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ACCOUNTING PRINCIPLES DEVELOPMENT PRIOR TO 1972

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Once upon a time the financial vice president of a certain large corporation was seeking to hire a new accounting firm. He called in three leading practitioners, and asked each the same question, "What is two plus two?" The first two accountants, cautious and conservative as befitting their craft, answered without hesitation "four." The third accountant, though, was apparently well versed in what some call the techniques of creative modern accounting. He came back with a query of his own: "What did you have in mind?" We don't know which of the three firms was hired, but the story serves to illustrate the distrust of financial statements being increasingly expressed in many quarters. As Abraham Briloff recently put it—"I think we have now moved into a time of hot-pants accounting." For those of you who don't know how to put hot pants on a financial statement, Mr. Briloff says that some current accounting, like hot pants, tries to disclose as much as possible to make things really exciting, but stays just within the law, restricting indecent exposure.

This mounting criticism has not gone unnoticed by the accountants. Within the past year the profession has accelerated its efforts to set up machinery to produce more acceptable and timely solutions to the problems we face. The culmination of these efforts resulted in last month's publication of a "Report of the Study on Establishment of Accounting Principles", more commonly known as the "Wheat Report" in honor of the Committee's chairman, Francis Wheat, a former SEC commissioner.

Our purpose here today is to review briefly the development of accounting principles up to this point, and to acquaint you with the recommendations of the Wheat Committee. The widespread support it has received indicates that this is the immediate direction that development of accounting principles will take. Our firm is proud of our participation in the Committee's work, that the final conclusions incorporated many of our suggestions, and that we were first to pledge financial support to the foundation recommended by the report. My comments will focus primarily on the efforts that the profession has made over the years to meet these challenges and the reasons why it is urgent for all of us that we move swiftly to develop comprehensive acceptable standards. I will also discuss the status of some of the Accounting Principles Board's current projects. Then the next speaker will go into some detail about the Wheat report and what can be expected in the future.

GOVERNMENTAL INTERVENTION

The primary threat now forcing accountants to move fast is the possibility of the government taking accounting principles out of the private sector of the economy. Accountants won't soon forget the investment tax credit episode last fall. You may recall that Congress declared that all taxpayers could decide for themselves how to account for the credit after the APB had issued an exposure draft specifying that only the deferral method could be used. The Board then withdrew the draft and issued a statement strongly objecting to congressional involvement in setting accounting standards. The episode was especially disturbing because our efforts have been geared to reducing accounting alternatives, not to creating them.

Another area where the government seems to be creeping into our world concerns a proposed IRS regulation to require taxpayers to adopt for financial reports the same methods used for taxes. The American Institute of Certified Public Accountants is vigorously challenging this proposed regulation, pointing out that the objectives of financial reporting are far different from the objectives of income tax law. As of now the matter is still under deliberation by the IRS.

I think most of us here probably agree that governmental decree of accounting principles would be disastrous.

CONFLICTING DEMANDS ON ACCOUNTING PRINCIPLES

Let's take a minute to consider why the setting of reliable accounting standards has been such a difficult task. Accounting and financial reporting have often been said to be arts rather than sciences. There are no laws of nature to guide us. On the contrary, financial statement users have diverse and conflicting needs and desires. We say that financial statements should fairly present, but fair to whom and under what circumstances? Stockholders of public companies want aggressive earnings to keep stock prices high. The managements of public companies also are interested in presenting flattering earnings per share, especially when they are acquisition minded and when they stand to benefit from stock option plans. On the other hand, lenders want conservative balance sheets. Stockholders of closely held companies have varied wishes, but they are often most interested in keeping income taxes and estate taxes down. Prospective investors and security analysts are concerned with realism–what has the company done or, better yet, what is it likely to do in the future. And the emphasis is changing. For many years business owners and their creditors were the parties mainly interested in financial statements, but now the relationship between management and investor is paramount. The profession is badgered from some quarters to move fast, tighten the rules and eliminate the alternatives, but at the same time many business people say "leave us alone–we're doing fine".

One of the biggest problems has been the increasing complexity of business transactions. For example, in 1953 the accounting for stock option plans was specified in Accounting Research Bulletin No. 43. This was fine for traditional plans, but when companies developed more complex plans such as those involving variable numbers of shares, and variable option prices, ARB No. 43 didn't cover the ground.

COMPOSITION OF THE APB

In reviewing what has happened to this time, I will concentrate on the Accounting Principles Board, which is the current vehicle for setting our standards. Before the APB was formed, the profession's efforts had succeeded in defining many principles in practice, but had failed to choose between existing alternatives and, by so doing, to weed out undesirable ones.

Let me spend a minute or two discussing the APB itself. The present Board consists of eighteen members. Eight are partners in the "Big 8" national accounting firms, 6 are partners in smaller firms, 2 are from the academic world and 2 from industry. Each Board member is appointed by the president of the American Institute and serves a term of three years, with a maximum of two terms. The members retain their positions in the business or academic world and serve the Board on a part time basis only, although Board activities consume about 50 percent to 75 percent of their time. They serve without compensation, and are assisted by other members within their own organizations who also serve without pay.

Several facets of the Board's composition have been challenged during the current debate. For example, some advocated that the Board be increased to

21 members while others have suggested a much smaller Board, say 5 to 7 members. In answer, it has been said that a smaller Board might be too narrow a base to achieve support for controversial opinions, but that a larger Board might be too cumbersome to get the job done expeditiously. The part-time nature of the Board has been criticized on the basis that the problems are huge enough to require full-time deliberation. Additionally, there have been some who suggest that Board members may not be able to reach independent conclusions because they are not removed from the special interests of their clients. The Wheat Committee considered all of these matters.

BOARD RESEARCH

The research effort has been the principal area of Board operations to draw fire from the Wheat Committee. The major reason for the delays apparently has been the distraction provided by the authors' regular activities, whether they be business or academic. In three cases there were delays of about two years just in deciding who the author of a study would be. Another criticism has revolved around the methodology used. For example, in Accounting Research Study No. 10 on goodwill, Reed Storey, the director of the Research Division, said "in my opinion, this study falls short of meeting the qualifications of an accounting research study" because the authors are primarily advocates of a particular position and do not present a balanced evaluation of the pros and cons of alternate courses.

PARTICIPATION BY OUTSIDERS

In recent years, the Board has increasingly sought the participation of outsiders in reaching its decisions, and I'd like to talk about that for a minute.

In its early years, the Board usually reached decisions internally and issued Opinions. However, as a result of being forced to renege on Opinion No. 2 on the investment credit, the Board found that it was unable to dictate rules without general acceptance. Shortly, the Board began to issue exposure drafts soliciting comments from other interested parties, and, in the last few years they have solicited other viewpoints even before issuance of an exposure draft. For example, in considering several of the controversial issues in the recent past, symposiums have been held at which organizations like the National Association of Accountants, Financial Executives Institute, Financial Analysts Federation, the SEC and others have presented their views. More recently, the Board has been holding open public hearings on troublesome topics. To date, hearings have been held on the marketable securities issue, accounting for the extractive industries, and lease accounting. The Wheat Report provides for even more direct participation by accountants not in public practice.

THE BOARD'S ACCOMPLISHMENTS

The Board's history has not been one of smooth sailing. Even so, I believe that the Board has made substantial progress in eliminating some of the least desirable accounting alternatives previously existing. Twenty-one opinions have been issued, and three more will probably appear within the next month or so. Additionally, four statements have been issued, the last one, on fundamentals, being the culmination of the Board's first basic charge, to define broad accounting principles.

Probably the most serious criticism leveled against the Board has been that it has moved too slowly in solving critical problems. This sluggishness has stemmed largely from the difficulty of merging and compromising the widely divergent views of those interested in financial reporting as I mentioned earlier. Possibly if business conditions had remained unchanged since 1959, the Board might have had more success. But the 1960s and the 1970s have been periods of rapid change and innovation in the business transactions we are trying to measure. It seems that for every problem solved, two or three new ones pop up. Consider lease accounting. Back in 1966, the Board issued Opinions Nos. 5 and 7, and it was thought that the problem was substantially solved. However, since then the new varieties of leases, some designed to circumvent the rules, have been endless. I recall one situation where a public utility bought a $100 million generating plant to be paid for over a thirty-year period, and did not report the resulting liability or asset on its books. They had structured the transaction with certain technicalities circumventing Opinion No. 5.

Another criticism frequently leveled against the Board has been that several of the recent opinions have used what critics call the "cookbook" approach, spelling out every detail of the situation rather than just setting broad guidelines. The opinions on earnings per share and business combinations are examples. However, I believe there are some circumstances requiring detailed guidelines. Experience has demonstrated that broad statements have not always been adequate to insure uniformity in applying them. I guess if we always want good food, we'll sometimes have to use a cookbook.

CURRENT BOARD PROJECTS

I thought you might be interested in some of the more pressing topics on the Board's current agenda. The most recent schedule lists 26 items covering a broad range of topics. Time doesn't permit discussion of many of these problems, but I'll outline a few that are expected to result in opinions within the next few months.

- **Accounting Policies** The most imminent Board pronouncement is on accounting policies, exposed last December and formally approved by the Board about two weeks ago. It has not been very controversial, and the only substantive change from existing practice is that industries having peculiar accounting methods will be required to disclose such methods in their financial statements.

- **Accounting for Income Taxes–Special Areas** In January an exposure draft was issued on certain income tax matters not covered in Opinion No. 11. The Board will soon issue two Opinions reflecting substantially the conclusions in the exposure draft. One of the Opinions will primarily require disclosure of unremitted earnings of subsidiaries for which taxes have not been provided. The requirement in the exposure draft that there be disclosed the amount of taxes payable if such earnings were remitted currently has been dropped. The second tax Opinion will cover situations where an investor picks up its equity in a less than 50 percent held company under the provisions of Opinion No. 18. In such cases the investor is to provide for taxes as if he expects to receive dividends eventually. However, if there is a strong indication that the the investment will be sold, capital gain rates should be used.

- **Marketable Securities** One of the more controversial issues today concerns the accounting for marketable securities not carried at equity under Opinion No. 18. The traditional way is to carry them at the lower of cost or market, and to recognize gains only as realized. This topic is part of the broader subject of fair value accounting, as was Opinion No. 18 requiring equity accounting for substantial investments. Some critics believe that the Board should first consider the broad question and then the components, but the

Board apparently feels that fair value accounting for securities with quoted market prices and liquid markets is a far sight easier than many of the other problems of fair valuation. It seems to me that the partial progress that may result from the piecemeal approach is superior to no progress at all. Everybody in the world except accountants believes that if you hold a security and it goes up, you have made a profit. I think it's time we start telling it the way it is!

In the recent past, the Board held a symposium and an open hearing on this topic, and market value accounting was widely accepted by most of the participants. Last fall an exposure draft of such an Opinion was nearly issued, but representatives of the insurance industry convinced the Board to delay it. The peculiar problem that the insurance companies have results from their tremendous investments, totaling billions of dollars, in securities, and the gigantic effect that stock market fluctuations would have on their income statements. For example, one large insurance company reported that, in a particular quarter in 1969 when stock prices were fluctuating widely, it would have reported a loss of $200 million, and other quarterly reports would reflect similar gyrations which the companies believe to be misleading. The matter is still under investigation, and the Institute earlier this month delivered an extensive position paper on the topic to the SEC. Right now there are five possible ways the final conclusion might go. The first is to leave the status quo. All of the other four possibilities involve carrying the securities at market value on the balance sheet, but they differ with respect to the realized and unrealized gains and losses. Generally the differences revolve around whether such gains and losses should be shown in the income statement or as stockholders' equity items in the balance sheet. One possibility is that gains and losses would be included in the income statement on a long term yield basis over a five year period. I think the possibility of resolving this matter during 1972 is remote.

- **Lease Accounting** Lease accounting is one of the most controversial issues now being considered. As of 1966, Opinions Nos. 5 and 7 had apparently solved the lease problem. Opinion No. 5 considered the lessee from a balance sheet standpoint, whereas Opinion No. 7 considered the lessor from an income statement standpoint. The Board acknowledged in issuing Opinion No. 7 what could be considered an inconsistency between the two Opinions in the balance sheet treatment of leases reported on the "financing method" by lessors when such leases are not considered installment purchases by the lessee. In these instances the property is not reported in the balance sheet of either lessee or lessor. Since the issuance of Opinion No. 7 the major criticism of the two Opinions has centered on this reporting inconsistency.

More recently the criticism of lease accounting has shifted to the reporting by manufacturers of a sale of property under Opinion No. 7 where the property is leased directly by the manufacturers, or is sold to a third party who in turn leases the property. These transactions are generally associated with young, undercapitalized manufacturers in the computer and computer peripheral field. In essence, these companies have been treating as sales, transactions that are leases in substance. They have done this in two ways. The first is by creating what they call full pay-out leases which they say are qualified for the financing method under Opinion No. 7. This is done by using a significant residual on rather short-term leases (for example, three years). The other method is to structure sales to computer leasing companies which in turn lease to lessees on short terms, sometimes month-to-month. The problem in treating the transactions as sales is that the manufacturer guarantees to use its "best efforts" to replace equipment which comes off-lease. Such guarantees impose considerable contingent obligations upon the manufacturer.

The SEC in particular has been concerned that such transactions should not be reported as sales under the provisions of Opinion No. 7. Under strong pressure from the SEC, the APB issued an "accounting interpretation" on manufacturer-lessor accounting in October 1971.

In the meantime, the Board has requested position papers on a revision of Opinions Nos. 5 and 7 and has held open public meetings with those directly interested in modification of the Opinions. The timetable for revised Opinions has been extended considerably since the Board commenced its study. The latest schedule calls for publication of a revised opinion in December of this year.[1]

- **Extractive Industries** An item on the agenda drawing current fire from the financial press is the accounting for extractive industries. Recently the *Wall Street Journal* reported that "the accounting profession's rule-making body, already typecast as Casper Milquetoast for repeatedly watering down stiff accounting proposals in recent years, appears ready to play the same role in a new drama". The drama concerns "full-costing" versus "field costing" in such industries as oil. Under "field costing" if productive efforts to produce oil in a certain field are unsuccessful, the costs are charged immediately against income, representing costs which will produce no future revenues. Under

[1] *Opinion No. 27, Accounting for Lease Transactions by Manufacturer or Dealer Lessors, November 1972.*

"full costing", such costs are capitalized under the theory that they are included in the total effort which finally results in producing wells. The Board was previously reported as favoring "field costing", but the current position is somewhat of a compromise between the two with "full cost" opponents still unhappy because they believe that it is closer to "full-cost" than to "field-cost" accounting.

- **Early Debt Retirement** One area where the Board is attempting to eliminate alternative accounting concerns the early retirement of debt through refunding. In practice three methods are now acceptable for handling the difference between the debt reacquisition price and the carrying amount of the retired debt. One method is to recognize the difference in income currently, and the other two involve amortizing over the life of either the new issue or the old issue. A recent discussion draft proposed that all gains and losses resulting from debt refunding would be recognized currently in the income statement.[2]

- **Stock Compensation Plans** Another topic high on the agenda these days concerns the accounting for stock option and related plans. ARB No. 43 covered the accounting for traditional plans, but many corporations have replaced these plans with more complex plans. There may be an exposure draft on this topic after the April meeting. In the case of non-qualified plans, it will propose that compensation be recorded in the amount of the difference between the option price and market value on the date the option price and number of shares become fixed. Because this may be of interest to some of you, let me illustrate. Assume today you get an option to purchase stock at today's market, 30. Also, assume that the option price drops one dollar for each one dollar increase in market. Assume further that the market goes to 60 and the option is exercised at an option price of zero. When this type of plan first came out, no compensation was recognized. Then an interpretation of the AICPA required recognition of compensation for the difference between exercise price and market at the date of grant, in this case \$30. The proposed Opinion would require recognition of \$60 of compensation. By contrast, qualified plans will require no recognition of compensation because the option price equals market value at the date of grant. There is not unanimous agreement on this treatment because some believe that it is inconsistent to recognize no compensation for qualified plans while compensation is recognized for other plans.[3]

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[2] *Opinion No 26, Early Extinguishment of Debt, October 1972.*
[3] *Opinion No. 25, Accounting for Stock Issued to Employees, October 1972.*

CONCLUSION

As you may have concluded, the setting of accounting standards has been a formidable and perplexing task, and we as accountants seem to be falling further and further behind in our efforts. We are being challenged and criticized more and more in the courts, in the business world, in the financial press, and by the government. The APB has made considerable progress in its twelve years, but changing conditions have expanded the job to the point where the APB as currently structured cannot adequately meet these challenges.

The ball is in our court. As accountants, we must be prepared to develop more swiftly adequate machinery to meet these challenges. This is very much as important to those of you in industry as it is to us in the accounting profession.

We now have the comprehensive Wheat Report authored by a broad based group calling for significant changes in the present standard making procedure. It has been endorsed by the American Institute and plans are being made to expedite its implementation. Our Firm has participated to the fullest in the Wheat Committee studies, and has pledged to support its recommendations both financially and professionally. I recommend that each of you consider helping in this effort in whatever way you can. After all, let's keep the hot pants where they belong–not on financial statements. ●