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# Accounting Problems and Institutional Investors

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# ACCOUNTING PROBLEMS AND INSTITUTIONAL INVESTORS

It is no news to anyone in this audience that American business has been growing rapidly in recent years, and that growth brings change.

The need to keep corporate financial reporting abreast of changing business conditions has been commented on widely. Reliable and understandable corporate information is the concern of management, financial analysts, the accounting profession, credit-granting institutions, 27-million private investors, and institutional investors. Indeed, the health of the economy is dependent upon it.

Three basic groups are involved with improved corporate financial reporting. First, there are the managements who bear the responsibility for regular public disclosure of their stewardship. They essentially are the producers of financial information. On the other or receiving end are the consumers of such information -- the investors and the credit-grantors. In the middle is the accounting profession, represented by the American Institute of Certified Public Accountants.

In this mixture, the accountants have become the catalyst for the creation of feasible and realistic accounting standards and principles. And their role in setting standards has taken on added significance to a large extent because of the growth in numbers and importance of institutional investors.

More demanding and more sophisticated than other investors, they insist on financial information that is more comprehensive and more consistent than American business is accustomed to giving. The institutional investor is knowledgeable, active and skeptically inquisitive. Institutions are placing equity securities in their portfolios at accelerating rates; and it is reasonable to anticipate that this trend will continue. As these institutions become increasingly equity-oriented, their appetites for information about corporate developments become correspondingly more hearty.

The needs of institutional investors have brought increasing pressure on the accounting profession in its role as standard-setter. This role has come to the accounting profession through a process of natural evolution. Public accounting grew out of the need to provide confidence in the reliability of financial statements. In filling the need the profession has established accounting and auditing standards. It also has provided a code of professional ethics which requires its members to adhere to these standards and to be intellectually and financially independent of its business clients.

The American Institute of CPAs has had a major part in the development of technical and ethical standards over the years. The establishment and improvement of these standards began early in this century. As the public need for financial information grew, the accounting profession recognized its increasing responsibility to the public.

Today the issuance of authoritative pronouncements on accounting principles is the responsibility of the Accounting Principles Board of the American Institute. As an institution in the private sector, the Accounting Principles Board does not have the power of an agency of the government. Like other professional organizations, its power rests on its special expertise.

However, the governing Council of the AICPA now requires all members of the Institute to note in financial statements of companies they audit any departure from an Opinion of the Accounting Principles Board. Also, the Securities and Exchange Commission requires that financial statements of corporations within its jurisdiction be audited by independent accountants and the SEC usually backs up the pronouncements of the Board by requiring companies to follow them.

In addition, stock exchanges see to it that listed companies publish audited financial statements. Ordinarily the exchanges will not permit companies to use accounting principles to which the auditors take exception.

Major objectives of the Accounting Principles Board are to improve accounting and reporting standards and to remove unnecessary alternative accounting principles which make it difficult to compare financial statements of different companies.

Members of the Accounting Principles Board are appointed by the President of the American Institute with approval of the Board of Directors. They are chosen because of their ability as leaders in the field of accounting thought.

Currently serving are fourteen CPAs in public practice, two professors of accounting, and two financial executives in industry. This is not an ivory tower group. They are very much in touch with the realities of the business world. It is a group of very able and thoughtful men who are striving to reach agreement in areas where there are strong controversies and no clear indications of basic truths.

APB members devote a great amount of time to the Board's work, and many of them are aided by several of their partners and staff. Their work is voluntary -- neither the American Institute of CPAs nor the government could hire talent of this caliber for the job.

The procedures for issuing APB Opinions are designed to assure that all points of view are given consideration. Ordinarily, the first step in developing an Opinion is a research study of the subject. The results are published and circulated to knowledgeable people for comment.

A committee of the Board is then appointed to consider the subject. This committee develops points for debate by the full Board and later prepares a draft of an Opinion. In the course of its preparation, consultations usually are held with key groups in the business community, including those from industries which will be most affected by the proposed Opinion.

The draft is then considered further by the entire Board. When the Board is satisfied that it covers the subject properly, the draft is printed and thousands of copies are "exposed" for comment to leading accountants, financial executives in industry, government agencies, and stock exchanges. Large numbers of comments are received (up to 1,000 in one case) and each member of the Board receives a copy of every letter of comment.

Redrafting usually follows in light of the comments. Finally the Board votes on the matter and, if the Opinion receives an affirmative two-thrids, it is issued.

Since its formation in 1959, the APB has made considerable progress toward codifying generally accepted principles and reducing unwarranted differences in accounting practice.

For example, Opinion 9 established conditions under which a gain or loss is considered extraordinary, and conditions under which nonrecurring items are considered to be adjustments of prior periods. In addition, this Opinion and Opinion 15 dealt with earnings per share, requiring that companies adhere to two additional reporting requirements in their financial statements. One, earnings per share must be reported on the face of the income statement. Two, there must be disclosure of the dilutive effect on earnings per share of convertible preferred stock and debentures, stock options and stock warrants.

Opinion 10, issued by the APB in 1967, requires that consolidated financial statements include the owner's share of the accumulated undistributed earnings and losses of unconsolidated domestic subsidiaries. Prior to this Opinion, the parent's share of the income of an unconsolidated subsidiary often was recorded only when distributions were made.

Opinion 8 brought greater order into accounting for pension costs and Opinion 11 improved accounting for income taxes. And so on.

These are some of the major changes in financial reporting already accomplished by the Accounting Principles Board. But much more needs be done.

The merger movement has raised serious questions regarding the accounting for business combinations. The problem arises simply because the cost of an acquired company differs from the amount of its net assets on its own accounting basis. But what to do with that difference is among accounting's most complex and controversial problems.

In most acquisitions the buyer has to pay more for a company than the historical cost of the company's assets. This excess cost may represent a variety of things -- plant and equipment and other tangible assets which are worth more than the seller's recorded costs; trademarks, processes and franchises which are carried by the seller at little or no cost; and an unidentified intangible which, for want of a better name, is called goodwill. One might think that costs of an acquired business would in some manner be applied against future revenues before arriving at net income. But today's accounting methods permit some of these costs to elude income determination altogether.

Present accounting permits the recording of an acquisition as a purchase, a pooling of interests, or a combination of the two. Pooling of interests accounting may be used only when a merger is made through the issuance of voting stock. On the other hand, purchase accounting must be used when a company is acquired for cash, debt or non-voting stock and may be used when a company is acquired for voting stock.

In purchase accounting the acquired company's identifiable assets should be stated at current fair values, not at the values carried on the books of the acquired company. However, often the amounts on the acquired company's books are simply carried over. The excess of the purchase price of the acquired company over the stated amount of its net assets is designated as goodwill, which may or may not be amortized against future income. In most instances, goodwill has not been amortized, because a charge against income is likely to be avoided if such avoidance is permissible under generally accepted accounting principles. Goodwill amortization is especially unpopular as it is not deductible for federal income tax purposes.

In a pooling of interests, the book value of the acquired company is simply added to the book value of the buyer. The amount paid in excess of book value is not recognized as a cost. Thus, the buyer may be able to show a large increase in earnings without being required to reflect all of the costs of obtaining those earnings.

Quite clearly, the pooling-of-interests concept has encouraged the merger movement by allowing some companies to exaggerate the value of security packages offered in tenders without having to worry about accounting for the full cost of the acquisition.

Conditions today result in what might be called "non-accounting" for business combinations. Financial statements reporting this type of transaction could be misleading to the investing public. This is because the cost of an acquisition is partially suppressed by the currently permitted pooling-of-interests concept; and because the charge-off of goodwill is not now mandatory.

This is non-accounting. Quite obviously non-accounting produces higher future earnings. Some critics call this phenomemon "instant earnings."

Others, however, reserve the term "instant earnings" for other more specific ploys used in this area. For example, in a pooling it is considered proper to combine earnings of the acquired and acquiring company for all past periods. An acquirer having a low profit year can acquire a profitable company near the end of the year and report only the combined result -- instant earnings!

Or, an acquirer records the old historic cost of an asset which has a much higher value today. The asset may be land, a film library, or a marketable security. The acquirer may then sell the asset and add the difference to its income even though it paid the full fair value of the asset in the merger transaction -- instant earnings again!

There are other frailties in today's merger accounting, but this brief sketch highlights some of the major ones.

Leaders of the accounting profession are not alone in their concern over this non-accounting. Financial analysts, credit grantors, investors and government agencies have generally become alarmed. A recent article in the New York Times states:

> "The wave of business acquisitions and mergers in recent years has been furthered by loose accounting principles and practices."

And Dr. Willard F. Mueller, former chief economist of the Federal Trade Commission in a recent report to the Senate Judiciary Subcommittee on Antitrust and Monopoly Legislation concluded, among other things:

> "Accounting practices, as they have evolved in the last two decades, have granted merger-minded companies almost limitless opportunity to understate the market value of investments in acquired enterprises. The suppression of true asset values creates opportunities for acquiring companies artifically to inflate reported profits. As a result investors are misled and merger activity is encouraged. Under present accounting rules, firms expanding through merger have more leeway to manipulate asset values and reported earnings than firms growing internally."

Perhaps the most insistent demands for steps to correct the situation have come from the Securities and Exchange Commission.

Here's what former SEC Chairman Manuel Cohen said in October 1968, repeating earlier assertions of a similar nature:

> ". . .there is an urgent need for a reexamination of the basic criteria established for determining the applicability of purchase or pooling accounting in a combination. These standards have been seriously eroded over the years. This fact, along with the increased use of more complex securities, and differing methods for dealing with them, have brought distortions of the pooling concept beyond its original purpose."

Current Chairman Hamer Budge has expressed his concern over the problem and indicated that the urgency of the situation would require rule-making by the Commission, if the accounting profession did not act.

The Accounting Principles Board was responding to a public demand for action when it began developing an Opinion on business combinations and intangible assets. In February 1970, the APB after much deliberation issued, for broad public exposure, a draft Opinion on the subject.

The Board's tentative position calls for business combinations to be accounted for by either the purchase or pooling-of-interests method, but not as alternatives. Further, the draft Opinion states that the cost of all intangible assets acquired in a purchase should be recorded and should be charged against income over the estimated benefit period, but not to exceed forty years.

The new rules refine both the purchase and pooling methods, and establish criteria for obligatory use of pooling. All transactions not meeting the criteria would have to be accounted for as purchases.

Among the more important conditions set forth in the exposure draft for use of pooling-of-interests accounting are:

. . . The voting common stock interest of each combining company is at least one-third that of each of the other parties to the merger.

. . . The plan is carried out within one year and is effected by issuing voting common stock for substantially all of the voting common stock interest of another company.

. . . A combining company, other than the one issuing common stock to effect the combination, may pay only normal dividends and reacquire only a normal number of shares of common stock after the date the plan of combination is initiated.

. . . The combination agreement does not provide for (a) any future issuance of securities or other consideration on the basis of some event or other contingency, or (b) the direct or indirect retirement or reacquisition of the common stock issued to effect the combination.

> . . . The surviving combined corporation does not plan to dispose of a substantial part of the formerly separate companies within two years.

In those situations qualifying for pooling treatment, the proposed Opinion says that a merger consummated after the close of the acquirer's fiscal year may not be recorded as if completed prior to fiscal year end.

The draft Opinion further specifies that the cost basis of intangible assets, including goodwill, be amortized on a straight-line basis over the estimated benefit period of the specific asset, but not to exceed a period of forty years. A method other than straight-line may be used only when a corporation can demonstrate that another systematic method is more appropriate.

The draft Opinion outlined above has been distributed to over 50,000 persons in business, financial, academic and accounting circles. Comments received, and there should be many, will be reviewed by all members of the APB, and a final decision should be reached sometime this summer.

In recent testimony before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, Hamer H. Budge, Chairman of the Securities and Exchange Commission said, in discussing the draft Opinion:

> "If criteria such as these are adopted, the use of pooling accounting for business combinations will once again be confined to those that reflect the true pooling concept, which will be few in number."

He added that these restrictions as well as others under consideration --

"will go far toward removing ambiguity and uncertainty from financial reporting."

Critics of the Board's Opinion have accused it of attempting to curb the merger movement. Others have gone so far as to say that the APB is depriving the economy of the momentum provided by the merger trend. The only concern the APB has in the corporate merger movement is the manner in which business combinations are accounted for. The Board is neither for nor against mergers. Its objective is simply to see that when mergers and acquisitions occur, they are reported fairly to investors and the public.

Some interesting accounting problems arise as a by-product of the proposed opinion on business combinations. One of them is the method of determining a fair market value for securities in situations where no established market exists or factors make the quoted market value unrealistic. This question is not new to the accounting profession, but its importance will be increased by the new emphasis to be placed on purchase accounting for mergers and acquisitions.

Heretofore, most acquisitions made for voting securities have been treated as poolings of interests. This method makes it unnecessary to determine market value of securities issued because it recognizes only book values. Now, however, there will be many instances in which voting securities will be used to acquire another company and purchase accounting will be required. Under purchase accounting, costs are assigned to assets based on fair values.

The total cost of an acquired company is obvious if cash is the consideration paid. What happens, however, if securities are substituted for cash? Does the market value of the securities represent the cost of the acquired company?

The quoted market price of an equity security issued to effect a business combination may be used to approximate the fair value of an acquired company, if the market price, in fact, represents fair value. If, however, the reliability of the quoted market price of stock, is not a realistic yardstick for measuring true value, alternative procedures must be applied.

Some factors which could mitigate the usefulness of market value as an objective determinant of fair value of a security are: (1) issuance of large blocks of stock, (2) thin market for the security, (3) volatile market prices, and (4) use of unregistered securities.

In cases where market value as an indicator of fair value is in doubt, both the consideration received, including goodwill, and the extent of the adjustment of the quoted market price of the stock issued should be weighed to determine the fair value to be recorded. All aspects of the acquisition, including negotiations, should be studied. Estimates of the fair value of consideration received may be obtained through independent appraisals.

When disparities arise between the estimated fair values of consideration received and given, management must determine that value which is most realistic. Naturally, the CPA must satisfy himself as to the reasonableness of the conclusions reached by management.

The proposed APB Opinion on business combinations and goodwill will do much to correct the accounting abuses developed as a by-product of the merger movement. This reform will surely result in lower earnings being reported than current practice permits.

In another action, the APB has exposed for comment a proposed Opinion on changes in accounting methods.

Its main objective is to restrict changes to those situations in which it can be demonstrated that the new method will provide more useful information to the investor. There is a presumption that an accounting method, once adopted, will not be changed as long as the pertinent events or transactions continue.

The most important factor in reporting accounting changes is the need for comparability of financial statements among the periods presented. Therefore, the proposed Opinion would require that financial statements for all past periods affected by the change be restated on the new basis, with disclosure of the effect of the change on previously reported net income and earnings per share.

Under present accounting, companies may treat these changes in various ways, making comparisons of the financial data for different periods difficult.

Accounting for long term investments in common stocks is the subject of another Opinion being considered by the APB.

The equity method is now required for investments in unconsolidated domestic subsidiaries when presented in consolidated financial statements; it is frequently allowed for investments in 50%-owned companies; and it has been used in a few cases for investments in less-than-50% owned companies, particularly corporate joint ventures.

The primary question now is the applicability of the equity accounting method to unconsolidated foreign subsidiaries and to investments in common stocks when the investor company owns 50% or less of the voting stock.

Under the proposed Opinion, the equity accounting method would be extended to include unconsolidated foreign subsidiaries (unless they are operating under control or exchange restrictions), 50%-owned companies, long-term common stock investments of more than 25%, and joint venture investments of more than 10%. The implementation of this Opinion will produce more realistic and appropriate reporting in the affected areas.

The accounting profession and the Accounting Principles Board must remain responsive to business conditions. The Board's target is a moving one. A new tax, for example, or administrative changes in the regulations of old ones, or newly aroused investor interest in special industries such as banks and insurance companies -- all of these create new and different problems.

The accounting profession and its Accounting Principles Board have not remained inactive during this period of change. We have taken many steps along the road to greater comparability among financial statements through the elimination of alternative accounting principles, where such alternatives were not appropriate. The profession has risen to assume the burdens of its vital role in the continuing health of the economy.

But our economy is subject to constant and dramatic change. The appetite of investors for more and more data is insatiable; and the imagination of business leaders is unharnessed when it comes to unusual corporate structures, equity issues and opportunities for return on investment.

These changes will create new and complex challenges to accountants. I am sure that the profession will continue to demonstrate the awareness and responsiveness necessary to cope with them.

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