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SOME CURRENT DEVELOPMENTS IN ACCOUNTING AND FINANCIAL REPORTING

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I had the pleasure of appearing before you almost exactly two years ago in June 1974, to discuss SEC activities in the area of accounting and financial reporting. At that time, I said that I would not venture to analyze in depth the pros and cons of specific Commission actions in the accounting field, since, as a non-accountant, I am hardly competent to do so. I, therefore, described more generally the Commission's relationship to accounting and financial reporting as I saw it and the impact of current developments on our functions and responsibilities. I propose to adhere to that approach in my present remarks. I expect to update in part what I said then and, also, to discuss three recent developments in this general area, which I think are of particular significance.

First, by way of updating, I described to you, two years ago, the Commission's traditional position that instead of exercising its statutory authority to prescribe accounting principles and standards by rule, the Commission's policy was to rely significantly upon the private sector and the accounting profession to develop acceptable accounting principles and standards with the Commission participating in this process

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in a number of ways, and supporting the standards so developed. I referred to Accounting Series Release No. 4 of 1938 where this policy was initially announced and to Accounting Series Release No. 150 of 1973. In the 1938 statement, the Commission, in effect, said that the acceptability of financial statements for filing with it would depend in large measure on whether or not there was substantial authoritative support in the profession for the accounting treatment used; and in the 1973 statement, we refined this by saying that standards and practices promulgated by the Financial Accounting Standards Board ("FASB") would be considered as having substantial authoritative support and that treatment contrary to such FASB determinations would not be considered to have such support.

This traditional policy of relying upon the accounting profession and its established procedures and organs for setting standards has recently come under strong attack from, what to me, at least, is a rather surprising source, a major accounting firm. It is contained in a request for specified action filed with the Commission by Arthur Andersen & Co., on June 15, 1976. The immediate occasion for this petition appears to be an objection, shared by other major accounting firms, to a requirement announced in Accounting Series Release No. 177 of September 1975, and reaffirmed by a Commission letter of April 30, 1976, which requires that when a registrant makes a change in accounting principles, the registrant is required to file a letter from its independent public accountant in which the accountant states whether or not the change is to an accounting principle, which in the accountant's judgment is preferable under the circumstances. Members of the profession believe that this requirement is an unwarranted imposition on public accountants, since there are no adequate criteria for that determination and that the judgment of preferability which seems to be required by Accounting Principles Board Opinion No. 20 is to be made by the registrant rather than the accountant. The Commission indicated in its April 30th letter that the accountant is qualified to make such a determination and that the investors who rely on financial statements should have the benefit of the accountant's judgment in such a situation. I will not go into the merits of this particular controversy as we are called upon to reconsider that question by reason of the filing of the petition.

But Arthur Andersen's petition goes considerably beyond the limited issue of preferability and makes a sweeping attack upon the procedures and methods by which accounting standards, principles and practices have been established. If I understand their petition correctly, they conclude that, except to the extent that the Commission has prescribed particular accounting principles and standards, by rule, an auditor in order to discharge his responsibilities properly, must be free to exercise his own judgment concerning financial presentation without being required to conform to standards, principles and practices promulgated by the FASB or any other private body and that if disagreements within the profession or with their clients develop as a result of this process, they should be resolved by the Commission. They, accordingly, request the Commission not only to rescind the preferability requirements for auditors but also to revoke Accounting Series Release No. 150, and should the Commission not by rule define the current meaning of "substantial authoritative support," to revoke Accounting Series Release No. 4.

It seems to me that Arthur Andersen's proposal in this regard would work a change in the process by which accounting standards are developed which would be far-reaching as to be properly classified as revolutionary. According to press reports, Marshall Armstrong, Chairman of the FASB, has concluded that if this change occurred, he did not believe that the FASB could survive. This does not strike me as an unreasonable conclusion.

I will turn now to some significant developments which have occurred since 1974. Perhaps the most notable of these is our regulation on Replacement Cost. Under this regulation, approximately 1,000 capital intensive companies will be required to report the replacement cost of their depreciable properties and inventories and to disclose what cost of sales and depreciation expense would have been had they been computed on the basis of replacement cost. The Commission adopted the replacement cost regulation because it became apparent that conventional financial statements prepared on the basis of historical cost were not accurately portraying the economic realities of business enterprises. I doubt that there are many serious students of accounting or finance that will debate that point. We received numerous comment letters on our replacement cost proposal. Very few of those commentators quarreled with the general objective of the regulation, namely, to provide readers of financial statements with information that would assist them in ferreting out the illusory profits that inflation has created in historical cost financial statements. In this context, it might be useful to consider the comment letter we received from the Financial Analysts Federation, the professional society of financial analysts:

"We strongly endorse the Commission's proposed disclosure requirements regarding the replacement cost of inventory and productive capacities. We believe that despite the inherent imprecision of the data, this information will be useful to analysts and investors who wish to assess the effects of inflation on reported earnings. As analysts seek to determine the 'true earnings' of registrants, and as inflation distorts the reported results of operation, this information which the Commission proposes to require would be very helpful in the analytical process."

It is hard for me to accept arguments that question the utility of the replacement cost data after having read an endorsement such as this. However, our endorsements were not restricted to merely the financial analysts; we received strong endorsements of our proposal from such companies as U.S. Steel, Atlantic Richfield, AT&T, J.C. Penney, Merck, Commonwealth Edison and numerous others. They are not, however, in the majority, many more companies did criticize our proposal. Those criticisms related to three principal points -- cost, "soft" data, and inadequate implementation guidelines -- and we have attempted to deal with each. The first and most predominate criticism was with respect to the cost of implementing our proposal. This presented the most serious and difficult question which the Commission faced in considering the proposal. It certainly is true that there will be costs and that these may be substantial. We concluded, however, that the issue being addressed, which is how to disclose and how to measure the impact of inflation upon the true financial position of business enterprises, is of sufficient importance so that an effort to accomplish this in a meaningful way is justified even though the cost will be significant. We have, however, sought to minimize the aggregate cost of implementation insofar as possible by establishing a size test which specifies that only companies with assets in excess of $100 million will be required to report the replacement cost information. We adopted a size test of this nature for two reasons: first, we are aware that most security holdings are in large companies and inflation has been particularly acute in capital intensive companies. Therefore, by restricting our regulation to large, capital intensive companies, we can provide the greatest amount of information to the greatest number of investors at the least cost. Secondly, we are aware that these companies generally have more sophisticated information systems and greater depth of financial and engineering talent in their organizations, and as a result, are not required to employ to the same extent as smaller enterprises the costly services of appraisers, outside accountants and the like. Proportionately, therefore, the cost is smaller for such companies. As a consequence, we believe that by selecting these larger, more sophisticated companies, we are able to avoid undue costs burdens.

In addition to concerns over cost, we have heard considerable concern expressed over the "soft" nature of the replacement cost data. Many auditors and registrants have expressed concern that the replacement cost information will lead to legal liabilities and as a consequence, should be avoided. In order to provide registrants and their auditors with a reasonable degree of protection, we have proposed a safe harbor rule. The safe harbor rule basically says that if the information is prepared in good faith and the assumptions and inherent imprecisions in the data are set forth, then the company will be construed to be within the safe harbor rule and not in violation of the securities laws. The safe harbor rule is presently only a proposal. I reasonably expect, based upon the comment letters we have received and their generally supportive nature, the safe harbor regulation will probably be adopted in a form generally similar to that proposed.

Finally, numerous commentators have criticized our regulation from the standpoint that there are no established guidelines for the implementation of replacement cost and therefore there will be no comparability among companies reporting replacment cost information. In response to these criticisms, we have formed a 30 man advisory committee which is meeting with the staff of the Chief Accountant's Office every four to six weeks for the purpose of responding to various questions on the implementation of our replacement cost regulation. I would encourage all companies who are impacted by our replacement cost regulation to take advantage of the advisory committee. This could be done by either attending the advisory committee meetings or by submitting written questions to the advisory committee. Questions which you wish to have considered by the advisory committee should be sent to the SEC's Chief Accountant. We would prefer that the questions be in Staff Accounting Bulletin format --a statement of the facts, the question, and your recommended interpretive response. The advisory committee will discuss these questions and the Chief Accountants office will publish a written answer to the questions in the form of Staff Accounting Bulletins.

In addition to our formation of an advisory committee, we have noted that industy task forces are being formed for the purpose of determining appropriate guidelines for the implementation of replacement cost in their industry. Task forces in the forest products industry, air lines industry, steel industry, chemical industry, electric utilities, hotel industry, retailing and others have been formed and are currently preparing guidelines for the implementation of replacement cost in their industries. We think this is a very productive and appropriate manner of attempting to provide uniformity in the determination and reporting of replacement cost information.

A number of people have been rather critical of the replacement cost regulation because there are difficult questions yet to be answered. In the minds of these individuals, the very existence of difficult unanswered questions argues that replacement cost is not appropriate and should not be pursued. It seems to me that such a view is extremely shortsighted. It took accountants a great number of years to establish the conventions that are presently used in the historical cost financial statements and they are not through yet. It is unreasonable to believe that all of the replacement cost questions can be answered instantly. It is important to keep in mind that the Commission is not expecting companies to have all of the answers to the many difficult questions. We are expecting that many companies will find it desirable to experiement with various approches to replacement cost before settling upon what to them appears to be an appropriate method. In lieu of having precise "cook-book" answers to these difficult questions, companies may chose to present the replacement cost information in a number of fashions and describing the methods and assumptions employed in each of these various amounts. There are very few limitations to what can be disclosed in satisfaction of our regulation. It is extremely important to keep in mind that for the first one or two years, we expect many companies will be experimenting and we will be tolerant of such experimentation. Nonetheless, we do believe that the information, although it may be order of magnitude information in the first couple of years, will be useful to investors; consequently, we believe this mandated experiment will be most worthwhile.

Numerous individuals have questioned the utility of replacement cost data we are requiring. I must say I find this to be a rather surprising criticism. Lets take one rather simplistic example: As we all know during periods of rising prices, the LIFO inventory costing technique will result in less income that the FIFO technique. Companies in the same industry employ either LIFO or FIFO and some use both techniques. As a consequence, it is virtually impossible to make meaningful company-to-company comparisons because of this major difference in inventory costing techniques. However, if all companies report cost of sale on a replacement cost basis, the significant.disparities will be greatly reduced and more meaningful comparisons can be made. The same can be said for depreciation expense; numerous companies have acquired property, plant and equipment many years ago, and consequently, they have rather modest depreciation charges in their income statements; however, other companies within the same industry to which these first companies are being compared may have acquired their property, plant and equipment recently, and are reporting much higher depreciation expense. When both companies are required to report depreciation expense on a replacement cost basis, this significant variation in depreciation expense is eliminated.

It also seems clear that the replacement cost data generated by our regulation will provide meaningful information to macro-economic decision makers. For example these data may successfully communicate to legislators that capital shortage is a serious problem with serious consequences and must be dealth with. Additionally, such data should display that the effective federal tax rate alter eliminating illusory inventory profits and considering depreciation shortfall is much greater than 48 percent. In fact in some instances the effective rate may be so high to consitute an erosion of capital.

Internally, it would appear that these data can be used in numerous ways, such as pricing or profit performance evaluation. How is it possible for a business manager to evaluate the profit performance of two divisions if one of those divisions is reporting depreciation on old equipment and the other division is reporting depreciation expense on newer, more costly equipment? Further, dividend policies should be evaluated in light of replacement cost information.

If a company is earning its profits only through lower depreciation and inventory holding gains, then possibly it should restrict its dividend payment so as to insure there is adequate capital retained in the company to replenish the assets which have been utilized in the generations of profits. As business managers become more familiar with replacement cost information, I am confident that the utility of the information and its uses will grow rather significantly.

Before leaving our discussion of replacement cost, I thought it might be useful for me to read to you a passage that I came across in a recent issue of Business Week wherein they are describing a revolution that is taking place within the accouting profession. Business Week states:

> "Behind the revolution is the inescapable fact that inflation, and all that goes with it, has made a shambles of the traditional income statement that shows only whether a company has made or lost money. Earnings per share growth may still captivate naive investors, but more critical observers now realize that it does not tell how much a company owes, or whether it can raise enough money to keep growing, or whether the earnings are real or simply the result of inflation and arcane accounting practices."

Our regulation with respect to replacement cost information is designed to address itself, among other things, to the information gap which Business Week refers to.

Turning now to another subject, it seems that in this Bicentennial Year our country is engaged not only in celebrating the events of 200 years ago, but also to a surprising extent, in a critical reevaluation of where we are now and where we should be going. As a part of this reevaluation, there is a critical examination of many things that the government does or does not do, including, particularly, government regulation of business activities. The Commission, like many others, is engaged in this type of reevaluation. In the field of disclosure and financial reporting, the principal instrument for this purpose is a far-reaching study of the corporate disclosure system by a distinguished Advisory Committee on Corporate Disclosure chaired by former Commissioner Sommer and having fourteen other members. These members come from a variety of backgrounds. They include people from industry, the securities business, financial analysts, accountants, practicing lawyers, professors of law and of economics and representatives of what might be called the public interest sector. What they have in common is that all of them have been deeply involved with the disclosure system in their respective occupations and professions as purveyors of information, users of information, reviewers of information and interested observers of the process.

The Advisory Committee has set for itself an ambitious agenda. They proposed not merely to examine the disclosure system administered by the SEC, but to examine the entire corporate disclosure system, both that part which is regulated and that part which is not. They propose to ask such questions as what purposes are served by the disclosure system; and what purposes should it serve, and in that connection the Committee will examine modern theories concerning the functioning of the securities markets and portfolio analysis; what characteristics should the information produced by a system have relating to such things as comprehensiveness, accuracy and so on; what is the cost of the system; and what is the incremental cost of each improvement in reliability and comprehensiveness of information.

Commissioner Sommer, and others who initiated this venture, noted that while the disclosure system has been widely discussed and commented upon, there are certain gaps in the empirical data to how the system actually works and what are its costs, uses and values. In an effort to fulfill this gap, the Committee as a first step, is in the process of interviewing the management of some thirty companies which prepare information. The issuers are being asked to provide copies of documents filed with the Commission since January 1, 1975, and to indicate which items of information in those documents, in the opinion of the company, are not significant to an evaluation of the company's securities. They are also being asked what information is provided otherwise than through Commission filings, to financial analysts, shareholders and others and about the costs, in considerable detail, incurred by the company in connection with corporate disclosure. They are also being asked for their opinion concerning the system.

In addition, questionnaires are being sent to people concerned with the information provided by these companies. More specifically, these comprised intermediaries who disseminate corporate information such as Moody's and Standard and Poor's, financial analysts who use the information in their work and finally, the investment decision makers, both institutional and individual.

Disseminators of information are being asked what type of information they disseminate and to provide samples. They are being asked where they obtain this information, and the extent to which they use information derived from SEC filings and how these filings might be improved.

The financial analysts are being asked about such questions as what use they make of the various items of information contained in filed documents and how useful they think it is, what other items of information about the company they use and from what sources did they obtain it, and how important it is to them. They are also being asked what other items of information which are not available would be of value, and to assess the relative importance of various sources of information.

Institutional investment decision makers are being asked to indicate their transactions in the company's securities, the items of information in the filed documents which they use, other sources of information which they use in making their decisions and what information which they do not receive which they would like to have, as well as the relative importance of various sources of information in their decision making.

A shorter questionnaire will be sent to individual investors. All of these questionnaires are being supplemented by personal interviews.

It would seem that this initial approach by the Committee could provide a body of emperical data concerning the disclosure system far more extensive and valuable than ever existed before. After analysis of this information and further study, the Committee will make a report, and hopefully, will complete its work by July 1, 1977. Needless to say, we look forward eagerly to the results of this study and we expect that it will be very useful.

The work of the Committee is not a mere academic enterprise. It is contemplated that it will provide a basis for major improvement in the functioning of the disclosure system both in terms of the value of information provided and in terms of the cost of providing it.

While we look forward eagerly to the results of this study, we are in the meantime doing some things which are designed to reduce the regulatory burden on corporate issues. For example, we propose to reexamine Form S-14, particularly in connection with merger proxy statements. Presently, many of these are documents of formidable size and complexity, very costly to produce and rather overwhelming to the average investor. We propose a new short form for companies meeting the standards for the use of Form S-7 and to transfer other information to a Part II, which would not be sent to shareholders unless requested. With respect to Form S-7, we have concluded that the experiment initiated last year, which relaxed the conditions for the use of the Form has worked well and we intend to propose additional changes which will permit more companies to take advantage of its benefits. We propose to modify Form 8-K in a manner which will substantially reduce the number of current reports required to be filed by eliminating nearly half of the fourteen items of information now called for. We believe that these items can more appropriately be included in annual and quarterly reports.

Our staff estimates that these changes will reduce the number of 8-K's by approximately 44%.

We also propose to make certain revisions in Rule 14a-8 relating to stockholders proposals. While some of these revisions will broaden the range of proposals which could be submitted, others are designed to avoid devices by which the purposes of existing rules are circumvented and to reduce the amount of space in the proxy statement which has to be devoted to such proposals. We also propose to provide management of the Commission with more time to consider such proposals.

Thus, as you can see, there are some interesting potential developments at the Commission with respect to accounting and financial reporting at this time.