

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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### TOWARD COMMON ACCOUNTING STANDARDS

An Address by

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It seems to me that what brings us together at this conference is the increasing recognition that our capital markets are becoming international; that the viability and efficiency of national trading markets are becoming increasingly important to countries other than those in which they operate.

Domestic securities markets throughout the world are becoming international public markets -- they attract and are dependent upon the participation of large numbers of investors both national and foreign -- and in the broader sense, their performance directly affects the economy of not only the host country but also of free enterprise countries throughout the world. Investors today do not recognize geographic or political boundaries. Indeed, in today's world of multinational business enterprises, such restraints have become outmoded and unrealistic. It is apparent that the securities markets of the world have become affected with an international public interest.

In our country disclosure and finance reporting have demonstrated their importance to a healthy capital market. A business increasingly recognizes no international

boundaries and as investors increasingly look across borders in committing their funds, financial reporting and accounting must learn to speak an international language. That means we must have improved and more uniform accounting standards. There is already an Accounting International Study Group, organized in 1966 and consisting of Canadian, United Kingdom and United States independent public accountants. Perhaps this is a beginning in the formidable task of achieving some acceptable level of accounting uniformity on an international basis. Hopefully this conference can lead to broadening that effort.

At the SEC, we had been working on improving financial reporting in our own country for almost 40 years and we still have a lot to do. Indeed since financial reporting must constantly adapt itself to new economic circumstances and managerial methods, we have a never ending job in developing and maintaining standards of financial reporting.

Perhaps the best contribution I can make to this conference is to review the interplay between business, the accounting profession, the government overseer and the

courts in our development of financial reporting and the redoubled effort we are about to make to achieve greater uniformity and comparability in financial reporting.

It has often been said that the financial statements and related financial information are the heart of the registration statements and other reports filed with the Commission. The securities laws in the United States contain specific language giving the SEC the responsibility for determining that these financial statements are prepared in a manner which furnishes the information needed by investors and stockholders.

In the hearings which preceded passage of the Securities Act of 1933, our first federal securities law, Congress considered the alternatives of creating a large force of Government auditors to verify the financial statements or of requiring registrants to obtain audits by independent professional accountants. The accounting profession testified to the Congress that they had the capability and, because of their Code of Ethics, the independence to represent the interests of investors. They said that if

the financial statements of publicly owned companies were certified by independent public accountants employed in the private sector, the public interest would be protected. Congress agreed with the contention in adopting the 1933 Act, and the other Acts administered by the Commission include the authority to require certification of the financial statements.

In the implementation of its authority over the accounting and financial reporting of registrants, the Commission has always followed a policy of cooperation with the accounting profession and has refrained, as much as possible, from prescribing detailed accounting rules. Accounting Series Release No. 4, issued in 1938, provided that the Commission would allow companies to follow accounting practices which had "substantial authoritative support" unless the Commission had previously announced different requirements. The Commission has made such announcements only a few times, preferring to collaborate with the accounting profession in determining acceptable practices. The requirements for the specific financial statements and supplemental data to be included in a filing are set forth in filing forms that are prescribed, such as

Form S-1, the principal form used for registering securities under the 1933 Act, and Form 10-K, the principal form used for registering under the 1934 Act. We also issue special accounting releases from time to time when we need to deal with a particular accounting or auditing principle or procedure. In addition, particularly in the early years of the Commission, some of the opinions issued by the Commission dealt with accounting practices of registrants.

We also take the initiative in establishing requirements for new reporting procedures or additional financial data when we deem it necessary or desirable in the public interest. Actions of this type in recent years have included an amendment of our registration and annual report forms to require diversified registrants to provide more detailed reporting on earnings of their major lines of business and on sales of principal product lines, and to require statements of source and application of funds to be included with other required financial statements. We also require that substantial differences in financial statements

of annual reports to stockholders from those in annual reports filed with the Commission be explained to stockholders. This seeks to insure that there are no major differences in what is presented to the Commission and to the investor. The Commission also has taken steps to provide greater understandability and completeness of press releases on company operations.

Unfortunately, there will always be companies which will operate on the fringe of accounting practice. In some cases, these companies "shop around," searching for an accountant who agrees with the reporting practice they wish to follow. In order to be sure we are aware of such practices and to strengthen the position of accountants who insist on proper reporting, we recently adopted a reporting rule to require registrants to notify the Commission when independent accountants are changed. It will also require provision of information on any disagreements with the former accountants regarding accounting principles and practices, financial statement disclosure, or auditing procedures, and comments of the displaced accountants regarding the statement of disagreements.

However, for the most part, the accounting and auditing standards which must be observed in the presentation and

the examination of the financial statements filed with the Commission are developed and promulgated by the accounting profession. In connection with this process, our accounting staff maintains a continuing liaison with the major professional accounting and financial organizations in the United States. The principal organization concerned with the development and improvement of these standards is the American Institute of Certified Public Accountants, whose current membership is over 85,000.

The AICPA maintains standing committees or boards to study and deal with matters pertaining to ethics, auditing standards and procedures, and accounting principles. Their pronouncements in these areas are binding on their members who, as I noted, comprise most of the independent accountants who certify the financial statements filed with us. By working with these committees and boards in the development of their pronouncements, we are able to influence the development of standards which we consider necessary

for preparing and auditing financial statements.

Over the years a great many statements on accounting principles have been issued by the Institute. Prior to 1959 they were issued by a Committee on Accounting Procedure as Accounting Research Bulletins. In 1958 when there was some dissatisfaction with then current efforts to develop and improve accounting standards, a committee, of which our Chief Accountant was a member, recommended that the Institute establish an Accounting Principles Board to increase the quantity of accounting research and bring improvements in both the quality and quantity of future pronouncements on accounting standards.

Since the APB was established in 1959 it has issued a number of major opinions, all of which were considered by the Commission or the Chief Accountant prior to their adoption. Our accounting staff meets with the APB subcommittees to assure that principles are acceptable to the Commission. In some difficult areas many conferences and discussions are necessary in order to develop satisfactory

opinions. This was particularly true regarding opinions issued by the Accounting Principles Board on "Earnings per Share," "Business Combinations," and "Intangible Assets," all of which dealt with very troublesome and difficult problems that existed in the 1960's. Other significant opinions issued by the Board relate to the accounting for leases by lessees and by lessors, cost of pension plans, income taxes, the equity method of accounting for investments in common stock, and the reporting of results of operations and of changes in financial position.

Although the APB did much good work in the 1960's, the profession began experiencing difficulties in this same period. Lawsuits began to be filed in increasing numbers, particularly against some of the largest public accounting firms, with respect to the quality of their work and some heavy settlements were made. A few of these are particularly significant. In the Yale Express case it was claimed that the accountants did not insist that the company disclose the operating problems it was encountering even though

they were aware of them. The presiding judge in the matter of U.S. vs. Simon, in charging the jury, stated that they need not consider only whether generally accepted accounting principles and generally accepted auditing standards were followed -- but that should they follow a stricter standard, that is, did what was done result in a fair presentation to stockholders?

In the BarChris decision the court found that the parties involved, including the independent accountants, had not been fully responsive in meeting their duties under the Securities Acts. Specifically, the court found there were material misstatements and omissions in the financial statements included in the prospectus, sufficiently deficient to impose liability on the accountants, and that the defense of due diligence was not available to the auditors with respect to the expertised portion of the prospectus because a reasonable investigation would have disclosed that the prospectus contained materially false and misleading statements.

In the 1136 Tenants Corporation case, the courts decided that even though the accountants were engaged for the sole purpose of bookkeeping rather than auditing, they nevertheless had a duty to take notice of unusual transactions and to report appropriately to their clients.

These court decisions raised serious questions about the extent of the generally accepted accounting and auditing standards established by the profession. As with its predecessor, dissatisfaction with the APB began to be heard. Questions arose regarding its ability to solve difficult problems, the quality and the general acceptability of some of its opinions, and the independence from their clients of the practicing accountants who constitute a large majority of the membership of the Board. Questions such as these led to a general questioning of the adequacy of the Board as it is presently constituted to promulgate the accounting standards necessary for guidance in preparing financial statements.

Because of these problems the President of the AICPA in early 1971 appointed two prestigious committees to explore ways to improve the Institute's function of

establishing standards of financial reporting. One study group, which was chaired by former Securities and Exchange Commissioner Francis M. Wheat, studied the operations of the APB and possible alternatives and has made recommendations for a new structure to supplant the APB. This structure, which has now been endorsed by the governing council of the AICPA, would have, as its primary group for determining standards, a seven member full time board. It is hoped that this will enable a faster response to developing problems. The Board also provides for a greater representation from other groups and thus it is hoped that its opinions will have even greater acceptance than those of the APB. The proposals by the study group have received wide support. On April 28 the Commission sent a letter to the AICPA board of directors endorsing the concepts proposed and suggesting a public hearing to provide assurance of the acceptability of

"the charter, by-laws and rule making procedures which will govern the operations of the three new entities as well as the method by which financial resources will be obtained."

We believe that the development of accounting standards should stay in the private sector and hope that the new structure will increase public confidence in accounting principles and in financial reporting generally.

At the same time that the study on Establishment of Accounting Principles was originated an accounting objectives study group was formed for the purpose of studying and refining the objectives of financial statements. The Study Group, headed by Robert M. Trueblood, a former president of the Institute, is considering: who needs financial statements, what information is needed, how it should be communicated, and how much of the needed information can be provided by accounting. It has conducted interviews with businessmen and government officials on a wide scale and is, this very week, holding public hearings in New York for the purpose of hearing from all interested persons. The Commission expects to meet with Mr. Trueblood's committee and will be very interested in the conclusions reached. Perhaps they may point the way to a decision as to whether there is a practical way to reflect current values in a company's formal financial statements.

This leads me into thoughts of the future. Where do we go from here? I believe that we must evolve some way to give a better portrayal of economic reality. One thing that is clearly required is a more complete description of accounting policies followed by all reporting companies. This past April the APB issued an Opinion requiring a statement of accounting policies. I hope this will generate sufficient information to enable better comparison of results of operations and financial position, particularly between companies in the same general business. This may require that sufficient information be given to compare two companies which follow different accounting policies. If practice under this new Opinion does not generate sufficient information, the Commission will have to consider action of its own.

It is also my belief that, despite the progress made since 1964, when our then Chief Accountant, Andrew Barr, reported to Congress on this problem, a further reduction on permissible alternative accounting treatments in identical circumstances must be made. There is simply no basis for alternatives when fact situations are identical. It may be

that some of the disclosures which we think are necessary (I am thinking here of disclosure of some type of value information) will have to be made outside of the financial statements.

Finally, what about forecasts? You are no doubt aware of the British practice of including forecasts in public documents, particularly when a takeover or exchange is contemplated. You know also that the Commission has not permitted forecasts to be included in documents filed with it. However, we know forecasts are made and are used by those who know of them and we are presently studying whether and how to get such forecasts into the prospectuses and reports filed with us. We have asked the interested groups in the financial community to work with us on this. One question to be dealt with is to what extent liability should attach to forecasts. Another is whether they should be attested to by independent experts. Clearly any forecasts to be made would have to be accompanied by disclosure of the material assumptions made and those assumptions would have to be reasonable. Although our study is not yet near completion, it already seems clear that any use of projections or forecasts should be voluntary until sufficient experience is gained as to their usefulness in our country.

Looking to the future I hope that out of this Conference will come an effort to resolve the differences in accounting standards and accounting approaches among the economically advanced countries. It is true that an international capital market calls for some degree of commonality in accounting standards. But this can not happen over night. The history of improving accounting standards and practices in my own country shows that, although it took us almost 40 years to get as far as we have and there is still much to be done, each step along the way contributed to public confidence in the financial reporting disclosures as the basis on which investment are made. What is necessary is that we show a will to move together and the ability to make progress towards commonly accepted international standards.

Let me quickly review what seem to me to be the major points to which we should give priority in working towards this goal.

First, what is the purpose of accounting and who is it for? In some countries, accounting is deemed being

primarily for the purpose of guiding management and letting owners know where they stand. Increasingly, a country which has or hopes to have broad public participation in investing in its economic activity will have to accept that one of the primary purposes of accounting is to inform the investor and the potential investor.

Secondly, from our experience in the United States, it appears that investment values are related to earning power more than anything else. In other countries, market values are related to dividends more than to earning power. As the focus is put on the reliability of a dividend rate rather than on earning power, or the reverse, the emphasis in accounting approaches will be different. I am hazard-ing a guess here, but it does seem to me that the trend in investment thinking is towards an emphasis on earning power.

Thirdly, there appears to me to be broadening acceptance of the concept that the accountant has an obligation to apply those principles and standards and express those qualifications which will best present a fair view of the position of the business. By position I think we will increasingly mean fair value and earning power and basic economic reality as it relates to value and earning power.

Fourthly, I look for accounting to go in the direction of reducing alternatives and options and moving towards decisions which call for that specific accounting treatment which will best reflect the earning power. This means that the desirability of making earnings statements as comparable and as uniform as possible will gain priority over the frequently conflicting objective of affording management choice and flexibility in the way it keeps score.

Fifthly, I would expect accounting to move in the direction of reflecting current values and away from the current emphasis that prevails, at least in our country, on historical cost.

Finally, in looking at the long-term evolution of accounting, I believe that just as we moved from primary emphasis on guiding management and reporting to owners, and from there to informing investors, and from there to assisting in the decisions of potential investors, we will in the future increasingly expect the accounting process to assist in the decisions needed to establish and seek national economic and social goals.