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(202) 755-4846

THE ACCOUNTING PROFESSION AND ACCOUNTING PRINCIPLES

An Address By

Ray Garrett, Jr., Chairman

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Any profession is fortunate to produce a great man when he is really needed. And Robert Trueblood was the man for the time when the purposes of financial reporting needed a new appraisal and reinterpretation for the economic and social climate of the last quarter of this century.

Financial reporting in the accepted mode suffers from its inevitable appearance of simplicity and numbers. Its superficial precision masks a multitude of difficult judgments, estimates and assumptions, if not predictions, as to the future. It purports to make so clear what is so murky.

Our problem -- ours at the SEC and yours -- is to endeavor to educate the consumers of financial reporting as to what the statements presented in the accepted mode mean and what they do not mean, depending upon the purpose for which they are consulted. Robert Trueblood and his committee understood the functional approach to the preparation and understanding of financial statements with comprehensive clarity. We are struggling with devices, of limited effectiveness, to impart enough of this sophistication to investors and others.

There is evidence that much remains to be done. I recently received a study by Marc Epstein of California State University, based upon an extended survey of both the preparation and use of corporate annual reports to shareholders. He found that the financial statements thereunder were regarded by shareholders to be the most read and the most valuable part of annual reports. He did not probe into what investors thought they were learning from these financial statements. My own guess is that many of them, at least, really thought that they were getting something only from the bottom line -- the earnings per share.

This guess finds some support in Mr. Epstein's data to the effect that the portion of the annual report that was least read and regarded as least valuable was the footnotes to financial statements. And, of course, it is in the footnotes that the serious effort is made to inform the user of the underlying principles and assumptions so that he can better judge what information is being imparted.

This gives me some pause, because the SEC has made major contributions to the growth of financial footnotes as a literary form. We have pending designs to expand the form still further.

It is tempting, naturally, to attribute the non-use of footnotes to the peculiar difficulties that accountants seem to have with the English language. Perhaps if lawyers wrote the footnotes, much of this aspect of the problem would be solved. However, accepting the weaknesses in that idea, and further accepting the fact that improving the quality of CPA prose is a long-range project at best, we take refuge in the concept of differential disclosure. Even if the ordinary investor cannot get beyond the numbers, especially the number -- earnings per share -- there are those experts, the financially-sophisticated analysts whose judgments become available to ordinary investors, who understand the footnotes -- or are at least ashamed to admit that they do not.

So the system, and the direction that we are going, is clearly valid. If it is not, we had all better find ways to make it so, because it is coming under increasingly hostile scrutiny.

SEC officials, like others in government, need fairly thick skins. Everything you do is painful or unsatisfying to someone. Some people just don't like us. To paraphrase Buddy Hackett, some people hate us like sin, others just hate us regular.

The first thing you have to understand is that there is no cause for this, because the criticisms are hopelessly antithetical. On the same day that I got a letter accusing me and all of the staff of being Communists and atheists -- because we were trying to stop some phoney preacher from robbing the faithful by selling them skinplasters -- our Denver office was bombed by some local group of revolutionary maniacs whose note accused us of being the slaves of the capitalist-imperialist pigs.

It disturbs me somewhat more when we get criticism from a learned profession with whom we work so closely as we do with the accounting profession, for what I can only regard as the wrong reasons. Obviously, I am not referring to criticisms of the quality of our judgment on particular matters. The accounting profession has not distinguished itself for unanimity on substantive questions, and I am not suggesting that it should; but I also am not surprised that you all do not agree with us on all technical subjects. I am happy enough to have substantial authoritative support. I realize, because I have been told, that Sandy Burton is *ipso facto* substantial authoritative support. He is authoritative, and we all know that he is substantial. But I am also happy to find some corroborative substantial authoritative support.

I am disturbed, however, at criticism that seems to be based upon misunderstanding of motive and of strategical situation. I particularly have in mind criticism to the effect that we are creeping up on the FASB and some dark night intend to do it in. The reason that this is disturbing is that, from our point of view, we are a major bulwark against serious efforts to cause us to preempt the field of establishing accounting principles and auditing standards, and, in special areas at least, against serious efforts to cause the government to assume the auditing function.

I presume that you all know the history of federal securities legislation well enough to know that one of the propositions debated in 1933 and 1934 was that a government agency should perform the auditing function. Fortunately, the proposition did not carry.

In both the Securities Act and the Exchange Act, however, Congress gave us the authority to establish accounting principles. The Commission declined to exercise this authority in what I like to refer to as the great treaty. We would accept statements prepared in accordance with generally-accepted accounting principles, which would be principles having substantial authoritative support, except that where several inconsistent principles had substantial authoritative support, we might insist on one rather than another.

It was a good treaty, meaning it was good for both parties. It was also good for the public interest and the interests of investors. The accounting profession has had agonizing difficulties in establishing exclusive principles. The result has been a well-publicized lack of comparability and erosion of those exclusive principles that have been promulgated. The record has been, in many respects, less than splendid. That is unfortunate, but it does not necessarily impugn the treaty. One must speculate on how it would have gone if the Commission had taken the task unto itself. Presumably, there would have been more uniformity, but possibly at the expense of less responsiveness to the needs of changing conditions and new industries. What surely would have been lost is the sense of responsibility and duty on the part of financial executives and the accounting profession. While one may justly criticize the collective and individual responses to this duty from time to time in the past, it has led to the monumental effort that produced the Financial Accounting Standards Board.

It is the official and personal desire of all of us at the SEC that the FASB should succeed. What is threatening it?

One serious threat is that certain significant members of Congress simply do not trust the accounting profession either to establish adequate accounting principles or to perform satisfactory audits in critical areas.

As a most recent example, there was a move in the House to include in the energy bill that it recently passed, a provision for GAO to conduct annual audits of so-called integrated oil companies and to report results in accordance with accounting principles established by a special government body. Our objective, along with those of the AICPA and its members, and others, led to a provision, in the bill as passed by the House, for GAO to make full verification audits of such companies for cause or when asked to do so by an appropriate Congressional committee, and for the SEC to establish accounting principles for such companies in consultation with the FASB.

The bill containing these provisions is so controversial in so many respects that these accounting provisions do not seem likely to become law at this time, but they illustrate which way the wind is blowing.

Why would substantial members of Congress think this sort of thing necessary or even desirable? Why, despite the protestations of the Comptroller General as well as ourselves, would they want a government agency to staff itself to recapitulate the work of the independent auditors? One reason seems to be that they do not really believe in the independence and objectivity of the private auditors. This mistrust appears to be grounded in the belief that important information about oil reserves, costs and production is being kept from the public and from Congress.

Another reason seems to be that financial statements, under present accounting principles, even if adequate for the needs of ordinary investors, are not adequate for the needs of a congress worried about energy resources and, more immediately, prices to the consumers. In other words, the financial statements are sufficient for their intended purpose, but not for some other purpose. If this is true, the reasonable solution ought not to be destruction of the present system but the creation of some new mode of special purpose reporting.

In other areas, we have been urged by some company executives and public accountants to exercise our dormant authority because the FASB cannot or will not act quickly enough. Some of these urgings are not easy to resist. We were, for example, impressed with the argument that the requirement to write off goodwill after a purchase, whatever its merits in ordinary cases, has a serious disadvantage in that it handicaps American bidders for the purchase of American companies in competition with foreign bidders not subject to such a requirement The foreigners can afford to bid higher. This argument is particularly appealing in the present climate. With some regret, we concluded that the cost of relief through SEC action would be too high, in part because it would, at least _pro tante_, abrogate the treaty.

On the other hand, in other areas we have not been willing to stand idly by when it appeared that some further disclosures would be constructive, pending the FASB's further progress on its long docket of matters, most of which are at least urgent. As you all know, we have been adding things to the footnotes -- for the benefit of those who read them.

For this purpose, we emphasized the distinction between principles of measurement and matters of disclosure. The former are covered by the treaty. The latter are not. The balance sheet treatment of financial leases, for example, is for the FASB, but further disclosure of their existence and possible significance is not.

This bifurcation of the total financial reporting process has not met overwhelming acceptance. How many persons who complain really care about the underlying principle of separation of primary responsibility and how many just do not like the particular disclosure we propose to require is not always readily discernible. We have, in any event, had arguments addressed to us in terms of principle, denying the validity of this distinction, especially when it imposes on footnotes subject to the auditor's opinion.

It is my judgment that this distinction -- whatever one's opinion might be of its intellectual credentials -- is essential to enable us to abide by the treaty, to wait for the FASB to come to measurement solution. In the presence of urgent importunings to take action in specific areas, it gives us something meaningful to do short of assuming the FASB's role.

Consider, for example, the subject popularly referred to as "accounting for inflation". The FASB is engaged in a fundamental study of the subject, but we believe that important current disclosures may and should be made without awaiting a final decision on whether to maintain or alter the fundamental theorum on which the whole structure is built.

We have recently proposed the inclusion in notes to financial statements of certain limited data based upon the replacement cost of corporate assets. Specifically, we have asked for four pieces of information, two oriented toward the income statement and two toward the balance sheet. These are cost of sales and depreciation, computed on replacement cost basis, and the current replacement cost at the end of the year of productive capacity and inventories. We believe that this information will significantly assist investors in assessing the current economics of a business enterprise which will be of great assistance in making judgments about the future. While we have not suggested that historical financial statements are without value, we do believe that in a time of inflation and dramatic economic change they may lag reality sufficiently to be unreasonably biased if they are used uncritically. We do not have to look far to find examples of historical cost financial statements that do not reflect today's realities. Utilities and petroleum companies are two examples.

We have noted around the world a move in the direction of financial reporting based on replacement cost. In some countries, proposals have gone far beyond ours. In Australia, for example, there has been a proposal that the basic financial statements be changed to use replacement cost information. In the United Kingdom, the recent report of the Sandilands Committee made a similar recommendation. It may be that ultimately we should consider such a fundamental change, but the Commission believes that such a change should come from a careful study of all the issues, such as the conceptual framework project now being undertaken by the FASB.

In making our proposals, we also gave consideration to the possibility of general price level adjusted financial statements as the only form of supplemental information, and we concluded that this would not be a sufficient answer, even though we did not reach a conclusion that such information was worthless. We believe that in an inflationary enviornment relative price changes between enterprises are very significant and that the application of a single general index representing a composite of all changes in the economy cannot effectively communicate to investors, or for that matter, to managers, how the forces of inflation are affecting a particular enterprise. Such an approach is still an historical cost approach, even though it is based upon units of purchasing power, and, accordingly, it does not indicate the impact of relative price changes on enterprises.

We certainly recognize that our proposals are controversial, and in making them, we have provided for a substnatial comment period which ends on January 31, 1976, so that all interested parties will have an opportunity to consider them with care, in the light of their own situations, and supply us with comments. We are not committed to the specific words of our proposal, and we are cognizant of the costs which it may impose upon registrants. Nevertheless, it seems to me that there is a real need for information of this sort, both to assist investors in making judgments about current and future economics, and also to assist managers in their own decision-making.

Our principal concern, of course, is information for investors. On the other hand, I think we must recognize that data are not developed solely for this purpose. We have seen a number of examples of companies that have established replacement cost systems for their own internal purposes and found them extremely useful. While a few of these companies have presented such data in external reports, the majority still use it solely for internal decision-making. While we cannot believe that managements are unaware of current costs, we do think that many do not have a system which brings such costs to their attention, on a regular basis, as part of their control over operations. It seems reasonable to think that such data may be valuable.

We have also heard a great deal in recent years from the business and financial community about the inequities of our current tax structure and the fact that taxation based upon historically-computed income may result in taxation of capital in an inflationary economy. There is logic behind this view, but I think it must be recognized that Congress is not likely to be responsive as long as corporations are telling one story to their shareholders, while at the same time urging another on Treasury and the Congress. Management cannot have it both ways. If they wish to tell their shareholders that everything is going well, it is unlikely that they will be able to communicate a different message to the tax man.

It seems essential, therefore, that business begin to develop systematic and regular data which are part of their information system recording the impact of current costs. Data which are developed only to make a tax case is suspect, particularly in an environment such as today's, which must be characterized as anti-business. I suspect that the ultimate recognition of replacement cost on a tax basis will not be easy to achieve, but without having it part of the regular corporate information system, I am convinced that it is impossible. We hope that our proposals will constitute a first step in this direction.

In recognition of the potential cost of such a system, we have asked for comments on whether initially replacement cost data should only be required of companies above certain size levels and whether such data should be labeled as unaudited. We have observed from early comments some agreement that requirements should only be imposed upon companies above a particular size. Our Chief Accountant advises me that he has developed a mathematical expression of these views. He says that commentator generally feel the rule should be applied to companies of a size of X plus 40 million, where X is the size of the commenting company. I should say in fairness that we have not yet heard from any of the Fortune 500 in this regard.

I urge you to take pains to explain our proposals and their potential significance to your clients. This is not just some more expensive bureaucratic nonsense. It is radical, and it will cost something. But it offers promise of providing the foundation for a corporate reporting and income taxing system that may stem the alarming capital erosion that continued high rates of inflation are threatening. It will also provide experience to help the FASB in its determinations regarding the principles of measurement.

Accounting and financial reporting can never be a static art. It must be constantly reexamined as the underlying facts and trends change. It takes the best intelligence and labor of all of us to hope to reach wise decisions. And I suspect the challenge has never been greater to the cooperative patterns that have served us for 40 years. The ravages of inflation, the energy crisis, the xenophobia, and the popular and political mistrust of the private sector -- at least the big business segment of the private sector -- make it incumbent upon us all to demonstrate that the profession and the Commission are up to the task without further governmental intervention.