailed information is presented, the same valuation basis is used, the same measurement unit is used, and the approximation procedure(s) used by the
two companies (if applicable) are appropriate to the respective flow(s) of each company. Yet, the concept cannot be applied in the absence of an accounting framework. A specific accounting framework must be assumed to serve as a foundation for implementation of the concept of comparability.
CHAPTER III

FUNCTION OF THE FINANCIAL ANALYST

Introduction

Chapter III investigates the function of the financial analyst, with particular emphasis on a determination of the specific methods of evaluation (and the relative importance, thereof) employed in the analysis of financial statements as part of the determination of investment opportunity. It is necessary to explore the nature of the analyst's evaluations in some detail in order to provide the basis for an investigation of the application or impact of the concept of comparability, as developed in Chapter II, to the financial analysts as a user group.

Objective of the Financial Analyst

The main objective of the financial analyst is the determination of investment opportunity through an analysis of facts. One analyst in defining the function of individuals in his field states:

In most simple terms: a Security Analyst attempts to distinguish between the thousands
of companies to determine which may represent true value—or real investment opportunity.¹

A review of the writings of individuals in the security analysis field indicates that analysts attempt to make the tools and procedures used in this selection process as scientific as possible.

The goal of both the professional scientist and the financial analyst is the same—to understand and foresee. The technique applied to achieve this objective consists of breaking up each phenomenon into simple elements, and these in turn into still simpler ones, in the hope of discovering phenomena so evident and familiar that further analysis and explanation are unnecessary.²

The analyst naturally deals with information which is more subjective than that of a physical scientist. However, the analysts do emphasize factual analysis in reaching investment decisions. The authors of what is probably the leading textbook in the field of security analysis state:

The kind of security analysis we regard as a most rewarding discipline is concerned primarily with values which are supported by the facts and not those which depend largely upon expectations.³

This emphasis on factual analysis tends to exclude

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speculation, which is typically based on less objective information. The attempt to rely on factual information, as opposed to highly subjective information, increases the relative importance placed by the analyst on financial data obtained from "certified" financial statements.

Nature of the Selective Role

The analyst may get involved in such roles as sifting through vast quantities of information and reducing it to a few key figures for publication in one of the investor services. However, it is the role of investment selection that the financial analyst must emphasize. Concern over the responsibility associated with the task of investment selection apparently generates much serious thought by the analysts on the proper selection techniques. The selection process is at best a difficult task. One writer comments:

Admittedly the investment analyst has a most difficult responsibility. He must analyze a multiplicity of shifting components, including the make-up of management itself, and develop recommendations regarding the merits of a specific situation.  

An evaluation of a security may be made as part of general recommendations on several securities or for a particular investment decision such as the purchase, sale, or retention of a single security. In either case the analysis of the merits of a security requires a high

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4Atkinson, op. cit.
degree of skill and good judgment. The capable analyst possesses a

knowledge of basic accounting; ability to read and interpret a balance sheet, a profit and loss statement, and the principal items in each; knowledge of general economics; awareness of current business conditions and competitive standings of industries and companies.⁵

Yet knowledge, skill, and good judgment are useless tools in the absence of valid information. Adequate information is requisite to effective analysis. Lawrence R. Kahn, a former president of The New York Society of Security Analysts, in describing the functions of security analysts, points out that the analyst must first set up, analyze, and project the existing figures in relation to a particular industry and the companies within that industry.⁶ If the existing figures are inadequate or misleading, the analyst will be forced to undertake extensive effort in an attempt to correct this information deficiency. It is possible that the analysis could even be halted at this first step or rendered useless if the needed information cannot be obtained.

As part of the initial steps in the investment selection process, the analyst typically evaluates


potential investments according to several major investment characteristics. These characteristics include marketability, taxability, and risk. Marketability, of course, refers to the relative ease of buying or selling an issue at a going rate, while taxability refers to the limited variation that is found among securities with regard to taxation of income. The risk factor is associated with anticipated receipts (interest, dividends, capital gains), changes in interest rates, and changes in the purchasing power of the dollar. The first type of risk applies to both debt and equity securities; the latter two pertain mostly to debt securities. 7

An evaluation of the risk associated with anticipated receipts appears to be the area of main concern to the typical analyst. The risk associated with anticipated receipts is reflected in the financial ability of the security issuer. There seems to be general agreement among financial analysts that earnings is the main factor in measuring financial ability as an indicator of anticipated receipts. Assets are also regarded as important as a contingent source of funds, if earnings are not sufficient. This is given relatively more importance with fixed payment securities such as bonds and preferred stocks.

7A succinct discussion of the problem of evaluating these investment characteristics is found in Investment Management (New Jersey: Prentice-Hall, Inc., 1959) by Harry Sauvain.
The analyst must also try to decide what a given security is worth. While this may be determined in part by an evaluation of the investment characteristics, many analysts treat this as a separate process. Sauvain, for example, points out that there are two basic functions included in the selection role:

One is that of grading, that is, of classifying securities according to grade in terms of each of the major investment characteristics. The other function is that of valuation, or deciding what a security is worth.

Earnings is again regarded as the primary factor in arriving at a final valuation with assets evaluated as a secondary factor.

**Method of Analysis**

**Ratio analysis**

The analyst typically starts his analysis by examining existing financial statements. One of the basic tools used in this analysis of financial information is the construction of a number of key ratios. These ratios are used both in evaluating the risk factor and the worth associated with a given security. Roy A. Foulke, Vice President, Dun and Bradstreet, Inc., and a well-known authority on ratio analysis, describes the ratio

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as a symptom of the business analogous to the blood pressure, pulse, and temperature of an individual. 9

Not all financial analysts emphasize the same ratios. However, ratios are typically computed in an attempt to evaluate both performance and financial strength by measuring profitability, short-term liquidity, and long-term solvency or safety of investment. Another set of ratios measures the relationship of market price to various factors of direct importance to the stockholder.

Profitability is measured by such ratios as earnings to net worth, sales to net worth, earnings per dollar of sales, and earnings per share. Sometimes total invested capital is used (including long-term debt) instead of net worth or net assets. Indications of growth and stability are achieved by comparing the ratios for a period of several years. Short-term liquidity is typically measured by the ratio of current assets to current liabilities, collection period of accounts receivable, turnover period for inventory, ratio of inventory to net working capital, and ratio of current liabilities to tangible net worth. Safety of investment is measured by such ratios as total debt to net worth, fixed assets to net worth, and common stock to total capital. Special ratios relating market price of the stock to various

factors include a computation of sales, earnings, dividends, and net assets per market dollar. The dividend payout ratio is also important to the existing or prospective stockholder.

Financial analysts, in order to facilitate comparisons, often set up a spread sheet emphasizing key figures and ratios for several companies. An article in the *Financial Analysts Journal* reproduced an example of an actual spread sheet used in analyzing companies in the petroleum industry. This full-page spread sheet included such items as sales, pre-tax income, net income, earnings per share, price-earnings ratio, etc., over a five year period for eleven companies. The author of that article stated that "similar spread sheets are prepared on the steel industry, the chemical industry, the drug industry, etc."\(^\text{10}\)

**Evaluation of earnings**

Earnings is generally considered to be the single most important financial indicator in evaluating both the risk factor and the worth of a security. Therefore, the analysis of earnings is one of the more important tasks of the analyst. The first problem facing the analyst is the development of what he believes to be the real earnings for the period or periods under review. An

\(^{10}\)Johnson, *op. cit.*, pp. 71-73.
important part of the analysis of earnings is to develop an earnings trend for projection into the future. No one can accurately foretell the financial future of a company, but it is generally thought that the study of the financial past is helpful in attempting to estimate the future. Probably the easiest procedure of projection is extrapolation. This consists of simply extending the trend established by historical figures beyond their established limits into the future. Another procedure is to forecast the future by anticipating definite changes from the historical record. Sauvain describes this procedure as interpretation and states that

the difference between interpretation and extrapolation is that the analyst tries to find in the record of what has been going on evidence of new or changing influences on the financial ability of the issuer.11

The past record, however, is the key to either method of projection.

Forecasting of earnings can be done either by projecting all major components of the income statement or by projecting return on capital employed. The former method requires more detailed information; the latter emphasizes an average profitability factor and changes in total invested capital.12

11Sauvain, op. cit., p. 192.

12Graham et al., op. cit., pp. 461-463.
Cash flow analysis

Cash flow analysis has recently been the subject of increased attention of both financial analysts and accountants. There are, in general, two possible uses of cash flow information by the analyst. One is to use cash flow information as a supplement to the evaluations of the balance sheet and the income statement. The other is to substitute net cash flow for net earnings as the main indicator of investment potential.

Limited evidence of a tendency to attach strong importance to the net cash flow of a company is found in some of the quotes included by Perry Mason in his extensive research study. The writings of leading financial analysts, however, do not typically place much emphasis on net cash flow. Graham and Dodd, for example, specifically point out that there is no logical basis for any transfer of emphasis from net earnings to cash flow. A recent issue of the Financial Analysts Journal included the following comment in discussing an opinion of the Accounting Principles Board:

Thus, the Directors of the Financial Analysts Federation are of the opinion that use of cash earnings per share data should be avoided in security research reports and analyses. Moreover,

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14 Graham et al., op. cit., p. 176.
the Directors are of the opinion that isolated statistics on cash flow in security research reports and analyses may be misleading unless they are utilized in proper conjunction with net income figures and a complete analysis of source and application of funds.  

In view of the above comments, it appears that net earnings and other accrual data are considered by leading analysts to be the most important information in evaluating investment potential and that cash flow information is evaluated as supplemental information.

Arriving at a valuation for a given security

In order to obtain a thorough understanding of the complete analysis made by a financial analyst, it is necessary to look at the specific techniques used in arriving at the final evaluation of a security. The most important characteristic of preferred stocks and bonds is safety of investment. "The essence of proper bond selection consists, therefore, in obtaining specific and convincing factors of safety in compensation for the surrender of participation in profits."  

The degree or margin of safety is evaluated in terms of the relationship of earnings to fixed interest charges. The earnings left after fixed charges or the


16Graham et al., op. cit., p. 309.
ratio of available earnings to total interest requirement is the typical measurement device. The stability of earnings is also important since this may affect the margin of safety deemed necessary. If there is a possible threat of sharp decreases in earnings, a greater margin of safety is required. The evaluation of both the earnings trend and the current level of earnings complete the analysis of earnings as the source of future fixed interest payments.

Balance sheet values are considered to be of secondary importance, as stated previously. The balance sheet is evaluated from a defensive viewpoint. Net worth, for example, as evaluated in the debt-equity ratios, is considered to be the margin contributed to a company by its owners, and it serves as a buffer to absorb any shrinkage in asset values before such shrinkage affects creditors. The working capital position of a company is also important, since short-term obligations must be met in order to ensure the safety of long-term obligations. A high working capital position also indicates an ability to meet fixed charges in the emergency event of temporary poor earnings.

The final evaluation of a specific common stock is not so clear-cut. Yet, earnings is clearly the basic factor. The analyst may reduce the complexity of his

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17 Sauvain, op. cit., p. 228. 18 Ibid., p. 224.
analysis by accepting current market prices of similar securities as a standard for valuation. A current market valuation can be determined by using the average price-earnings ratios for several similar companies.¹⁹ This average ratio or multiplier is then used to evaluate the current or expected earnings of the specific company in question against the current market price of its stock.

A more sophisticated approach is to arrive at a valuation for a security based on an independent evaluation. Graham and Dodd stress this approach in their intrinsic value method.

The analyst could do a more dependable or professional job of passing judgment on a common stock if he were able to determine some objective value, independent of the market quotation with which he could compare current price.²⁰ An independent or appraised value is arrived at when the analyst uses an earnings figure that he believes to be more normal than current earnings and/or a multiplier that he believes to be more realistic than current market averages.²¹

Several methods have been proposed by various writers for arriving at an independent valuation of a stock. Discussions and explanations surrounding these purposed methods are noticeably vague in specifying how to arrive at a final quantification of the important

¹⁹Ibid., p. 306.
²⁰Graham et al., op. cit., p. 435.
variables necessary for the valuation of a given stock.\textsuperscript{22} However, the evaluation of earnings discussed previously in this chapter is generally regarded as the primary source of information. A growth rate is derived from this evaluation, which in turn is used in establishing the multiplier or capitalization rate. Balance sheet factors such as the indexes of financial strength also exert some influence on the multiplier or capitalization rate.\textsuperscript{23} The multiplier or capitalization rate, once derived, is applied to the earnings or dividend figure deemed appropriate by the analyst.

Some methods of arriving at a valuation for a security stress dividend payments, while other stress earnings. However, even if dividends are regarded as the basic factor, total earnings must be evaluated along with the pay-out ratio in order to estimate future dividends. Anticipated dividends are naturally more important in low-growth stocks than in stocks with a high degree of potential growth.

**Evaluating qualitative information**

The analyst does not always rely on quantitative information alone. He usually tries to obtain as much


\textsuperscript{23}Graham et al., op. cit., p. 445.
information on qualitative factors as possible, to be used either to reinforce or to modify the quantitative analysis. The most important qualitative factors revolve around the nature of the business, character of management, and general economic prospects.

One writer, in listing the principal points that an investment analyst would consider in a thorough analysis, includes the normal quantitative factors discussed previously, in addition to such intangible factors as:

1. The ability of management (including depth and provision for succession)
2. Nature of industry and the company's relative position
3. Size and quality of research efforts
4. Degree of competition and threat of new competition
5. The importance of labor costs in connection with union strength and ability to pass on increased costs to customers

Most of these qualitative factors are, of course, reflected in the quantitative data. They are nevertheless important enough to be carefully evaluated for important evidence on possible modification of trends and current data. The analyst is "always on the watch for a 'flag' indicating change in a company's circumstances."  

It is not within the scope of this research study

24 Hopiak, op. cit., p. 18.

to probe all of the factors of a qualitative nature which might be included in the analysis of investment opportunity. The study is concerned with qualitative information only to the extent that such information is reported in the financial statements and is subject to the concept of comparability.

**Reliance on Comparisons**

Any brief examination of the writings of financial analysts reveals that comparative analysis is at the heart of investment selection. This is true both in the evaluation of industries and of companies within an industry. Various industries fill different needs of the investor with respect to growth, stability, income, etc. The analyst attempts to rank industries according to their attractiveness and individual companies according to their attractiveness within the industry group.

The comparative analysis of financial statements usually involves two dimensions. The first dimension is a time or interperiod comparison. Analysts are very interested in comparing the current set of financial statements of a given company with financial statements of the same company for prior years. This comparison in necessary in order to develop the trends and growth rates that


27Graham *et al.*, *op. cit.*, p. 703.
are essential to a general anticipation of the future, as well as determining the decision parameters for a specific evaluation of the security in question. A comparison over years is important both in evaluating the margin of safety for debt securities and arriving at a valuation or appraised value for equity securities. The time-comparative analysis is especially critical for an independent valuation of equity securities. The projection of future earnings and the derivation of the capitalization rate or multiplier necessary to such a valuation stems from this time-comparative or interperiod analysis.

The second dimension is an evaluation of the relative investment potential determined through intercompany comparisons. A strict emphasis on the intrinsic value method outlined in earlier paragraphs would seem to make it unnecessary to directly compare individual items on the financial statements of two or more companies in order to determine the relative investment potential. Comparisons would appear to be made only after the independent value of the stock had been established. As a practical matter, however, comparisons are commonly made between major statement items as well as the final appraised value of the stock. Evidence of this can be found in the example of the spreadsheet type of analysis referred to earlier in this chapter. In addition, comparisons of various ratios and other financial statistics on
a less elaborate scale over time and between companies are commonly found in the writings of the financial analysts.

C. T. Horngren reinforces the observation on the importance of the comparative analysis of major statement items when he concluded, as a result of a series of direct interviews with financial analysts, that analysts study financial statements from a comparative viewpoint. They look for trends and changes in major items. Comparisons are made between years, between products, and between similar firms.28

As further evidence of the types of detailed comparisons commonly made by financial analysts, it is interesting to note that Standard and Poors' Corporation recently has been advertising a new handbook for analysts containing per share data for 425 industrial companies and 86 industry groups. This handbook contains per share data for:

Sales
Operating profit
Profit margin
Depreciation
Federal income taxes
Earnings per share and per cent of sales
Dividends per share and per cent of earnings
Price-earnings ratio

The tendency of financial analysts to include the direct comparison of many financial statement items as part of their analysis is probably attributable to several reasons. One of these reasons may stem from the realization that both the net income and the balance sheet valuations are the result of many measurements which are inherently arbitrary. Reliance on a single figure or even a few selected figures in evaluating investment potential becomes hazardous and would not be compatible with the emphasis placed by the financial analyst on factual analysis. This hazard is reduced by increasing the number of comparison points in drawing a total picture of the relative investment position of two or more companies. This also allows the analyst to develop what he believes to be the "representative earnings" of companies under evaluation. Also, trends can often be discerned more quickly in financial statement items other than net earnings.

Finally, it is difficult to evaluate the various trends and growth rates of a single company without direct comparison of all of the key items with similar companies. Sauvain points this out in a discussion of ratio analysis:

> The strength or weakness of a ratio is not only a matter of how it has changed from one time to another in the financial statements

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29 Advertising brochure, Standard and Poor's Corporation, New York.
of a company but it is also very much a matter of how it compares with the corresponding ratio for other companies and with the changes in this ratio for other companies.30

Summary

The financial analyst attempts to make his evaluations as factual as possible. This places a great deal of importance on the analysis of certified financial statements. The evaluation of earnings is considered to be the most important procedure, but careful attention is also given to ratio analysis. This is true for both the evaluation of the risk and the worth of a security. Qualitative information and cash flow information are evaluated as important supplemental information.

The analyst relies to a substantial degree on comparative analysis. Direct comparisons between two sets of financial statements are commonly made for individual statement items as well as for key ratios. The widespread use of comparisons by the financial analyst reinforces the need for comparability among financial statements. Chapter IV explores the apparent need of the analyst for comparability by examining the impact of the concept of comparability (concept developed in Chapter II) on the specific evaluation techniques employed by the analyst.

30Sauvain, op. cit., p. 196.
CHAPTER IV

A CONSIDERATION OF THE EFFECTS OF THE APPLICATION OF THE CONCEPT OF COMPARABILITY TO THE EVALUATION TECHNIQUES OF THE FINANCIAL ANALYST

Introduction

This chapter focuses on the application of the concept of comparability to the specific methods of evaluation employed by the financial analyst. Each area or factor of comparability, as developed in Chapter II, is examined independently, with emphasis on the potential impact of each area on the evaluations of the financial analyst, as outlined in Chapter III. The specific evaluation techniques receiving central attention in this investigation include comparative statement item (individual economic circumstance) analysis, ratio analysis, and the analysis and projection of earnings. Concentration is focused on the benefits which would accrue to these evaluation techniques with the achievement of comparability according to the concept developed in this research study. This chapter is not concerned with how to achieve the concept of comparability in financial reporting. Instead, the focus is on what the effects of achievement would be for the financial analyst. Pertinent comments or specific
attacks made by financial analysts are also included in order to relate directly their expressed concerns to each of the areas or factors of comparability.

As indicated in Chapter II, it is necessary to assume a framework of accounting to serve as a reference point in order to discuss the application of the concept of comparability. The framework of accrual accounting assumed in Chapter II is also applicable to this chapter. It should also be emphasized that any references to comparability made in this chapter (with the exception of comments attributable to others) refer specifically to the concept of comparability as developed in Chapter II.

**Statement Presentation**

**Captions**

The statement presentation area of comparability includes the variables of statement captions, statement classifications, and detailed information. As stated in Chapter II, uniformity in the statement presentation variables between two sets of financial statements in the reporting of a given financial statement item is generally necessary to produce comparability. With respect to statement captions, the achievement of comparability would assure the financial analyst that the same statement caption appearing on two sets of financial statements indicates the presence of similar economic circumstances (statement items), whereas divergent statement captions
would indicate the presence of different economic circumstances. The current state of financial reporting does not allow such an interpretation to be made with any degree of assurance. This impairs the comparative analysis of individual economic circumstances and could also lead to misinterpretations of key ratios.

There is some evidence that financial analysts recognize the potential problems associated with a lack of comparability in the area of statement captions. Harry Sauvain, author of *Investment Management*, points out the dilemma created by a lack of uniform captions among companies in the reporting of non-operating income and expense. He cautions that "in preparing the spreadsheet the analyst may therefore have to identify items of non-operating income and expense."¹ A more vociferous attack on statement captions appears in an article in the Financial Analyst's Journal:

An example of varying terminology may be found by examining the listing of sales revenue by companies in the steel industry. Included are such captions as "Sales", "Net Sales", "Net Sales, etc.", "Net Sales and Operating Revenue", "Sales, Less Freight and Cash Discounts", "Gross Sales, Less Discounts, Returns and Adjustments", and "Gross Sales, Less Returns, etc." Quite possibly the information included under several of these captions could be the same, but there is no

way for the reader of the financial statements to assure himself that this is the case.\textsuperscript{2}

The author goes on to state that accountants would be doing financial analysts a real service if they would standardize the nomenclature and the interpretations used in the financial statements for the various industrial groups.\textsuperscript{3}

What is the potential effect of the present lack of comparability in the area of statement captions? When faced with the dilemma of divergent statement captions in present financial statements, the analyst may assume either that the captions indicate different economic circumstances or that the same economic circumstance is indicated. As an illustration, suppose the analyst is evaluating the sales position of two companies where "sales" are reported for one company and "net sales" are reported for the other. If the analyst assumes that the same economic circumstance is indicated, he may be misled in evaluating the sales position of the two companies, if the headings do, in actuality, represent divergent circumstances (i.e. net sales for one company and gross sales for the other). On the other hand, the analyst might assume that a comparison is not justified when, in actuality, the same economic circumstance is presented.


\textsuperscript{3}Ibid.
It may also be possible that the analyst would feel compelled to attempt to investigate what is actually represented by the divergent statement captions. In any event, when faced with divergent statement captions in present financial statements, the analyst is either unsure of the validity of a comparison of the reported item, or he must waste valuable time in an attempt to ascertain the true state of affairs.

A somewhat similar problem is posed, in present financial reporting, when the same caption appears on two sets of financial statements. As an illustration, suppose the analyst is again evaluating the sales position of two companies and "net sales" are reported by both companies. With the existing state of reporting, the analyst cannot be sure that the same economic circumstance is being reported by the two companies or that it is reported on a comparable basis (in accordance with the concept of comparability). Again, the analyst is faced with the problem of being misled by making the wrong assumption about what is reported. The achievement of comparability including uniform statement captions, in reporting a given economic circumstance among companies would assure the analyst that direct comparisons could be made without fear of distortion. This would also allow divergent statement captions to communicate clearly to the analyst that different economic circumstances are being reported.
Statement classifications

Statement classifications constitute another variable of statement presentation. As indicated in Chapter II, statement classifications may be either disclosed or undisclosed. Disclosed classifications occur when accounts are grouped together for listing in the same section of the financial statements. Undisclosed classifications occur when the grouping results in a single figure reported on the financial statements. An example of a classification divergency would be where one company has deducted sales discounts in arriving at net sales, while another company has included sales discounts as a selling expense. This would be a disclosed classification divergency where sales discounts appeared separately on the financial statements and an undisclosed classification divergency where they did not.

Disclosed classification divergencies are commonly criticized by financial analysts. Sauvain, for example, in discussing rearrangements of the income statement which the analyst might find necessary, comments that "sometimes depreciation is not listed in published statements as an operating expense but is deducted further down in the income statement after profit from operations." Similarly, in discussing rearrangements of the balance

3 Sauvain, op. cit., p. 203.
sheet which might be necessary, Sauvain comments that "prepaid expenses are often classified as miscellaneous assets; usually they may properly be treated as current assets." ¹⁴

Disclosed classification divergencies, however, do not pose the most serious threat to the financial analyst, since he can reclassify the account to conform to the treatment of other companies. A much more significant problem is created where the classification is not disclosed (where two or more accounts are grouped together for reporting as a single figure). Recognition of this problem is found in the following criticism levied by a committee of financial analysts in a study of annual reports in the oil and gas industry:

The amount of excise and sales taxes included in gross operating revenues should be disclosed, either through a deduction to obtain a net figure or else through a footnote to the profit and loss statement. Most integrated oil companies provide adequate disclosure of this item, but there are a few which still do not even note whether their gross income is before or after taxes (emphasis added). Some others note that gross includes excise taxes, but either do not disclose the figure or bury such information in the text of the annual report. ⁵

¹⁴Ibid., p. 200.

Undisclosed classification divergencies, although potentially more serious, do not seem to be as widely criticized by financial analysts as disclosed classification divergencies. The most probable reason for this trend in criticism is the difficulty of ascertaining when undisclosed classification divergencies occur. In other words, the existence of the problem does not always come to the attention of the financial analyst.

Classification divergencies are not uncommon. Evidence of the wide disparity in the statement classification of sales and excise taxes was given in Chapter II. An investigation of the cement industry found variations in the statement classification of freight charges and packaging costs. The statement captions in the previous quote referring to the steel industry indicates the likelihood of similar variations. It is not unlikely that investigations of groups of other companies would disclose other classification divergencies.

A divergency in a disclosed classification might affect the interpretation attached to the reported item by the financial analyst. For example, the reporting of prepaid expenses in other assets as opposed to current assets might affect the interpretation of the liquidity of the prepaid expenses. A divergency in undisclosed

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6Chapter II, p. 24.
statement classifications between two companies can affect the reported dollar magnitude of individual economic circumstances. This could distort the analysis of individual economic circumstances. It might also distort one or more key ratios used by the financial analyst. For example, a divergency in an undisclosed statement classification of sales taxes or sales discounts might distort the turnover of assets (\( \frac{\text{sales}}{\text{assets}} \)) and net earnings as a percentage of sales. Similarly, a divergency in the undisclosed classification of prepaid expenses might affect the current ratio and evaluation of working capital. Although net earnings would typically not be affected by undisclosed classification divergencies, the analysis of components of earnings might be distorted.

The achievement of comparability with respect to undisclosed statement classifications would increase the reliability of the analysts' evaluations, especially the comparative evaluation of ratios and individual economic circumstances. The achievement of comparability in undisclosed statement classifications would assure the financial analyst that an account which is not reported separately in the financial statements has been added or deducted from a total appearing under the same caption for two companies. In other words, the achievement of comparability in undisclosed classifications would assure the financial analyst of uniform item constituency behind
a given statement caption to the extent that the same items apply to both sets of statements. The achievement of comparability with respect to disclosed classifications would assure the analyst that the same implied meaning was attached to the reported item.

**Detailed information**

The third statement presentation variable is the reporting of detailed information. The lack of comparability in the reporting of detailed information has often been sharply attacked by the financial analysts. In evaluating the reports of aircraft manufacturers, an analyst comments that the group appears to be going backwards on one aspect—details as to the operating statement. Only four of the companies now break down figures into cost of sales, selling, general and administrative expenses, etc.

A committee of four analysts, in evaluating the financial reporting of the oil and gas industry, comments that a considerable lack of uniformity exists among oil companies in the reporting of annual charges for depreciation, depletion, amortization of intangible drilling costs, retirements, surrendered leases, dry hole costs and other exploration expenses. In many cases, a number of these items are combined in such a manner as to make it impossible for the analyst to determine the so-called cash earnings figure and to make valid comparisons with similar figures for other companies.

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8 Anderson, *op. cit.*, Sub-committee report on the Aerospace Industry, p. 82.
It is strongly recommended that an attempt be made to achieve a greater degree of uniformity in reporting these expense items.  

A comment which could be interpreted as a criticism of a lack of comparability in all three of the statement presentation variables of classifications, captions, and detailed information is found in Sauvain's book on *Investment Management*. Sauvain comments that "because the form and detail of published financial statements vary considerably, the security analyst has to devise a standard form of balance sheet that will best serve his purpose."  

Sauvain makes the same comment concerning the income statement.  

The impact of comparability, or a lack thereof, with respect to detailed information will vary significantly according to the type of information involved. Detailed information presented in connection with the income statement is perhaps the most critical, owing to the significance attached by the analyst to net earnings. The analyst evaluates each item on the income statement as part of his analysis of historical earnings, to serve as a basis for projecting future earnings. As mentioned in Chapter III, one method of projecting future earnings is to project all of the detailed items on the income

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statement. It is obviously necessary to have the same income statement detail between two companies in order to make projections to the same extent for both companies. Even if the analyst projects only the net earnings of two or more companies under analysis, he needs the same general information in order to make the projections on the same basis. This is due to the fact that the detail appearing in the financial statements often flags changes not apparent in totals or the net earnings figure. For example, changes in crucial operating expenses such as research and development often have special significance for future expectations. An increase in research and development expenses might cause the analyst to project an increase in net earnings for future years, whereas an increase in another expense such as salaries and wages might cause the analyst to project reduced net earnings.

There are other potential distortions to the analyst's evaluations, resulting from a lack of comparability in the reporting of detailed information, which are closely related to the analysis and projection of earnings. For example, the failure of a company to report the cost of goods sold eliminates the possibility of evaluating the gross margin of the company and of making a direct comparison of that item with other companies. The same would be true in the failure of a company to disclose separately non-operating expenses and income.
Comparability in the reporting of detailed information in connection with the income statement would provide the analyst with the same general information on two or more companies in order to make projections on the same basis. It would also allow other evaluations pertaining to the income statement to be made on the same basis. At the present time, an analyst may be forced to compare a statement which shows only a single operating expense figure with a statement which sets forth cost of goods sold, selling expenses, and administrative expenses, along with major items in each category. Similarly, one statement may detail non-operating items, while another statement may show a single net figure or even bury non-operating items in operating categories. Any brief examination of a number of current annual reports indicates the existence of wide variations in the detailed information that is revealed in connection with the income statements of the reporting companies.

The importance of comparability in the reporting of detailed information is not confined to the income statement. The comparability of detailed information pertaining to the balance sheet is also important. The existence of comparability in such information would help ensure the reliability of the analyst's evaluation of both short and long-term liquidity. For example, a divergency between two companies in presenting information concerning the breakdown or composition of inventories
(supplies, raw materials, work-in-process, and finished goods) can affect the comparative evaluation of the inventory liquidity and working capital positions. Similarly, the failure of one company to disclose the important details (interest rate, maturity, form of security, sinking fund provisions, call provisions, etc.) of funded debt can affect the evaluation of the debt position of two companies. The failure of one company to disclose the market value of marketable securities can affect the comparative evaluation of short-term liquidity and the future cash inflows. The disclosure of both cost and market values allows an evaluation of the probable effect of the disposal of the securities on net earnings. Divergencies in the breakdown of fixed assets by categories or in presenting both gross and net book values can affect the comparative evaluation of the fixed asset position and the need for replacement of capital equipment. Consideration of the need for replacement of capital equipment could also have some bearing on the analyst's evaluation of the proportion of future earnings available for dividend distributions.

The achievement of comparability in the reporting of detailed information would assure the analyst of the same information for the evaluation of two or more companies. This does not, however, determine the information which should be disclosed in order to maximize the usefulness of financial statements for the analyst.
determination of the information which is desired by the analyst is not within the ambit of this study.¹²

**Measurements**

**Valuation basis**

The measurement area of comparability involves the variables of the valuation basis, the measuring unit, and economic flow approximations. The achievement of comparability, with respect to the valuation basis, would assure the analyst that any difference in the dollar magnitude of a given economic circumstance reported by any two companies has not been artificially distorted by a divergence in the choice of the valuation basis to be used in the statement presentation of that circumstance. A divergence in the selection of the valuation basis in the presentation of a given economic circumstance will typically affect the dollar magnitude of the reported net income as well as the individual economic circumstance. Any ratio involving either the affected economic circumstance or net earnings would also be distorted.

Different valuation bases are presently used among companies in the reflection of various economic circumstances. Acquisition cost is probably regarded as the most common basis. Other valuation bases used include

¹²A fairly comprehensive presentation of the detailed information desired by financial analysts is found in the study by Corliss D. Anderson which has been referred to previously in this chapter.
market values, discounted present values, and replacement costs. The achievement of comparability in this area, as discussed in Chapter II, would be accomplished by the uniform use of a valuation basis in the reflection of a given (the same) economic circumstance among companies. *Accounting Trends and Techniques* yields evidence of the present use of different valuation bases among companies in the presentation of the same economic circumstance. Where this occurs, the evaluation techniques of the analyst become subject to distortion.

Financial analysts recognize problems associated with divergent valuation bases. Graham *et al.* list as one of the complications in the analysis of the area of depreciation and fixed assets the fact that accounting rules permit "a value other than cost as the basis of the amortization charge." Sauvain points out the problem of differences among companies in the valuation basis (cost versus equity) used for reflecting an investment in unconsolidated subsidiaries. Anderson states that the valuation basis used by a company in the reflection of

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13 For example, information on inventory pricing reveals that 529 companies used lower of cost or market, 136 companies used cost and 40 companies used some other basis; *American Institute of Certified Public Accountants, 1964 Edition*, p. 46.


marketable securities and inventories should be clearly stated for the financial analyst.\textsuperscript{16} A prominent banker comments on the problem of the difficulty that is encountered in determining how inventories are carried and costed.\textsuperscript{17}

What are some of the potential specific distortions created by a lack of comparability in this area? Since a divergency in the valuation basis affects net income, the analyst's comparative projection and capitalization of earnings can be distorted. This could affect any final intrinsic values determined by the analyst.\textsuperscript{18} As mentioned previously, all ratios involving net income could also be distorted. This would include such key ratios as the coverage of fixed interest charges, coverage of preferred dividends, net earnings as a percentage of assets, earnings per share, and market price to earnings. Other key ratios could also be affected, depending upon the particular divergency in question. For example, a divergency in the valuation basis used to reflect fixed assets could distort such ratios as the turnover of fixed assets and long-term debt to fixed assets. Such a

\textsuperscript{16}Anderson, \textit{op. cit.}, pp. 37 and 41.


\textsuperscript{18}The concept of intrinsic value is discussed in Chapter III, p. 67.
divergency might create a distortion to both the numerator and denominator in the computation of the ratio of net earnings to assets. Divergencies in the valuation basis used to reflect marketable securities or inventories could affect the current ratio and evaluation of working capital. The achievement of comparability in the valuation basis used in the reflection of a given economic circumstance would eliminate distortions in the reported dollar magnitude due to divergent valuation bases and thus aid in ensuring the reliability of the analyst's comparative evaluation of earnings, ratios, and individual economic circumstances.

Measuring unit
The measuring unit is similar to the valuation basis in that the magnitude of a reported economic circumstance is typically affected along with net income and key ratios. Comparability with respect to the measuring unit would assure the analyst that financial statement items have been measured by a uniform scale representing the same economic purchasing power. This would aid in ensuring the reliability of the analyst's comparative evaluation and projection of earnings, ratios, and individual economic circumstances.

The position of the financial analyst with regard to the problems created by changes in the purchasing power of the dollar is not clear. Some surveys of the
financial analysts have indicated a lack of interest in general price-level adjustments. Some conflicting evidence is offered by the comment of Graham et al.: "We believe that adequate reporting to stockholders should clearly segregate the portion of the year's results that is attributable to changes in the price-level." Additional evidence of concern over price-level changes is found in an article by a prominent analyst in the Financial Analysts Journal, where price-level changes are listed as one of the variations in financial reporting that present a constant challenge to the financial analyst.

It is entirely possible that the average financial analyst either does not fully recognize the potential limitations to his analysis created by changing price-levels or that the process of adjusting is simply viewed as being too overwhelming to undertake. Accountants have been concerned with the lack of comparability

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20 Graham et al., p. 147.

imposed by changing price-levels, as evidenced by the following comment from Accounting Research Study No. 6:

The purpose of price-level adjustments, which might more accurately be characterized as corrections for changes in the price level, is to express or restate each item on the financial statements in terms of a "common" dollar, that is, in terms of a dollar of the same general purchasing power. Such figures can logically be compared and more meaningful conclusions can be drawn than from the original unadjusted cost figures.  

The mechanics of adjustment are explained in substantial detail in the research study noted above. This is the type of adjustment process consistent with the concept of comparability developed in this study. It is recognized that there is the likelihood of some distortion occurring due to the use of average index numbers for some of the adjustments. However, this is unavoidable.

At the present time, adjustments are not commonly made for changes in the purchasing power of the dollar. This creates a situation for innumerable distortions between financial statements and in the evaluation of financial statements by the analyst. Net earnings, for example, becomes the result of deducting from sales various expired costs measured in dollars which represent different purchasing power. A figure determined in such a manner is potentially misleading. In a period of continuously rising prices, reported earnings is likely to

\[22\]Staff of the Accounting Research Division, "Reporting the Financial Effects of Price-Level Changes," Accounting Research Study No. 6 (1965), pp. 24-25.
be overstated because part of the reported profits will
be necessary to replenish exhausted inventories, fixed
assets, and other operating assets. Thus, a portion of
the reported earnings really represents a recovery of
capital. It would only be a coincidence if such a recovery
of capital occurred to the same extent for any two com-
panies. In addition, it would seem that the net figure
used to evaluate profitability and return on the invest-
ment committed to a company by the stockholders cannot
properly include a partial recovery of capital.

A projection of earnings based on historical data
unadjusted for changes in purchasing power can also be
misleading. Any future event which causes the old dollar-
cost allocations to be replaced by more current dollar-
cost allocations can cause a substantial change in the
level of reported earnings. Such an event would be the
modernization or replacement of old plant and equipment
facilities. Another significant deviation in the earnings
pattern could be caused by dipping into old costs asso-
ciated with a lifo-valued inventory, as would be done if
the purchased quantity fell below the sales quantity in
any given period. Changes in dollar cost allocations
caused by such events are artificial to the extent that
they are due to changes in the purchasing power of the
dollar. In addition, artificial changes in earnings might
occur due to changes in the general price-level movement
(i.e. acceleration, deceleration, or even reversal). All
of these potential distortions could have affected prior earnings, if the events occurred in periods under review, or they could occur during future periods under projection. Either situation could cause the projection based on historical analysis to be substantially different from actual results. Again, there is no assurance that the distortion would be the same for any two companies.

The failure to adjust for changes in the purchasing power of the dollar also affects ratio analysis. The analysis of profitability is especially impaired since the typical measures of profitability relate earnings to invested capital. A double distortion is created in the analysis of this area. A continued inflationary trend, for example, results in an overstated earnings measured against an understated investment. Both earnings and invested capital need to be adjusted for general price-level changes in order to obtain a meaningful evaluation based on uniform purchasing power. The failure to adjust for general price-level changes also affects the ratio analysis of liquidity and safety of investment. Many of the important ratios include components which are often measured in old dollars representing different purchasing power. Items which are purchased in different periods and remain on hand for several periods during changing price levels, impair the ability to make meaningful comparisons between the individual items or aggregates including such items.
Some accountants would argue that changes in the purchasing power of the dollar have not been significant enough to cause any real concern to the analyst. Yet the reported earnings of a company for any year may include depreciation on facilities which were purchased ten, fifteen, or twenty years ago. The use of the lifo inventory valuation method could result in a carrying value of inventory based on a purchase price which is several years old. Capital invested by stockholders and long-term creditors also is often represented on the financial statements by dollars of a period several years in the past. Thus, several of the key figures used by the analyst may be affected by a substantial general price-level change, due to the aggregate effect of changes in purchasing power over several years.

**Approximation of economic flows**

The third measurement variable is the approximation of economic flows. Comparability with respect to this area would assure the analyst that the accounting methods of approximation used by any two companies are appropriate to the respective underlying economic flows. Comparability would not assure the analyst of uniformity in approximation methods among companies. As indicated in Chapter II, a uniform method applied to dissimilar flows does not produce comparability. Therefore, uniformity in this area of accounting does not appear to be a desirable objective.
of the analyst. The existence of divergent approximation methods among companies is necessary in order for comparability to exist in accounting for dissimilar economic flows.

Comparability with respect to the approximation of economic flows is important to all of the methods of evaluation used by the analyst. As in the cases of the valuation basis and the measuring unit, the achievement of comparability would help to ensure the reliability of the analyst's comparative evaluation of earnings, ratios, and individual economic circumstances. There are presently widespread variations among companies in the accounting methods of approximation. It is not generally known, however, to what extent such divergencies are justified by differences in the basic nature of the underlying economic flows. One detects an intuitive consensus among accountants that these variations are not fully explained by dissimilar flows. This consensus is supported, in part at least, by the fact that alternative methods of approximation selected by a company are not required to be justified by the nature of the underlying economic flows. This indicates a likelihood that the divergencies in methods are not fully justified by dissimilar flows.

A quotation included in Chapter II indirectly refers to this problem where it is argued that the lack of criteria for the selection of specific accounting procedures for given situations represents one of the most significant vacuums in accounting literature. (See page 38, Chapter II.)
Divergencies among companies in the accounting for economic flows appear to represent the area of greatest concern to the financial analyst. The most common attacks voiced by the financial analyst focus on the lack of comparability among companies in such accounting areas as depreciation, inventories, and capitalization versus expense. In commenting on the security analysts' problems in evaluating inventories and depreciation, Graham et al. comment that

the security analyst is interested in these matters from two practical standpoints. First he must make up his mind as to what treatment of inventory and depreciation will supply the most helpful approach to calculating the "normal" earning power and—less importantly—the actual asset values. Secondly, to the extent possible, he must develop means of placing all companies in a given industrial group on the same accounting basis, as regards inventories and depreciation, to permit a proper comparative analysis.24

Graham et al. also comment on the varying treatment for book purposes of items which may be expensed or capitalized.25 Sauvain adds additional evidence on the problems created by items which may be treated as operating expenses in the period in which they are made or capitalized to be amortized in future periods. He states that

security analysts generally try to make adjustments for such differences in accounting treatment in such manner as to make all statements conform to the usual practice in an industry or to provide the most conservative statement of earnings.26

24Graham et al., op. cit., p. 138.
Sauvain also comments that "a more serious problem for the analyst is presented by charges for depreciation, depletion, and obsolescence..." and that "adjustment, if it is undertaken is usually to some basis that the analyst considers conventional or normal for the industry in which the company is engaged."27 A recent article in the Financial Analyst Journal includes the comment that until the accounting profession can promote uniform policies for handling depreciation under the new laws, confusion will continue to be widespread. In the meantime financial analysts have their work cut out for them.28

As discussed in Chapter II, a lack of comparability exists between two sets of financial statements when either divergent approximation methods are applied to similar flows or when uniform methods are applied to dissimilar flows. For example, such a distortion might occur between two companies in the approximation of the outflow of inventory. This could result in significant differences in the reflection of both the inventory position and the cost of goods sold. The distortion of the inventory position could affect the working capital position, including the current ratio and turnover of inventory, both of which are important in evaluating short-term liquidity. The operating margin and the level of net earnings could be affected.

27 Ibid.

because of the distortion of cost of goods sold. The change in reported earnings could affect all of the profitability ratios and miscellaneous ratios which relate earnings to some other figure. This would include net earnings as a percentage of sales, net earnings as a percentage of stockholder's equity, net earnings as a percentage of assets, coverage of fixed interest charges, earnings per share, price to earnings, and dividend payout.

Another distortion might occur in approximating the expiration pattern of productive fixed assets. This could lead to a misleading statement of the depreciation expense and the fixed asset position. The distortion of the depreciation expense could affect net earnings and all of the ratios involving net earnings as listed in the preceding paragraph. The ratio of net earnings to fixed assets would be subject to distortions in both the numerator and denominator, since both the net earnings and fixed assets might be misstated. The distortion of the book value of fixed assets could also affect such ratios as stockholder's equity to fixed assets, fixed assets to long-term debt, and turnover of fixed assets.

Variation in the approximation of economic flows in only two problem areas, inventories and fixed assets, affects at least twelve key ratios important to all three areas of ratio analysis (short-term liquidity, long-term solvency and profitability). Obviously, the evaluation
and projection of earnings, as well as the determination of the multiplier or capitalization rate, is also affected. Other possible areas of divergent approximation of economic flows could also be discussed. However, the effects on the evaluations of the analyst would be much the same. Comparability with respect to economic flows would be of substantial aid to the analyst in achieving evaluations which are not distorted.

Unfortunately, the area of approximation of economic flows, the greatest area of concern to the financial analyst, is probably the most difficult area to resolve in the achievement of comparability. The difficulties inherent in resolving the nature of such flows and in determining the evidence to be used in selecting the appropriate method of approximation for a given company have already been pointed out in Chapter II. This does not mean, however, that the financial analyst is unjustified in demanding comparability in this area.

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29 The development and use of the multiplier or capitalization rate by the financial analyst is explained in Chapter III, page 67.

30 Demands for uniformity by the financial analyst, however, would not be justified. As indicated previously, demands for strict uniformity among companies in the approximation of economic flows would not be realistic in light of the inherent differences among companies. Recent evidence suggests that analysts perhaps are becoming more aware of this fact. Dr. Morton Backer reports that while analysts are disturbed by the diversity in accounting methods, they do not favor rigid, uniform procedures. (News report, op. cit.) To the extent that this view is
The objective in the preparation and certification of financial reports presumably is the communication of financial information for the benefit of user groups, in the ranks of which the financial analyst warrants considerable importance. As a user group, the financial analysts have a right to attack whatever they perceive to be failures to meet their needs in financial reporting, unless it has been conclusively demonstrated that it is impossible or not desirable to meet those needs. Such conclusive evidence has not been offered for any of the factors of comparability included in the concept of comparability developed in this paper. At the same time, it must be admitted that there is not conclusive evidence that comparability can be fully achieved with respect to each of the factors in the concept of comparability. Much additional research is needed to determine how far the implementation of comparability can be achieved.

Summary

This chapter has examined the application of the concept of comparability to the evaluations of the financial analyst and the potential impact of that concept on his analysis. Much of the discussion centered on distortions occurring in the evaluations of the analyst which might not be shared by all analysts, accountants have the task of logically demonstrating to the analysts the difference between uniformity and comparability.

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be eliminated with the achievement of comparability. Only a limited number of illustrations was discussed. However, it appears that the potential impact of comparability would be significant for the financial analyst.

The potential distortion in all of the areas where comparability currently does not exist presents a staggering problem to the financial analyst. The present task of deciphering financial statements is described by one writer as an almost Herculean task:

The analyst's task becomes that of a meticulous investigator to ascertain identity, similarity, or discrepancy of principles and methods employed by different corporations in identical or affiliated industry groups. Where principles and methods differ widely the analyst is faced with the burden of either reducing, if possible, the differences to a common basis or else of evaluating them. Either is often an almost Herculean task. 

The achievement of the concept of comparability developed in this paper would substantially reduce the deciphering problems of the analyst. It is difficult, often even impossible for the analyst to convert most financial reports, as they are presently prepared, to a comparable basis. The existence of comparability would not assure the financial analyst of obtaining financial statements of maximum usefulness. This requires the development of an accounting framework based on relevancy to the needs

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of financial analysts, with implementation of such a framework in conjunction with the concept of comparability developed in this paper. Future research is needed to determine the extent to which such implementation can be achieved.
CHAPTER V

CONCLUSIONS

The primary objective of this research study was to develop a specific concept of comparability. The secondary objective was to examine the potential effects of the application of this concept on the evaluations of the financial analysts as users of financial statements. Two hypotheses were established at the outset of the study:

Hypothesis I

It is possible to establish a concept of comparability which is sufficiently precise to determine its presence or absence between two sets of financial statements.

Hypothesis II

Comparability represents a desirable goal of financial reporting.

An examination of the concept of comparability, as developed in Chapter II, seems to warrant the conclusion that the first hypothesis is true. As indicated in Chapter II, the essence of the concept of comparability is the equivalent reflection of individual economic circumstances. Therefore, the concept of comparability consists of the variables or factors which are necessary for the equivalent reflection of economic circumstances. (These variables are summarized on page 49 of Chapter II.) Each of these variables is distinct and can be separately
evaluated in the determination of the presence or absence of comparability in the reporting of an economic circumstance. In order to determine the presence or absence of comparability between two sets of financial statements, however, access to internal information of both companies would typically be necessary. This means that the user of financial statements would not normally be in a position to determine the presence or absence of comparability. This point will be amplified in a subsequent discussion.

There is one important qualification to the acceptance of the first hypothesis. This qualification is created by the existence of problem areas in accounting where either the nature of the economic flow in connection with a given economic activity has not been resolved or evidence pertaining to that flow is not available. As discussed in Chapter II, it is impossible to determine the appropriate accounting method of approximation to be used in such a situation, and comparability between two companies in the reporting of the affected economic circumstance becomes indeterminable.

The second hypothesis would also appear to be true. Examination of the potential effects of the concept of comparability on the evaluations of the financial analyst (Chapter IV) indicated that substantial benefits would accrue to the analyst with the achievement of comparability among financial statements. All factors in the concept of comparability appear to be important in ensuring the
reliability of the analyst's comparative evaluations. In the absence of any known negative effects accruing to other users of financial statements, the achievement of comparability must be viewed as a desirable goal of financial reporting.

There are several important implications which follow from the concept of comparability developed in this research study. In examining the concept of comparability, it becomes apparent that the user of financial statements would typically not be in a position to evaluate the existence or absence of comparability. For example, the user of financial statements would not be able to determine undisclosed classifications, he would not be able to ascertain if differences in detailed information were due to materiality, and he would not be able to ascertain whether or not the approximation methods used were appropriate to the underlying economic flows. In order to be able to determine if comparability exists, the user of financial statements would typically have to have access to the internal information of both companies. Such access would not usually be available. If such access were available, financial statements for the sophisticated user would be largely unnecessary, since each user could prepare his own set of statements according to his own specifications.

This also points out the limitations of disclosure
in achieving comparability. More than a few accountants seem enamored with disclosure as the vehicle for attaining comparability. The main shortcomings of disclosure lie in the areas where alternative accounting procedures are used to approximate economic flow patterns. It is obvious that the disclosure of the accounting procedures used by a company in such approximations is not in itself sufficient to ensure comparability. Such disclosure would highlight the extent to which divergent procedures are used. But this would yield no evidence on the applicability of the procedures used. In order to determine the applicability of procedures used by each company, the analyst would need access to internal information relating to the typical flow patterns for each company. If the analyst determined that adjustments or conversions were necessary to produce comparability, information such as quantities, prices, etc. would also be needed. It is not likely that all of the needed information could practically be disclosed in the financial statements or even appendages to the financial statements. In the absence of such information, the financial analyst must rely on the integrity and skill of the preparer(s) or independent examiner(s) of the financial statements for the existence of comparability. This emphasizes the need for a clear understanding of the nature of comparability by both the preparer (or examiner) and the user of financial statements.
An examination of the concept of comparability developed in this paper also indicates that comparability can be distinguished from uniformity. Uniformity is the more restrictive of the terms and implies a complete lack of variation in the preparation and presentation of financial statements. This would include uniformity in valuation and measurement procedures as well as in reporting techniques such as classifications, captions, and detailed disclosures. In the literature of the field, uniformity and comparability are often seen as the same phenomenon.\(^1\) Comparability among financial statements, however, can be viewed as a goal of financial reporting. Uniformity is only partially compatible with that goal. Uniformity produces comparability in some situations and not in others. Uniformity in the statement presentation variables (captions, classifications, and detailed information), as well as the valuation basis and the measuring unit, is typically necessary to produce comparability in the reporting of a given economic circumstance. Uniformity in accounting approximation methods, however, produces comparability only where the economic flow being approximated is similar for both companies. Uniform accounting

\(^1\)This was especially true at the time the first draft of this study was written almost two years ago. More recent articles have started to distinguish these two concepts to some degree. One of the most recent attempts was by Herman W. Bevis in "Progress and Poverty in Accounting Thought," Journal of Accountancy, 122 (July, 1966), p. 35.
procedures applied to differing economic flows creates a lack of comparability. Comparability is the constant and uniformity is the variant, applicable where justified by similar economic flows, and not applicable where economic flows are dissimilar.

The concept of comparability also points out that comparability and what might be referred to as "basic identicalness" (existence of the same operating conditions) can be distinguished. The relation of comparability and basic identicalness has sometimes been confused in the literature. Basic identicalness is not likely to be found between any two companies. Some writers have implied that comparability cannot be achieved because of the absence of basic identicalness. However, there is nothing in the concept of comparability which requires the existence of the same operating conditions. The existence of variations in operating conditions does require, however, that careful attention be given to the appropriate reflection of dissimilar economic circumstances. As indicated in Chapter II, the concept of comparability has the twin objectives of reporting similarities as similarities and differences

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2The following remarks apparently illustrate this position: "The impossibility of presenting the accounts of different companies in the same industry on a completely comparable basis arises from the fact that physical and financial conditions and management policies are different, and this must be reflected differently in the accounts." Maurice E. Peloubet, "Is Further Uniformity Desirable or Possible," Journal of Accountancy, 111 (April, 1961).
as differences. The fact that basic identicalness does not exist among companies increases the importance of achieving comparability in financial reporting.

A final implication of the concept of comparability, as developed in this paper, is that the achievement of comparability in financial reporting would not, by itself, provide the ultimate solution to maximizing the usefulness of financial statements to user groups. As demonstrated in Chapter II, the concept of comparability can be applied to different accounting frameworks. In order for financial statements to be of maximum usefulness to user groups, the accounting framework must be selected in light of the needs of user groups. This requires a careful investigation of the needs of user groups. In order to maximize the usefulness of future financial statements, future research should concentrate on the two issues of comparability and the relevancy of the accounting framework to the needs of user groups.
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