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# THE NEED FOR CHANGE IN ACCOUNTING POLICIES

An Address By

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On any occasion when I talk about change as I plan to do today, the ironies of life continually confront me. As a lawyer, much of my career has been devoted to assisting clients reduce uncertainties by predicting the outcome of various actions. As a conservative by inclination, I am inclined to look with some satisfaction at the institutional structure which exists today. As an individual, I am comfortable, as most of us are, with familiar ways and things and distrustful of attempts to impose "improvements" which will rearrange and perhaps threaten successful patterns which have been established over a period of years.

And yet, in my current position, I find myself and my colleagues branded as impatient, dedicated to dramatic change without adequate study of effects and unsympathetic to the cries of those whose livelihoods will be ruined and whose children will be sold into slavery as a result of our precipitous actions.

As I contrast my accurate self image with these external perceptions, I can only take comfort in a new law which is now in the final stages of development in the Office of our Chief Accountant. This law we will call Burton's Law of Anticipatory Multiplication. It holds that all changes seem several times more significant and more threatening when viewed in prospect than in retrospect. Human beings do not frequently welcome change but they cope remarkably well with it after it has occurred. Once the reality is faced, it is generally neither so monumentally different nor so threatening as it originally appeared.

This is not to say, of course, that change is not real. Over a period of years, very significant changes in our institutions do occur. This is necessary and desirable, since changes are the safety valve by which our system is able to operate effectively and within a broad consensus without periodic explosions or revolutions. We view the Commission's current activities in this light. We are helping evolution in our areas of responsibility so that our basic free capital market institutions will continue to operate in a fashion consistent with public expectations and economic realities. The practical alternative to successful evolution is not the indefinite preservation of the comfortable old ways but rather increasing pressure for radical replacement of the whole system.

As I look at today's environment, it seems to be characterized by an increased demand for fairness and openness, and extraordinary substantial economic uncertainty. Our institutions must be responsive to these characteristics. In the Commission's areas of responsibility, we are attempting to assist in the evolution of our capital market system consistent with these realities. We are confident, for example, that the central market system on which we are working will represent a market characterized by fairness to buyers and sellers and by full disclosure of trading data.

Another important part of our capital market system which is of more direct interest to those of you here today is the framework of full disclosure of the economic activities of issuers of securities which serves as the basis for sound investment decisions. This includes, of course, the vital role of the accounting profession in assuring the high quality and reliability of that disclosure to investors. Despite analytical theories casting doubt on the utility of disclosure in the making of investment decisions and the persistent cynicism regarding the use which ordinary investors can and do make of disclosures, we are firmly of the view that more complete, meaningful and frequent disclosure of the operations and financial condition of our publicly-held companies is more important than it has ever been. It is essential for the perservation of our economic system.

It is apparent that this disclosure framework, as it relates to financial matters, must be responsive to a changing environment. While a large number of rules and conventions have developed over the years to assist in the presentation of meaningful information to investors, we must constantly be willing to re-examine these guidelines in the light of changing circumstances. There must be a recognition that traditional models, rules and modes for disclosure may not be adequate in periods of major economic change such as we are experiencing today.

By way of example, let me look at a few areas of financial reporting and indicate how traditional approaches may have to be adjusted. One that comes immediately to mind is the effect of inflation on the meaningfulness of financial reporting. As we all are painfully aware, the rate of inflation in the United States and the world today is at a high level. This affects our business entities in a variety of ways. Costs rise, and prices follow. Plans must be constantly adjusted to take into account changing prices in different areas.

Decisions as to optimum credit, inventory, capital expenditure and financing policies must be reviewed more frequently than has usually been the case.

Under such conditions, traditional financial statements have many weaknesses since they are based on a long run averaging approach. I do not have to be a great accounting theoretician to realize that historical costs lose much relevance in times like these. The current multipliers placed on reported earnings in the market place reflect many things, but one of them certainly is a recognition that today's accounting figures based on historically incurred costs tend to overstate income.

We must all be sensitive to the need for a re-examination of the traditional accounting approach, and perhaps more imminently to the need for supplemental disclosure to reflect the impact of inflation on corporate results.

I noted with interest last week that the Financial Accounting Standards Board issued an exposure draft which proposes to require companies to make supplemental disclosures of certain price level adjusted financial information. We welcome experimentation in this regard and we hope that the long exposure period will give the Board the opportunity to examine such data and to evaluate its usefulness to users of financial statements.

In the months ahead, we also expect to propose some disclosure requirements designed to show the impact of inflation on reporting companies. These proposals will represent an additional step beyond our release last year which urged the disclosure of "inventory profits." They will propose footnote disclosure of replacement cost information and the effect on income of using such an approach.

While disclosure may be helpful, it may be that utlimately a major revision in basic financial statements is needed. In this connection, I am pleased that the Financial Accounting Standards Board is currently giving a high priority to the re-examination of the conceptual framework for accounting and reporting. This is clearly of great importance and should result in significant improvements. I hope in this connection that the Board will not be too closely guided by the traditions of accounting, even those which appear so basic that they are integral parts of the catechisms that have been chanted by many generations of accounting students.

In our recent release on uncertainties in financial reporting, we indicated our willingness to look at unusual and innovative presentations as well as our belief that some uncertainties required more substantial and specific disclosure than they have received. While the disciplines of a single valued, articulated set of financial statements should not be lightly abandoned, there may be some cases in which such a presentation simply doesn't tell the economic story. In such situations, accountants must recognize that their primary function is to communicate operating results and financial position effectively, not simply to prepare financial statements. In an overwhelming majority of cases, financial statements prepared in the traditional world do communicate to users, but when they do not, we must not be so tied to the mold that we forget its basic purpose.

I do not want to give you the impression that the Commission will cheerfully accept all kinds of filings on the grounds that they are innovative and experimental. When such proposals are presented to the staff, extremely careful consideration must be given to the appropriateness of the approach used in the particular case and to the precedential implications of any filing accepted. Nevertheless, we stand ready to respond favorably to innovation and have already done so on some occasions.

In one case, for example, a registrant proposed that it prepare supplemental financial statements based on appraisal values. The Commission encouraged the registrant to proceed and offered some suggestions designed to avoid misleading investors, which were accepted. Ultimately, however, the registrant concluded that the timing was not right for this approach due to a number of business uncertainties which developed.

In another, more recent, case, the Commission responded favorably to a registrant's proposal that certain appraisal data be included in footnotes to financial statements. Although we have requested additional information before making a final decision in this case, I anticipate that our final answer will be to permit this disclosure.

I should point out that in general, we have not found registrants and their accountants and lawyers anxious to develop innovative and experimentive approaches in filings with the Commission. Financial statements and other disclosure documents have been too often approached from the viewpoint of limiting liability rather than providing information. This has led to a desire for rules that can be followed in contrast to statements of objectives to be achieved.

As an attorney who has spent many years in private securities practice, I can have sympathy with this tendency while at the same time recognizing its limitations. There is great comfort in a rule. And yet, if we allow ourselves to fall into the trap of trying to write a rule to cover every occasion, we will certainly sweep in many effects we don't want while at the same time failing to foresee many items which should be covered. In the accounting field particularly, recourse to rules leads too often to the triumph of form over substance. The conspicuous failures of accounting in recent years, such as leases and business combinations, are areas which are characterized by an excess of rules and a minimum of reason. I also regret to say that these are also the transactions most characterized by the presence of attorneys, whose task is to document transactions so that they conform to detailed rules and, hence, are eligible to be accounted for in a fashion contrary to their essence.

In this connection, the area which is most troubling at the present time is that of "off-balance sheet financing," of which leasing is a major part. In a sense, the title itself is a contradiction in terms. If a company obtains financing, it would seem intuitively obvious that such financing should be reflected on a financial statement designed to show financial position. But we have seen a steady flow of transactions whose principal purpose is to provide financing which are alleged to be exempt from such a requirement. In some cases, we have felt that the transactions went to such an extreme that we could not accept justification, no matter how well prepared and analogized to similar situations, for keeping them off the balance sheet. We will continue to look at such items as they come to our attention, and we await with interest the conclusions of the Financial Accounting Standards Board with regard to lease accounting. It seems particularly inappropriate in times like these, where we are told that the balance sheets and liquidity position of firms are of great importance to investors, that we accept the growth of financing devices on the basis of their non-presentation in the face of financial statements.

In the final analysis, it seems to me that rules are a necessary part of financial disclosure and that it is only fair to allow people to predict accounting outcomes of transactions at the time they are entered into. On the other hand, it is not reasonable to expect that rules will serve as an immunization against the obligation to reflect reality in financial statements

Rules, therefore, can only be regarded as a minimum. Good information for investors requires good will and good sense as well as good rules.

It is because a high level of judgment and professional skill is required in financial reporting that another major development seems to be occurring. This is the extended involvement of independent public accountants in all financial reporting of their clients.

Traditionally, financial reports have been regarded as the primary responsibility of the reporting company, and the auditor's attestation was regarded as assurance that the requirements of the accounting model had been met. More and more, however, the public accountant is becoming a partner in the reporting process. His responsibility is being recognized as joint rather than secondary. This does not mean that the accountant is assuming the task of recordkeeping, but when reporting decisions must be made, the accountant should be viewed as a participant.

We view this new development to be salutary for investors, not because we feel that managements are unreliable, but because we think that the expertise and professional skill of the independent accountant is likely to make public reporting better and more useful to investors. In our recent proposal on increasing disclosure of interim results, we have specifically articulated our belief that increased auditor involvement is desirable. In our adoption of rules covering increased disclosure of auditor-client relationships, we have required disclosure of the auditor of record in all proxy statements. We believe that both of these developments emphasize the desirability of the continuing involvement of the independent accountant in the financial reporting process.

I certainly recognize that this evolution, from one-time examiner of books to continuous partner in reporting, is one which has many implications which are troubling to the profession. Nevertheless, I think it is a trend which is responsive to the changing environment and one which is likely to continue. I believe that the profession will be able to develop adequate standards to enable them to accept these responsibilities effectively and without undue cost, either to the client in fees or to the auditor in terms of liabilities which may be assessed.

The increasing public responsibility of the independent accountant also suggests that there be greater openness about relationships between accountants and clients, the nature and organization of accounting firms and the quality control procedures used to assure adequate professional performance. We have noted with interest and approval the action of one major national firm in publishing an annual report covering its operations and we encourage others to follow that lead. In the year ahead, we expect to consider the desirability of requiring the disclosure in proxy statements of audit fees and other fees paid to the independent accountant. Such disclosure, which is consistent with that made in the United Kingdom, should make the financial side of auditor-client relationships a matter of public record and eliminate suspicions which may arise in the absence of knowledge. It may also be desirable to urge accounting firms practicing before the Commission to make public their quality control procedures and to provide a means for their doing so.

I have sketched today a number of changes which may have a major impact on the financial reporting environment. These include the need for innovative changes in financial reporting to reflect more accurately the impact of inflation, new kinds of financing and major uncertainties, the need to deal with these problems on the basis of the objectives of financial reporting rather than specific rules, the increasing involvement of public accountants as partners in the public financial reporting process of their clients, and greater disclosure of the activities of accounting firms. While such changes may be frightening in contemplation, if they are approached in a systematic way they can be blended into the current environment without undue difficulty. As we look back from the perspective of two or three years, I am confident that these changes will seem routine and evolutionary, and there will be general agreement that they have contributed to better reporting, a higher level of professional performance and improved capital markets.