NEWS

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CURRENT S.E.C. PROJECTS IN ACCOUNTING AND FINANCIAL REPORTING

Remarks Of

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It is suggested that I discuss with you current SEC projects in the area of accounting and financial reporting. I am, however, at something of a disadvantage since I am not an accountant and I understand that most, if not all, the people in this audience are not only accountants but expert ones. It would not, therefore, be very useful for me to try to analyze in depth the pros and cons of our recent actions in the accounting area. I prefer, therefore, a broader approach in which I will try to sketch the relationship of the SEC to accounting and financial reporting and the impact of current developments on our responsibilities as we perceive them. This, I hope, will help you to understand why we are doing the things we are doing and what we are, so to speak, driving at. We need your help in dealing with current problems, and thus there is a need for a better mutual understanding of our respective viewpoints and responsibilities.

The basic Congressional reason for creating the Securities and Exchange Commission was to protect investors and the public interest. In obtaining this

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objective, great reliance was placed on disclosure. One of the most important, perhaps the most important, elements of disclosure is accounting and financial reporting. Congress, therefore, gave the Commission broad authority in this area. For example, Section 19(a) of the Securities Act of 1933 provides that the Commission

> "shall have authority, for the purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts. ..."

Identical language with respect to reporting companies is found in Section 13(b) of the Securities Exchange Act of 1934.

Public Utility Commissions, which in the past had been given similar powers, have frequently responded by specifying "uniform systems of accounts." The Commission, however, from the beginning took a different tack, electing to rely significantly upon the private sector and the accounting profession to develop acceptable accounting principles and standards, with the Commission making suggestions, prodding, if necessary, and reinforcing standards so developed. Thus, in Accounting Series Release No. 4 (1938) the Commission said, in effect, that the acceptability of financial statements for filing with it would depend to a large extent on whether or not there was substantial authoritative support in the profession for the accounting treatment used.

This continues to be our policy. An important statement in that regard is found in Accounting Series Release No. 150 (December 1973) with respect to the establishment of the Financial Accounting Standards Board (FASB). In that statement the Commission referred to its historic practice of looking to the standard setting bodies designated by the profession to provide leadership in establishing and improving accounting principles. The Commission, therefore, sketched background which led to the creation of the FASB and endorsed its establishment. In recognition of the substantial experience, expertise and resources which would be devoted to the task, it referred to Accounting Series Release No. 4, above mentioned, and the policy there expressed stated that

> "for purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."

This policy has not been without controversy. In hearings in 1964, the House Committee on Interstate and Foreign Commerce indicated its concern that the Commission might be abdicating its responsibilities by deferring to the accounting profession. In the last year or two, this question has heated up considerably. Accounting has become the subject of controversy of what seems an unprecedented degree. The reasons why accounting, which was at one time regarded as a rather staid, conservative and even unexciting activity, has become controversial are many and complex. One obvious reason is the rate of change and the increasing complexity of the businesses which are being reported on. Another reason, I would suggest, is wide-spread public misunderstanding of the functions and limitations of accounting. I would suspect that unsophisticated investors tend to think of accounting as essentially a mathematical exercise. The accountant, it is thought, takes all of the assorted numbers that he finds in the books and records and arranges them and adds and subtracts; multiplies and divides them and comes out with a conclusion, for example, that the net worth of a company is $10,465,732.25 and that for the year it earned $1,647,418.91 or 83 cents per share. This is a fact related to the fact that two plus two equals four. You, of course, know that all this is an illusion and that the figures in large part reflect judgments and accounting conventions.

At a more sophisticated level, there was the uncritical and, to my mind, regretable emphasis which was placed a few years ago upon earnings per share and the trend thereof. Companies reacted to this by resorting to what was referred to as "creative accounting." For example, it appeared that the trend of earnings per share could be improved by making an acquisition and accounting for it as a pooling. This fueled the conglomerate movement. The emphasis on earnings per share also created a pressure on companies to forecast such figures for the future and many did so.

These tendencies in turn produced their own reaction. There is now an emphasis on the "quality of earnings." This concept is difficult to define and still more difficult to reflect in conventional financial statements. Yet, it is a valid concern.

A related question is the quality of liquidity. Sometimes the figures in a company's balance sheet, as summarized in its current ratio, do not portray its true liquidity status. Cash balances may not be so readily available if they are compensating balances. Companies may elect to acquire the use of assets by leasing them rather than buying them with borrowed money or subject to purchase money obligations. Such alternative arrangements may be substantially equivalent economically but the balance sheet presentation is very different. On the other hand, unused lines of credit and commitments for future financing do not appear on the balance sheet but they affect liquidity.

Information which may have a bearing on the quality of earnings or the quality of liquidity has certain other characteristics. It may not fit well into a normal financial statement and might unduly complicate it. Furthermore, adequate disclosure in these areas may be complex and of primary interest to users who wish to make a detailed analysis rather than to the average investor. These considerations, however, bear mainly on the appropriate method of disclosure; they do not justify the complete omission of significant information.

Alternative methods of accounting are another problem. Unlike those mentioned above, this one is not new but it is still very much with us. There frequently may be a valid reason for alternative methods. Just as it is desirable to account for the same thing the same way, it makes little sense to account for different things in the same way. It is often a matter of judgment whether two things are more alike or more different. The problem is intensified by changing methods of doing business and by multi-national corporations which operate in many different financial environments. The Commission and the accounting profession have therefore resisted pressures to impose uniform methods of accounting. However, in these fast moving times it sometimes seems as if alternative accounting methods emerge and expand at a faster rate than the accounting profession is able to proceed in eliminating unnecessary ones and establish standards for choice among those that survive. Further, alternative methods do create problems. There is the familiar one that the use of alternative methods makes it difficult to compare different companies in the same industry, which is a major part of the job of financial analysts. Comparability from year to year of the financial statements of the same company may also be impaired. Further, they create a credibility problem. A person who is influenced by the simplicistic idea of accounting, which I mentioned a moment ago, simply cannot understand how the bottom line can be significantly affected by simply choosing one acceptable accounting method rather than another.

Moreover, alternatives create pressures on accountants. Sometime ago, a respected accounting firm stated in a submission to the Commission that if management selected a particular accounting method simply because it would produce larger earnings, the auditor had to accept management's choice so long as the method chosen could be supported. Perhaps so, but I suspect that the public expects more than this from an independent auditor.

The Commission's recent projects and activities in the area of accounting and financial reporting are in large measure a response to the developments referred to above. Before going further into this, I want to mention the difficult distinction between financial reporting standards and disclosure. The Commission may defer to the accounting profession on accounting standards but it cannot surrender its responsibilities for full disclosure. Yet the two quite often overlap and sometimes they conflict. As the Commission indicated in Accounting Series Release No. 4, back in 1938, a misleading financial statement cannot be cured by disclosure elsewhere.

There is also the matter of timing. It is often suggested that rather than coming out with a pronouncement, the Commission should wait for the accounting profession to deal with the problem and should give the profession enough time to properly deliberate upon the matter and arrive at a considered decision. We prefer to do this when we can. Sometimes, however, we encounter situations where it appears that if we postpone closing the barn door, the horse will be long gone. Sometimes we respond by a holding action, preserving the status quo but with an announcement that we will reconsider after the FASB has had time to act. Our release last week on capitalization of interest is an example. We have indicated a similar willingness to reconsider after the FASB has developed an approach in several of our recent pronouncements.

As I indicated in the outset, I do not intend to describe in detail our recent actions in the accounting area but I do want to fit a few into the overall pattern. Our amendments with respect to lease disclosure were a response to "an important and dramatically growing form of asset acquisition" which was not reflected on the face of the financial statements or perceptively in the calculations of debt-equity ratios. I recall someone who pointed out to me that a large proportion of new jet airliners that we see flying around the sky do not appear on anyone's publicly available balance sheet. Neither do nuclear cores, although they are not cheap. We did not, however, take the step of requiring capitalization of financing leases, although it may often be the economic equivalent of other methods of acquiring financial assets, and even though we did not believe that APB Opinion No. 31 provided adequate disclosure. Rather, we are awaiting the consideration of lease accounting by the FASB but in the meantime, are obtaining disclosure.

In Accounting Series Release No. 148 (November 1973), we were concerned with liquidity and its management. This is clearly significant in a period of restrictive monetary policy and high interest rates. Compensating balances bear on effective interest rates. If you borrow a million dollars at 9% interest but you have to keep 15% or 20%

of it in the bank, you are not really paying 9% on what you use, you are paying something between 10-1/2 and 11-1/4%. Nevertheless, we again did not go all the way. We heeded your admonitions concerning the practical difficulities of determining and disclosing the effective interest rate after allowance for the impact of compensating balances, fees, etc. and eliminated that proposed requirement.

Similar considerations were involved in Accounting Series Release No. 149, likewise issued in November 1973, providing for disclosure concerning income taxes. This unpleasant subject has a bearing upon earning power, or in other words, upon the quality of earnings. It is frequently apparent to even a casual observer that a company is not paying income tax at the statutory rate of 48% of income; rather it is paying at some different rate, but it is not so apparent why this is so. The Internal Revenue Service, and presumably the Congress, know why, but the investor does not know unless you tell him. An explanation does more than gratify curiosity.

It will enable a user to make a judgment as to the likelihood of a given tax situation continuing, the impact on a particular company of proposed changes in the tax laws, and the probable cash outlays for taxes in the future. Again, this kind of data may not interest the casual investor, but that does not justify its total omission.

I would now like to elaborate a little on the theme that I mentioned earlier, that is, accounting is not a mathematical exercise. If I had not known that earlier, I found out about it rather painfully a couple of years ago. As a new member of the Commission, I was somehow maneuvered into going over to the Hill and explaining to Senator Proxmire, at a public hearing, why it was that the Commission had allowed certain defense contractors, such as Lockheed, to publish financial statements which so dismally failed to reflect the earnings power, or rather the lack of it, of the companies involved.

There was no very good explanation. It appeared that the historical financial statements of these companies embodied, to a surprising degree, judgments and estimates concerning such things as how much it would cost in the future to build novel and fiendishly complex pieces of equipment, and how many of them would be sold in the future and at what prices. These judgments figured prominently in the valuation of inventories carried at millions of dollars and in decisions to expense or to capitalize engineering and development costs, likewise measured in the millions, as well as determination as to the basis upon which such capitalized expenses should be amortized. These were not even accounting judgments. They were basically engineering judgments and most difficult ones which were further complicated by estimates concerning the rate of inflation, the outcome of litigation and the size and composition of future defense budgets. In the event these judgments and estimates quite often turned out to be wrong, it is hard to fix blame on anyone considering the difficulties involved.

I do not know how we can eliminate these problems which are not, incidentally, confined to defense contracting but arise in any major undertaking on the frontiers of technology. I would hope, however, that we can devise disclosure techniques which will give the users of financial statements of companies involved in these activities a better idea of what is actually going on and what risks are involved.

I would like to digress here to put in a plug for an infant industry. It is known as Technical Auditing and is being fostered by an old friend of mine, Frank B. Jewett, Jr. Frank, like me, is not an accountant and the title which he has chosen for his idea seems to offend accountants. He is, however, an experienced engineer and executive. His basic thesis, much over-simplified, is that in these large complex undertakings involving very advanced technology, top management must rely largely upon the judgments of their engineers and scientists. These engineers, in turn, despite their integrity and ability, have a bias. Having evolved the concepts, developed the technology and justified the projects from their inception, they become committed to the proposition that their ideas will work and will be cost effective. Frank's idea is to bring in independent engineers and scientists of equal standing in the technical field involved, whose responsibility is to the auditor and to the public. They will examine, perhaps with a skeptical eye, the estimates and assumptions involved and, hopefully, will spot the pitfalls before everybody falls into them.

I am not qualified to evaluate this proposition although it seems to me plausible. Needless to say, the Commission in no way endorses or sponsors this proposal. It will have to prove itself in the market place before we get into the act.

I am thus, at this late hour of the morning and by the long way around, led to the matter of projections. The Commission's disposition is to permit, but not to require, projections in filings with us provided that they have a reasonable basis, are based upon reasonable and disclosed assumptions, and do not extend beyond the boundaries of what is reasonably foreseeable. I, at least, am inclined toward this conclusion not so much because I think projections are necessarily a good thing but because they exist. Investors want them and get them. There is really nothing we can do about this except to charge people with fraud. We have to do this from time to time but I doubt if it is a satisfactory overall approach to a matter of this magnitude and importance. If we are to have projections, I suggest that people who are both responsible and knowledgeable, that is to say management, should participate openly in the process, that projections be made availabe to all investors and not only to a favored few, and that the whole process be subject to the discipline and control of the Federal securities laws. As we approach this question of projections, we find that accountants are quite skittish. They suggest that their role, if any, should be limited to adding up the figures. While I understand the difficulties I nevertheless find this hesitation a little surprising in the light of the extent to which, in contexts they are willing to rely upon estimates and assumptions as revealed for example, in the defense contracting situation, which I just mentioned. Quite probably, the skill and the independent status of accountants could exercise a salutary influence upon the tendency to project that which is desired rather than that which is likely to occur.

I have tried this morning to outline the circumstances and the general approach, and statutory responsibilities which underlie our current activities in the area of accounting and financial reporting. I hope that this will contribute to your understanding of the reasons for our specific proposals.

In closing, I would like to emphasize our desire to cooperate fully with accountants in the private sector, both private practitioners and those in corporate management, our need for their input, and our dependence and the dependence of the public upon their performance. The alternative, a corps of federal auditors, which was wisely rejected by the Congress in 1933, remains as objectionable now as it was then. In fact, I think it has become unthinkable. There will, however, continue to be a tension in our relationship, since if we are to rely so heavily on you to carry out the statutory mandate of investor protection, then we will have to expect from you and, if necessary, seek to require from you, standards of integrity and performance which are adequate to the needs of our times. In particular, we look forward to a fruitful relationship with the Financial Accounting Standards Board as it embarks upon its momentous mission.