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Leonard M. Savoie

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by
Leonard M. Savoie
Executive Vice President
American Institute of Certified Public Accountants

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# CHALLENGES TO ACCOUNTING PRINCIPLES IN THE 1970s

The 1970s may be the dawning of the age of Aquarius for segments of our population; but for the accounting profession it is the dawning of a period of intensified problems and pressures to act more positively than it has in the past. It is the time to let the sunshine in.

This will be a decade of action. The younger generation, long disenchanted with the complacency of the older generation will begin to assume positions of leadership in all segments of our life. They will move into positions providing the power base required to implement their ideas.

I hope the 1970s will be recorded as a time when many of the unresolved problems of the 1960s will be met, challenged, and resolved. Some issues such as air and water pollution, strike at the core of life itself. Still others are fundamental to the peaceful existence of man among men -- integration and welfare, for example.

But our main concern here today is with the need for improved accounting principles and methods as a basis for more reliable and consistent financial reporting to investors and the public.

The accounting profession has earned the right to set accounting principles by giving constant and careful attention to the maintenance and elevation of its standards. But if the profession is to continue to enjoy this privilege, it will have to redouble its efforts to meet the rising expectations of a better-informed public.

The work of the Accounting Principles Board has resulted, since its inception in 1959, in considerable progress toward codifying generally accepted accounting principles and reducing unwarranted differences in accounting practice.

The challenges of the 1970s will continue to be intense. The fundamental question will be whether the APB, as now constituted, can cope with the scope of problems to be met. If not the APB, then who?

The Securities and Exchange Commission has worked as close advisor in the development of generally accepted accounting principles. The Commission, although possessing statutory power to set accounting rules, has elected to leave their enunciation to the profession. When the Commission believes the profession is working too slowly, it becomes a sharp prodder for action.

If the APB and the private sector were to fail in carrying the burden of improving financial reporting, then the public sector, through the SEC or some other government agency, such as the Federal Power Commission in its industry, could be expected to step in.

This is analogous to the need for an insurance plan to protect an investor if his broker goes bankrupt. A recent Wall Street Journal editorial said "Our own preference would be for the industry to handle the job itself, but it now has the responsibility of showing that it can and will do so. If it doesn't, the Federal government seems likely to lend a hand."

Similarly, many of us believe that the job of improving financial reporting can best be done by the accounting profession -- not just for itself or for the business community, but for our society as a whole.

The Accounting Principles Board has shown a good record of progress. But a glance at the Board's agenda reveals that much remains to be accomplished. I believe the prospect for Board progress in the 1970s will be greatly influenced by its response to current problems.

Just as there have been occasional power failures in electric transmission, there have been occasional failures in accounting to be fully responsive on a timely basis to developing problem areas. These accounting power failures have been widely publicized. In today's jargon, accounting has a high profile.

The hottest problem area today stems from the wave of mergers over the past decade. This surge in merger activity has raised serious questions regarding the accounting for business combinations. The problem exists simply because the cost of an acquired company differs from the amount of its net assets on its own accounting basis. What to do with that difference is among accounting's most complex and controversial issues.

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 excessive use of the pooling-of-interests method, and because the charge-off of goodwill is not now mandatory.

This is non-accounting. Quite obviously non-accounting produces higher future earnings and results in what many call "instant earnings."

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 this subject.

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

Of special interest to the gas and electric industries is paragraph 85 of the exposure draft, which takes note of the rate-making process. Essentially, this paragraph calls for acquired properties to be stated at amounts estimated to be recoverable under rate-making policies. But it also calls for additional costs of acquired assets, tangible and intangible, to be deferred and charged to income over future periods which may differ from the periods charged for regulatory purposes.

The new rules define 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 a purchase.

Among the more important conditions set forth in the exposure draft for use of pooling-of-interest 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.
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> . . . The plan is carried out within one year and 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 year end.

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

Since the exposure draft was issued, hundreds of letters have been received from the business community, the majority of which oppose the Board's proposed opinion. Some of them are emotionally written, perhaps representing industry's resistance to reform, even though that change may be in the best interest of the public and eventually the best interest of business itself. Comments from financial analysts, educators and practicing CPAs, on the other hand, tend to favor the proposal.

And this leads me to observe that in some respects conditions today seem to be far from the dawning of the age of Aquarius and more nearly in tune with conditions of some 500 years ago, when Machiavelli said, "there is nothing more difficult to carry out, nor more doubtful of success, nor more dangerous to handle, than to initiate a new order of things. For the reformer has enemies in all those who profit by the old order, and only lukewarm defenders in all those who would profit by the new order. . ."

The proposed opinion does have its proponents who are more than lukewarm, including Chairman Hamer H. Budge of the Securities and Exchange Commission. In recent testimony presented before the subcommittee on Antitrust and Monopoly of the Senate committee on the judiciary, the Chairman said --

> "If the criteria such as these are adopted, 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 further that "these restrictions as well as the others under consideration will go far toward removing ambiguity and uncertainty from financial reporting."

And Business Week has observed that, "In the pooling of interests squabble, the accountants are expected to prevail, despite their many critics."

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 current merger movement, however, is the manner in which business combinations are recorded. 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.

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

This proposal will restrict changes in accounting methods to those situations in which it can be demonstrated that the new method will provide more useful information to the investor. It will also require that data in financial statements for all past periods affected by the change be restated to reflect the new basis, including disclosure of the effect of the change on previously reported net income and earnings per share.

Accounting for long term investments in common stocks is the subject of still another opinion being considered by the Accounting Principles Board.

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 fifty per cent owned companies; and it has been used in a few cases for investments in less-than-fifty per cent 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 stock when the investor company owns fifty per cent or less of the voting stock.

Under this proposed opinion, the equity accounting method would be extended to include unconsolidated foreign subsidiaries (unless they are operating under control or exchange restrictions), fifty-per-cent-owned companies, long-term common stock investments of more than twenty-five per cent, and joint venture investments of more than ten per cent.

Another area of accounting that has had a power failure is the accounting and reporting to investors in public utilities. Because of the pressing nature of other significant problems, it has been necessary for the APB to postpone consideration of the differences between generally accepted accounting principles and accounting principles followed by regulated companies.

As you know, there are many areas in which required accounting for rate determination does not coincide with accounting for nonregulated companies.

In an addendum to APB Opinion 2, the Board recognized that the rate-making process creates a phenomenon peculiar to regulated companies saying, "many of the differences concern the time at which various items enter into the determination of net income in accordance with the principle of matching costs and revenues."

In the opinion of the Board, timing differences between the recognition of income and expenses for regulated companies and what would otherwise be acceptable for nonregulated companies do not constitute departures from generally accepted accounting principles. However, the Board recognized that this conclusion is appropriate only when costs will be clearly recoverable out of future revenues. If there is doubt that the costs will be recoverable because of economic conditions or other uncertainties, the Board concluded that differences in accounting treatment for regulated companies do not represent an acceptable alternative to generally accepted accounting principles.

Some of the major areas of difference which are now being considered by a committee of the APB are: deferred taxes on differences between book and tax depreciation, and differences between amounts capitalized as plant costs for book purposes and expensed for tax purposes; original plant acquisition costs and the retirement or abandonment of a facility; capitalization of construction overhead expenses; deferred expenses relating to unsuccessful research projects; interest expense incurred during construction.

The committee is now scheduling meetings to study these issues and develop a point outline. Later this year, the subject will be moved to the active agenda of the full Board. And in 1971 the Board hopes to issue and Opinion on this subject. Undoubtedly the committee developing the Opinion will be in close touch with appropriate representatives of the Edison Electric Institute, the American Gas Association, and the Federal Power Commission throughout this period.

The APB has a full agenda of items in various stages of progress, in addition to those I have just mentioned. Some of the more important are: leases, funds statements, diversified companies, accounting for investments of life insurance companies, components of business enterprises, accounting problems in the extractive industries, fundamental concepts underlying financial statements of business enterprises, and interim financial statements.

Projects in the research stage are: inventory valuation, research and development costs, accounting for depreciable assets, accounting for working capital, inter-corporate investments, and financial reporting for inter-national business activities.

This partial list of projects may sound like a continuation of the past practice of attacking individual problem areas one by one. And it is likely that this approach will be continued in the 1970s.

But there should be some differences. First, opinions will contain less detail and will lend themselves to more ready interpretation. Second, they will follow research findings more closely. Third, and I say this hopefully, these research findings will be conceptually more soundly based.

Members of the APB are aware of the criticism that opinions are overly detailed and that the details do not involve matters of principle. But the details, whether matters of principle or not, have been furnished because the profession and the public it serves have needed detailed guidance. Last year, we commenced an unofficial accounting interpretations service to help provide detailed guidance and thus relieve the Board of this chore. Further development of these interpretations should enable us to make opinions shorter, confine them to major matters, and expedite their issuance. In the 1970s, this service should be firmly established. Interpretations are now being published on a timely basis in The Journal of Accountancy. In the 1970s, we intend to issue the interpretations as part of the APB loose-leaf service, indexed to the appropriate APB opinion text.

Accounting Research Studies will be of greater help in the 1970s than they have been in the 1960s. Two problem areas being researched are of particular significance; one relating to inventory valuation and the other to accounting for depreciable assets.

Each of these subjects is receiving attention now in research studies being conducted by Hod Barden and Charles Lamden, both partners in accounting firms, with the aid of accounting educators. The timetables call for completion much sooner than the average time taken by research projects in the past. It is conceivable that both could be completed and the APB could begin development of opinions on these subjects some time in 1971.

I am optimistic that when these steps have been taken and the Board has issued its opinions, we will have solutions to some of our most vexing problems.

As to inventories, I really do not expect the Board to develop detailed rules for pricing products. But I do foresee either the elimination of LIFO as a basis of valuation or the development of criteria for distinguishing when it must be used and when it must not be used.

The work on depreciable assets should lead to criteria for determining when to use which method of depreciation. If criteria cannot be developed, the Board should state a preference as to straight-line, declining balance, sum of digits, unit of production. It is conceivable that all but one method will be eliminated.

APB research is progressing on an even broader and more basic plan. The Board is well along in development of a statement on the fundamentals of financial statements. This is progress somewhat along lines originally envisioned for the Board -- before it became embroiled in putting out fires.

We have had two research studies on what accounting postulates and principles ought to be on a conceptual, articulated basis. And we have had one research study that takes an inventory of the pronouncements that constitute generally accepted accounting principles today. But until now the Board has not spoken on fundamentals. The draft statement to which I refer will be the first pronouncement by the Board on what are presently understood to be the fundamental concepts underlying accounting and financial reporting. It will not break new ground or introduce concepts the Board thinks ought to be followed. And it will refrain from rationalizing or wishing away the inconsistencies and conflicting concepts that exist.

Even this agreement on "what is" is hard to reach. I think that the Board will issue its statement in early 1971. The significance of the statement is that it should help us take the next step and consider "what ought to be." Various ways may be found to tackle this question. One approach has already been authorized by the Board as an Accounting Research Study. This is consideration of all known bases of valuation in financial statements -- including historical cost, replacement cost, discounted future value and market value.

This research might well lead to major changes in financial reporting. I think it is conceivable that in the 1970s we will see assets carried on a basis more closely related to current value than the traditional historical-cost basis.

Even before this research commences, we can see value accounting making inroads into financial statements. Investments of mutual funds and some insurance companies are now carried at market value. The APB itself requires recognition of market values of pension fund investments as a factor in determining a corporation's accrual for pension costs.

The Institute's committee on insurance accounting has recommended that marketable securities of insurance companies be stated at market values, with unrealized appreciation or depreciation, less related tax effect, taken into income currently on a spreading basis. The Accounting Principles Board has yet to be heard from on this subject.

Meanwhile, a new and significant use of market values in financial statements has appeared. A major brokerage firm, the first to offer its own stock to the public, issued a prospectus reporting net income after including unrealized appreciation and depreciation in market values of marketable securities, less related income taxes.

The summary of earnings showed earnings per share on this basis, and went on to disclose two more per-share figures. One was the per-share increase or decrease in the fair value of other securities for which a market value could not be determined, and the other was the sum of the preceding two per-share figures. The Institute's committee on stock brokerage accounting has recommended that a broker's marketable securities be carried at market value and non-marketable securities at fair value, with changes in values, less tax effect, shown in income. This recommendation is before the APB for approval now. Sure to be of major concern is the need for objective guidelines in determining fair values for restricted securities and other investments which are not readily marketable.

Despite the obstacles, there appears to be growing sentiment and authoritative support for requiring marketable securities of all companies to be carried at market value. My personal opinion is that this one step toward value accounting is coming fast.

The 1970s should see a number of other advances in corporate financial reporting. Very likely a statement of source and application of funds will become a basic statement, with the requirement that it be covered by the auditor's report. Even now the APB is studying the form and content of the funds statement in order to develop guidelines for its preparation. This is a necessary measure before making it a basic statement.

It is also likely that a five year summary of earnings statement will supplant the two-year income statement in annual reports. Most companies now give operating results of several years, but they are not covered by the auditor's report. This situation is not likely to continue for long. The SEC has proposed that a five-year summary of earnings be included in annual reports on Form 10-K, a recommendation of the Wheat study on corporate disclosure. The accounting profession will have to work closely with the SEC in making changes like this.

Similarly the SEC has recommended the presentation of information on sales and income by product lines in annual reports on Form 10-K. The APB will have to decide soon whether and to what extent financial information like this is necessary for a fair presentation of financial statements.

Still other areas which people will be talking about in the 1970s are reporting of budgets and forecasts and human resources accounting. Security analysts are more concerned with future projections than historical results. Pressures are bound to increase for presenting profit forecasts -- with some credibility added by an opinion of a CPA. This may not come about in this decade, but it is sure to be a lively topic for discussion.

Human resources accounting has already made a bow. R. G. Barry Corporation just published its 1969 financial statements on both the conventional basis and the basis of capitalization and amortization of investments in human resources. And in a recent Forbes magazine interview, Professor Sidney Davidson of the University of Chicago put in a plug for reporting the importance of people in quantitative terms.

Turning to another area to watch in the 1970s, a major research project being conducted under Institute auspices, but not as part of the APB program, is a study of basic cost concepts and implementation criteria. This study is being conducted by a team of professors at Stanford University. Although stimulated by the Congressionally authorized General Accounting Office study of uniform cost accounting standards for defense contracts, the Institute study is broader. It will look into costs for all purposes, including financial statements. And the research methodology may point the way toward a different kind of research in the 1970s. The Stanford professors have produced a model for studying various cost concepts, which they are testing by empirical means.

Bills now before Congress call for uniform cost accounting standards for defense contract procurement to be set either by the Comptroller General of the United States or by a White House appointed standards board. Enactment of some such new machinery is expected in this session of Congress. The impact of it may well be felt in areas beyond the original intent of the legislation.

Altogether, the 1970s seem to promise some new and exciting challenges to the accounting profession. I for one look forward to the dawning of the age of Aquarius, for it is time that we let a lot of sunshine in.

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