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CORPORATE ACCOUNTABILITY: A CHALLENGE TO BUSINESS

BY

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BEFORE

THE ECONOMIC CLUB OF DETROIT

DETROIT, MICHIGAN

APRIL 12, 1971

THE ECONOMIC CLUB OF DETROIT

"Corporate Accountability: A Challenge to Business"

When I was first invited to be with you today the suggestion was made that, since my appearance precedes by only three days the income tax deadline for some individuals, the subject of taxes and tax planning might be a suitable one for us to discuss.

However, I trust most of you have already filed your 1970 tax returns. If not, there is little I could say that would be of much benefit to you by midnight Thursday.

Therefore, instead of dealing with tax matters, I want to discuss a matter of critical importance to the business and financial community as well as to the accounting profession. It is the public demand for greater accountability on the part of business -- specifically, a desire for more complete and useful information on corporate financial affairs.

In a speech before a business group last fall, one of the officers of the American Institute of Certified Public Accountants cited several instances of lawsuits brought against companies for their reporting practices. He said -- "The odds are high that, before 1971 has ended, one or more of the corporations you represent will be attacked in the press, and possibly in the courts, for your company's financial reporting practices."

Little has happened since last fall to dispel that prediction. Hardly a week goes by that we do not read of criticisms or actions against companies for allegedly issuing false or misleading financial information.

You probably read stories in the newspapers just recently about a suit against one company, complaining that the highlights section of its annual report showed earnings-per-share figures without showing also extraordinary gains or losses.

Another concern has been charged by the SEC with failing to disclose properly its intended use of proceeds from a public securities offering.

Still another company was alleged to have overstated profits in its interim financial statements.

Obviously, many of these cases do not get beyond the allegation stage -- but the fact that they arise is sufficient cause for deep concern.

Public feelings run high on matters such as inadequate, inaccurate or misleading financial reporting practices. A letter-to-the-editor printed in The Wall Street Journal a few weeks ago shows how high feelings on this matter can run. The letter-writer, obviously a person with deep interest in financial statements, had this to say --

> "It is with considerable amusement that I read the 1970 corporate reports that are now pouring in... I cannot find one where the report states frankly -- 'Your management acted with stupidity in merging with X Company, which turned out to be a colossal blunder that astute men would have avoided...'. Nor have I been able to find even one annual report that states --

> 'In view of the debacle which occurred in 1970 under the present management, it is obvious this management is incompetent to run the company, and we recommend that your directors ask for their resignations...'.
>
> "On the other hand," the letter went on, "the reports often contain alibis and excuses which would do credit to a successful fiction writer."

Such brickbats are being thrown at you as business managers, for the scope of your financial disclosure; and at us CPAs, as auditors, for the accounting principles established for corporate reporting.

The fact is, however, that over the past several years major improvements have been effected to make corporate reporting more understandable and useful to stockholders and others. It has been said -- justifiably, I think -- that the American investor is the best informed in the world.

But the public -- your public and our public -- is not satisfied merely that things are better than they once were. They want to feel assurance that financial reporting is the best it can possibly be.

A complicating factor in the management-stockholder relationship is the increasing number of knowledgeable investors. The number of people now owning shares in American companies is over the 30 million mark. And, as one Wall Street observer has said, "30 million stockholders and their families can provide massive support to business enterprise -- or they can become the biggest lynch mob in history."

In my experience, most business managements sincerely strive to make their financial reports to the public fair and understandable. Naturally, managements are inclined to put their best foot forward -- and there is nothing wrong with such a desire as long as the results are not actually or potentially misleading.

The increasing scrutiny of corporate financial reporting practices, however, has led to a number of suggestions for new ways of setting accounting principles and establishing financial reporting standards.

Before considering the various suggested alternatives, let me outline the situation as it now exists.

To a very great extent, corporate financial reporting standards are established, or at least heavily influenced, by activities of the accounting profession. In earlier years, standards of financial reporting were promulgated by the Committee on Accounting Procedure, established by the American Institute of Certified Public Accountants in 1938. That committee, during its 21-year life, issued more than 50 pronouncements on accounting principles and related reporting practices. In my judgment, the activities of the Accounting Procedures Committee contributed substantially to the improvement of financial reporting in the United States and had an effect also in other countries throughout the world.

However, because of a cry for more action, both from within our profession and outside of it, and in view of the increasing complexity of corporate financial operations and the growing interest of the investing public, the American Institute created the Accounting Principles Board in 1959. I feel this was a major step forward in the methodology for handling our standard-setting role.

Today, the Accounting Principles Board is comprised of 18 members. They are distinguished accounting authorities appointed by the president of the American Institute subject to ratification by the Institute's Board of Directors. Each member of the APB is a certified public accountant engaged in public practice, private industry, or the academic field.

Incidentally, the members of the Accounting Principles Board receive no compensation for the time spent on APB matters. As a former member, I can assure you the demands upon a Board member's time are extremely heavy. Many members spend from 50 to 75% of their own time and are supported by one or more partners or staff on a full-time basis.

If one were to put a money value on the hours devoted by Board members and their partner or staff advisors, the total would run to several million dollars each year.

The Board does not work in an "ivory tower". It is not isolated from the practicalities of "real life". To a great extent it works through a structure of subcommittees assigned to deal with specific problem areas. In many cases, subcommittees are supported by well-qualified experts from various fields of endeavor when they are dealing with a highly complex and technical matter.

Early in the Board's deliberation of almost any subject, representatives of groups in industry, finance and government are invited to contribute their points of view. The base of such outside consultation has been enlarged over the years. When I was a member of the APB, and we were attempting to finalize our thoughts concerning Opinion No. 11, which deals with accounting for income taxes, each Board member reviewed, very carefully, more than 1,000 letters received from interested parties as a result of the exposure draft process. Obviously, Opinions of the Accounting Principles Board are not the product of only its eighteen members.

The Board has scheduled an open hearing on a proposed Opinion affecting accounting for certain investments in marketable equity securities. The open public hearing will be held in New York on May 25th and 26th. Anyone concerned with accounting for this type of investment will have an opportunity to make his views known.

This hearing will be the first on an open basis as compared with previously conducted symposiums on an invitational basis. It may very well prove to be a worthwhile extension of the Board's policy of exposing a proposed Opinion to wide debate before final decision is made.

Nevertheless, as I have noted, the APB, the American Institute and our profession as a whole have not been spared criticism.

There are some who say the Accounting Principles Board moves too slowly; others that it moves too quickly and thereby makes arbitrary decisions.

There are those who contend that the Board does not have broad enough representation from interested parties -- while others believe it is too large and unwieldly.

Some maintain that the Board is too concerned with details. Others worry that, since its members retain their firm affiliations, they may be subject to pressure from clients -- so that Opinions are compromises rather than definitive solutions to problems.

I can assure you that all members of the APB are very much aware of comments of this kind and that they take seriously all observations from responsible quarters on possible ways to improve the Board's performance.

Almost since its creation in 1959, the Accounting Principles Board has continued to study its own operations, attempting to improve the methodology. Major changes in its procedures have been made over the past few years as a result of this continuing self-examination.

I have no intention today to argue the criticisms that I have mentioned, although I may note -- as you no doubt have perceived for yourselves -- that all of them cannot be justified since some are contradictory.

My purpose this afternoon is to outline proposals that have been made for changes in the way corporate accounting principles and reporting standards are established.

You should be aware of these proposals in order to evaluate their impact on your own situation and on business generally in the event any of them were adopted.

One suggestion that has been made as an alternative to the activities of the Accounting Principles Board, is that the Securities and Exchange Commission should establish accounting principles used in financial reporting to the public.

Proponents of this idea point out that the SEC already has statutory authority to set the accounting rules for companies under its jurisdiction. And they take the position that setting the accounting rules for business is so important a function that it ought to be performed by Government.

Others look with disfavor on this idea, holding that government attempts to prescribe detailed regulations often lead to proliferation of red tape which is more hampering than wholesome for economic activity. They fear also that putting the establishment of accounting principles into the realm of government might make it subject to political lobbying.

Another suggestion for putting the establishment of accounting methods in the government sphere would place the function with a newly constituted court, possibly consisting of five members appointed for life by the President, with confirmation by the Senate. Apparently, such a court might itself set accounting principles; or, if it were designed as a court of appeals, accounting methods would continue to be devised by the profession, regulatory agencies and business itself, and then brought before the court by a dissenting party for judgment as to the method's validity.

Proponents of this suggestion maintain that such a court would bring more objectivity to rule-setting than do present procedures and would provide a more effective forum for objectors to particular rules.

Opponents of the court proposal again include, of course, people who disapprove enlargement of government power in principle. Objections are raised also on the ground that the proposal would introduce still another factor into the setting of accounting rules and needlessly complicate the process.

It is pointed out that until an issue had been brought before the court by a challenging party, there would be uncertainty as to what standards and practices would ultimately prevail -- that the process of complaint, arguments, counter-arguments, and final adjudication could be protracted, and in the meantime confusion and diversity would be rampant.

Further, those who do not go along with this idea are made uncomfortable by the fact that such a court would be a final and absolute arbiter, a kind of dictator of accounting practices. They note that the only other court in the nation from whose decisions there can be no appeal is the U. S. Supreme Court -- but that, in its case, judgments are handed down on the basis of whether something does or does not conform with the principles set forth in the Constitution. The proposed accounting court would not have the foundation of such criteria, and its judgments would therefore be rigid rulings for business, derived from the personal views of men holding lifetime tenure.

A third suggestion for change comes from individuals who, while believing that accounting principles should continue to be established by the profession, propose that the Accounting Principles Board be made up of full-time, paid members. These proposals vary, but most of them call for a Board smaller than the present 18-man body -- the suggestions range from a 5 to 7-man body of highly respected accounting authorities.

Proponents of a full-time, paid Board believe that its members -- since they would be obliged to disaffiliate themselves from their particular firms, companies or universities -- could more easily maintain independence. In other words, they would be immune from the attitude expressed by Jonathan Swift when he said, "I won't quarrel with my bread and butter."

Furthermore, proponents of the full-time, paid Board suggest, that by devoting all of their time to the issues, the Board could move faster than it does under its present structure.

Those who are against this proposal say that, while leading accounting authorities have been willing to contribute substantial time on a voluntary basis, they might be reluctant to accept a Board appointment as a full-time career.

Also, some worry is expressed that a Board composed of persons totally divorced from practice might become insensitive to evolutionary changes in the business and accounting environment.

A fourth suggestion as to an alternative approach (which is a modification of the proposal for a full-time Board) calls for a small group of paid commissioners who would oversee research and propose completed Opinions to a volunteer Board. The Board would accept or reject proposals but would not engage in their preparation.

Finally, another suggestion is that the current APB should be retained with its present structure, but headed by a full-time, paid Chairman.

In brief, these are some of the more significant ideas for changing the present system of establishing financial reporting standards and accounting principles.

At this point, let me make clear that the various suggestions for change do not by any means indicate that there is universal dissatisfaction with the way accounting principles are now developed. On the contrary, there are many who believe that the Accounting Principles Board should continue to function in much the same way it does right now.

The Board has a significant record of accomplishments. Its Opinions are generally accepted by industry, the financial community, the stock exchanges and the Securities and Exchange Commission.

In just the past few years, some of its more important decisions have had these effects:

- Employer payments into pension funds cannot be varied on a "willy-nilly" basis from year-to-year in order to make net income look better.
- Nor can sale-and-leaseback deals be arranged for that purpose.

- Extraordinary gains or losses are to be included in net income but presented separately so as not to distort the results from normal operations.
- Earnings per share must be calculated on a uniform basis and shown on the face of the income statement, along with any dilution that can result from the exercise of warrants, stock conversions and the like.
- New guidelines now govern mergers and acquisitions and the manner in which they are to be reported in financial statements.

Two new APB Opinions have been issued within just the past few days.

One Opinion requires that annual reports to stockholders include -- together with the income statement and balance sheet -- a statement of changes in financial position, often referred to as a "funds statement".

The other new APB Opinion requires a company to include in the current income statement its share of income or loss in all unconsolidated subsidiaries -- as well as in all other companies in which it can exert a significant influence; until now, the practice has generally been to report such income only as dividends were received.

These and other APB pronouncements represent substantial advances.

Other Opinions are on the way. The Board presently is giving its attention to accounting principles in more than 20 different areas -- some of which are of considerable importance.

For example, the Board is considering:

- accounting for marketable securities at market value rather than historic cost;
- imputing interest to long-term receivables and payables when no interest is stated or the rate of interest is below prevailing rates;
- requiring that a company disclose changes in its accounting methods and explain why the new methods are justified.

* * *

While all reasonable suggestions for improving still further the setting of accounting principles should be seriously considered, I think we should keep in mind that, in too many cases, projects are undertaken or basic changes are made without adequate consideration of all the possible consequences. And as a result, an effort to improve a situation brings on more serious problems.

Accordingly, before anything is done to alter or replace the only vehicle that we now have -- the Accounting Principles Board -- we should give careful consideration to the suggested alternatives and attempt to visualize their ultimate consequences.

With such considerations in mind, I convened a special Conference on Accounting Principles in Washington, D. C., last January 7th and 8th. The conference included 35 prominent CPAs -- representing 21 major accounting firms.

The conference had a 3-part purpose:

- to determine whether there was general agreement as to the desirability of reexamining <u>how</u> accounting principles should be established;
- to isolate the chief issues or questions which would need to be considered in any such reappraisal; and
- to explore the various alternative approaches to the conduct of such a study.

In opening the conference, I observed that in authorizing such a meeting, the Institute's Board of Directors recognized that the profession has a special obligation to take the initiative in sponsoring a candid reappraisal of how its standard-setting role could be made more responsive -- more responsive, that is, to the needs of those who rely upon financial statements in the decade of the 1970's.

After more than 10 hours of discussion, the conference adopted a resolution recommending the appointment of two study groups, working independently of one another. I have acted upon this recommendation.

The first study group will review the present structure and operating procedures of the Accounting Principles Board and appraise suggestions for improvement. The second group will re-examine the objectives of financial statements in the light of their appropriateness to today's conditions and needs.

The members for each study group have been selected and are organizing and setting up their ground rules. Each group comprises representatives from segments of business and professional life other than accounting.

For example, the accounting principles Study Group is chaired by Francis M. Wheat, a recent member of the Securities and Exchange Commission and a distinguished lawyer now practicing in California. Serving with Mr. Wheat are an eminent university professor, an exceptionally able financial analyst, a vice president of one of the largest industrial corporations in the country, and three CPAs engaged in the public practice of accounting.

The second study group, to deal with objectives of financial statements, is chaired by Robert M. Trueblood, an outstanding practicing CPA and a past president of the American Institute. Serving with him are a financial analyst, an economist, an industrial executive, two professors, and two CPAs from public practice -- each of whom was selected for his wide range of experience and known abilities in financial and accounting matters.

I am convinced that the work of these two groups will result in substantial benefits for the business community, users of financial statements, and our profession. The accounting principles Study Group is expected to conclude its mission within 6 months and the objectives Study Group within 18 months.

In closing, I want to mention one other event that directly relates to our subject this afternoon since it pertains to what underlies the whole concept of corporate accountability -- namely, business ethics.

In November, a 3-day symposium will be held to discuss the bearing of ethics on corporate financial reporting. The symposium will be jointly sponsored by the Financial Executives Institute, the Robert Morris Associates, the Financial Analysts Federation and the American Institute of Certified Public Accountants. Representatives of those organizations will be joined by lawyers, government officials, leaders of the academic world, and clergymen.

It is hoped and expected that this symposium can open new avenues of thought in the mutual striving for highest ethical standards in our respective business and professional fields. This is a creative response by the business community and the accounting profession to challenges arising from new conditions in our society and economy.

The call for greater accountability is part of the general mood of our time. As society has become more complex, the particular groups within it have become more dependent upon one another, but, at the same time, less able to know at first-hand what the others are doing. From this circumstance stems a rising insistence for new standards of accountability.

Thus, many Americans want greater accountability from educators as to the administration and effectiveness of public schools. A similar demand extends to agencies of government, the military, labor unions, and business.

Many large corporations are showing their awareness of this trend. Some have nominated individuals from minority groups for their boards of directors. Some have established "ombudsmen" in the top echelons of management. Some have appointed highly qualified scientists and have vested them with broad authority to deal with pollution problems.

Financial accountability is a major part of this overall picture. I am confident that corporate management and the accounting profession will meet the challenge.

# # #