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American Institute of Certified Public Accountants. Study Group on the Objectives of Financial Statements

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SECTION II

TRANSCRIPT OF
PROCEEDINGS

PUBLIC HEARING OF THE
ACCOUNTING OBJECTIVES STUDY GROUP.

May 15, 16, and 17, 1972
The Americana Hotel
New York, New York

TUESDAY AFTERNOON SESSION

May 16, 1972

The meeting reconvened at two o'clock, Chairman Trueblood presiding.

CHAIRMAN TRUEBLOOD: I think we're right on target, and Mr. Defliese is right on time. Phil, it's your podium.

MR. PHILIP L. DEFLIESE: Very good. Thank you very much, Bob.

I'm Philip L. Defliese, and while I'm managing partner of Lybrand, Ross Bros. & Montgomery and Chairman of the present APB, I'm here to present my personal views. My firm and I will present a formal paper at a later date, perhaps within a month. That paper will expand upon the views that I'm expressing now, so to some extent there will be considerable similarity.

I'd like to say at the outset that I don't envy this Group its chore. It's probably one of the most momentous undertakings that we could do in this half century, and as a result of the challenging aspects of it I think that the Group certainly ought to consider seriously the implications of its report. And to that extent I respectfully submit a number of procedural suggestions which I would suggest that they at least attempt to follow, in order to give consideration to those important aspects.

The time element, of course, is a very important restriction. I don't know how a subject of such far reaching

importance could be accomplished within the time limit the Group has set for itself. But because of that, it must restrict its emphasis by a considerable extent to the most pressing needs, and those which no doubt gave rise to the issue itself; and that is the needs of the public investors.

And when I speak of public investors, I include not only those who invest in equity securities but also those who invest in debt securities, because for the most part both are essentially public investors, and look to and rely upon the same data for their investment decisions. Therefore, I see no distinction whatever in terms of the information that they need.

Of course, I'm talking not only about individual investors but institutional investors, and to some extent the indirect investors such as policyholders and the like; but basically, the needs of these public investors are paramount. The needs of private creditors, such as banks and vendors are somewhat secondary. These people are usually in a contractual relationship, making it possible for them to obtain additional data and additional information upon which a decision can be made, and therefore the same statements are not as important.

Of course, government, taxing agencies, and regulatory commissions also have needs; but here again, because these are special-purpose-type needs, they can be fulfilled through additional input or perhaps through supplementary information designed for a specific purpose.

So the concentration should be on the public investor.

The Group should also spell out in its report those objectives which they consider to be long range, short range, and intermediate range, because whatever we do in the field of accounting cannot be accomplished overnight. Some of it may take a considerably long period of time, and therefore in making recommendations we need to distinguish between the short, long, and intermediate range.

Some of the problems that are involved will require a considerable amount of concentrated applied research, and only upon the completion of that research can we really determine whether or not the objectives in each of these areas are in reality desirable, and whether or not adequate techniques can be established in order to determine if they are workable.

Again, recognize the importance of moving as rapidly as possible. You should concentrate on the precise definition of the short range goals and the means of implementing, and defer any in-depth consideration of the other two. I think that more will be achieved in this way than to attempt to cover all three areas in greater detail.

And finally, after it has sifted through the material that I'm sure is presently descending rather rapidly, and contemplating it, and reaching some tentative conclusions, those tentative conclusions should be exposed for public comment and possibly public hearings. Our experience on the Accounting Principles Board indicates that until a tentative solution is proposed, it's difficult for interested parties to focus adequately on the many problems that they create. And

since the results of this report will have such far-reaching implications toward the final resolution of this problem, we would certainly want to have an opportunity to express views concerning the specific proposals that are being made.

As to the needs of the public investors--and I think this is the thing that should be concentrated on--no doubt the Study Group will carefully analyze the needs of these users, since they constitute such a large segment of our population, particularly with 32 million shareholders and the many indirect holders such as those in pension groups. But the question is: these needs have to be defined, as simply as possible, and the data categorized rather carefully, because, essentially, investors are required to regularly make timely decisions as to whether or not they will buy, sell, or hold a particular investment.

I mentioned before that I don't distinguish between a stockholder and a bondholder in this frame of reference, simply because the data upon which a decision of that sort rests is essentially the same. But, of course a decision has to be made as to whether or not an investor wants to invest in debt or equity securities. But usually that determination is based on considerations other than the financial data of the company itself. So we have to focus on the decision-making data for this purpose.

Now, of course, in the process we should also recognize that there are many other factors that are involved in making such decisions as to whether to buy, sell, or hold, and

this relates to the state of the art, the character of the industry, the movements in the economy, the competitive position of the company, the strengths and weaknesses of management and their research expertise, their relationships with labor, and their relationships with regulatory agencies. All of these have an equal and sometimes a greater weight in determining whether or not an investment should be made.

And so I would assume you will certainly put that in as a caveat.

Now looking at the data that the public investor or potential investor needs to know--he needs to know, first, what are the prospects for an adequate yield on his investment, in terms of dividend or interest, and for capital appreciation. And essentially that translates into a need for a realistic determination of periodic income--past, present, and particularly, future.

So as I see it, the need for a forecast of at least one year, and possibly several, is paramount.

The second thing he needs to know are the factors he can rely upon for the safety and return of his capital. In the bondholder situation, it's just as important that he know what the market for his bonds may be, as well as the ability of the company to pay off at maturity. Very few public investors investing in bonds actually look toward maturity for return of their capital. They are looking for the ability to move in and out of that investment, and even many of those institutions that manage substantial portfolios look upon debt

securities in somewhat the same fashion. So the return or safety of capital is not necessarily dependent upon the archaic concepts that we have of financial position, but upon market-ability.

To that extent, I think that in addition to the realistic determination of income that I mentioned, he needs to know what the liquidity-viability condition of the company may be; so some of our archaic concepts of balance sheet presentation should be remodeled to give cognizance to that.

The fund statement likewise may need some restructuring in order to portray adequately these factors.

Third, a more helpful indication is needed of the value of an investment, so that a proper choice can be made. And here, of course, is where accounting frequently leaves him very much in a vacuum--again because our balance sheets and financial statements are not structured to make any realistic portrayal of value. That means we might need to reflect current value rather than historical values in some areas, and to give recognition to intangible resources and some personnel resources.

Now, of course we have to recognize that accounting will never be able to establish the true net worth of a company. That can only be determined by the usual criteria of what a buyer will pay or a seller will take. We can only hope, I suppose, to provide more meaningful financial data as a guide.

Now I'd like to break down the three types of objectives as I see them, and discuss what might be done about them.

As the long-range objective, we should probably consider the introduction of current fair values, intangible values, and personnel values. This has been proposed many times, and we all recognize that presently it's highly impractical. What we have to do first is to determine whether or not this is theoretically possible, and then whether it can be implemented. I can't see how that can be done without a concentrated research project--lasting at least three years by a sizable, full time research group, which should be comprised of particularly unbiased people of diverse disciplines and philosophies, so as to make sure that we have all views presented.

I don't know whether you could ever get such a group as that to live together, but I don't see how we can really do the job well otherwise.

And of course it should be approached rather slowly and carefully.

Personally, I have an open mind on this. I doubt if fair values can be applied across the board, and I don't know whether they are necessarily needed for the determination of income as such. For example, I have a real question as to whether plant and equipment should be fair valued regularly, because this is not an asset that's intended to be sold or realized, but instead, to be used up in the production of income. And consequently, the need for applying current values in that instance is somewhat less.

Obviously, in other areas involving inventories and other resources that are intended to be put into production

or to be sold, fair values can have an important effect.

Now part of the study of this long range objective would be to make a closer analysis of periodic income. As I said before, this is a primary investor tool; and of course this means that we have to refine our realization concepts. We should recognize that income is comprised of a number of elements. It first arises out of the ability to provide a product or a service at a price in excess of cost. That's pretty basic; and of course here we use traditional cost accounting concepts to establish that basic profit. Of course, those concepts need some reexamination.

Second, another element of income is the effect of economic forces upon our resources, such as market fluctuations, which sometimes may be fortuitous and beyond our control, or at other times may be premeditated and controlled to a certain extent. I have in mind here particularly the marketable security problem that we are presently struggling with in accounting.

We know that when a security is ultimately sold, and a profit is made, we have a profit, and it's the difference between the cost and the selling price; but the question is: when is that income realized? Is it realized at the time of sale, or is it realized over the period over which it appreciates? Basically, that has to be established before we can really determine periodic income on any reasonable basis.

Another factor affecting income is the effect of discovery and research. One look at the oil and gas industry tells

you, of course, that income is certainly derived out of the discovery of oil, but the question is, when should that be reflected in accounting? And shouldn't our concepts of realization give some cognizance to the fact that income is being derived as the oil is discovered?

Likewise, in the research area, when a new product or a new element or a new method of something is derived as a result of considerable research, is there an income factor? Of course, that translates itself into sales of the new product, and therefore one element of income is that effort.

Finally, we have price level changes that enter into the determination of income. At the present time we give no cognizance to this, and we reflect the income at the time of sale, when in reality it may be the result of nothing more than a price level change. The question is, is that income, or isn't it?

At some point, accounting perhaps ought to be able to provide investors with an analysis of his periodic income along these lines. How much of it is attributable to price level change, and how much of it is attributable to a discovery or new research? These will take a long time to develop, and that's why I think the long study should be made in that area.

Jumping to the short range objectives, we have to recognize that until we can get the long range ones defined and implemented we have to concentrate on improving our historical cost accounting concepts so that the user's needs will be satisfied as well as they can be within the confines of this frame

of reference.

We should recognize that the alternatives that we have in accounting today grew because of differing industry practices and circumstances that frequently were borrowed by other industries. In our attempt to narrow these alternatives, we have tried--rather unsuccessfully--to find fundamental truths that can be applied across the board, and I don't think we're going to find that Holy Grail.

Instead, I think we need to concentrate on refining our realization concepts again, industry by industry, and not concern ourselves with inconsistencies that result from this. For example, it's rather foolhardy to consider that the same realization concepts should be applicable to land development companies as to a steel company, or to an oil and gas company, or an insurance company, or as to timber land. Even within these industries, we might find that circumstances are different, and therefore they need to be recognized.

I think the thing that has brought this home to the present APB more than anything else has been its current study of marketable securities, where we find that there's a difference in a company--say an industrial--that might have a temporary investment in a marketable security, or perhaps a long-range investment in a security that happens to be marketable, as against an insurance company that manages a tremendous portfolio of equity securities. And to say that the same realization concept should be applicable in each case is not to give recognition to the differing circumstances, intentions, and

mode of operation of these two different companies. Therefore the question is whether or not income realization concepts should be the same or different in that instance. I don't believe they should be the same.

In the whole process of this reassessment of realization concepts of industry by industry, we should sublimate the balance sheet to the proper determination of income. We recognize that the balance sheet does not in any way present fairly financial position today, and therefore to attempt to make it so is a futile exercise until we have assessed the long range goals that I mentioned, to determine whether or not they are feasible.

We should provide a balance sheet, and nothing more than a balance sheet, of resources and responsibilities that will provide a better appraisal of liquidity and viability. Right now our balance sheet doesn't attempt to do that very well. Our concepts concerning current assets and current liabilities are rather fuzzy.

The fund statement, of course, has attempted to put some light on this area, but that too needs some reassessment to see whether or not it will provide a better picture of liquidity and viability as to the future, because this again-- is what the investor is looking for: How will his company survive in the next few years and in the long run?

In this respect the Study Group's largest contribution can be the refinement, as I see it, of the realization of income concepts, sublimating the balance sheet in the process.

Now, the intermediate range objectives are of course those things that we might be able to do between now and the time we get to the long range, and I would think that perhaps what's needed there is to provide some mode of supplementary information to furnish the investor with additional information in making his decisions. Certainly, such things as a price-level statement, such as has been recommended by APB, would provide better perspective to the income statement, because it would at least attempt to neutralize the effect of price levels to some extent; second, perhaps the provision of some current values--management estimates, if necessary--of other resources, other liabilities, perhaps those that are particularly intended to be liquidated or to be placed into production, such as inventories of land for a land development company, and, of course, the effects of discovery and research. And in the oil and gas field we need supplementary data to provide the investor with a better concept of the resources available to the company.

Now this is not going to be an easy task, but nevertheless, such supplementary information would certainly bridge the gap between our short range and long range objectives.

And with that I hold my peace.

CHAIRMAN TRUEBLOOD: Thank you very much again, Phil, for a lucid, complete, and helpful presentation.

I'd like to start out with a question which kind of ties to some testimony we heard this morning, having to do

with the long range versus the short range versus the intermediate range.

First I'd like to say that we certainly agree--all of us, I'm sure--with everything you say about the horrendous size and frustrating nature of this task and the time table that was imposed upon us. Success may be reasonable or zero.

The statement was made this morning that objectives and goals should be rather pervasive. Let me just try an example. Financial statements should be useful for predictive purposes. Then, if you take that as an overriding goal, would you agree that the distinction between the short range, the intermediate, the long range, becomes more of an implementing process than a goal stating process

MR. DEFLIESE: I would agree with that, certainly. Assuming that we can agree on the long range objective and recognize the need to move from here to there, this will be an evolutionary process, hopefully at each step--providing the reader with more of a basis for prediction.

CHAIRMAN TRUEBLOOD: But would that not make it more possible, if we adopt that point of view, to come out with some kind of reasonable set of large, pervasive goals on realization and predictive capacity and so on, and give the profession time to work on the research and the decision-making process at the sublevel, which is really your breakdown--as I understand it--of the long range, short range, and intermediate?

MR. DEFLIESE: Well, as I indicated, obviously to

refine these long range objectives in a true sense, some long term research is going to be necessary, because the implementation aspects have to be dealt with. They are not going to be so readily obtainable. And without those you get nowhere.

And you may ultimately wind up nowhere if in the process of researching implementation it just is impractical. And so while it's fine to establish a pervasive concept of a long range goal--and assuming that for the moment it's fair value-- I don't think we can say that we're going to have to go there unless and until we have researched it adequately to know that it is a practical answer.

We've always said regularly that we would like our financial statements to more adequately portray the economic facts of life. Well, if we can get ten economists to agree on what the economic facts are, we'd be in a good position to move in that direction. But because we have set ourselves somewhat of an elusive goal, it's almost impossible to get there. Therefore there is a need for researching the goals as well as the implementation.

MR. GELLEIN: Could I just follow that up a little bit, Phil? Because I think it's pretty critical.

Do I interpret you correctly when you say, therefore, that perhaps our group cannot--or should not at this point-- even attempt to state what the long range goals are?

MR. DEFLIESE: I think you can attempt to state what you think they should be, recognizing that it is subject to research and implementation factors.

MR. GELLEIN: Well, that gets...

MR. DEFLIESE: ...I don't see how, in the time limit, you can go much beyond that.

MR. GELLEIN: You see, that gets to the point in the paper where you say, for instance, that what needs to be done first is to determine whether it's theoretically feasible and then whether it can be implemented.

MR. DEFLIESE: Right.

MR. GELLEIN: Now, it seems to me that it would be rather presumptuous to state a long range goal if it weren't theoretically feasible.

MR. DEFLIESE: Well, I grant you that there is a dilemma to that extent, but I think every research starts off with a premise.

MR. GELLEIN: It would be a hypothesis, wouldn't it?

MR. DEFLIESE: A hypothesis or a theoretical starting point. And I have no problem starting with that and then saying well, we need to research this not only from an implementation standpoint, but from a theoretical standpoint, because there are elements here that might put the theory in question. We don't know whether users would be at an advantage, or whether their ability to make investment decisions would be enhanced by this data. It might be more confusing, and to that extent it can't support a theoretical user need. You can create a theory in vacuum, perhaps, but I don't think we want to do that. I think we want to create a theory in context, and unless we can be satisfied that the contextual and the theoretical

hang together, there's no point in moving in that direction.

DEAN DAVIDSON: Well, I followed what you were saying with great interest, except that I tried to go through a translation process, both in what you were saying and--in fact--what people were saying this morning, as I got going on this. And that is, whenever you said "current value," I would substitute "historical cost" and see how that would make the statement sound.

So--for example, you said the need for current values on plant is somewhat less, and I translate that to say that the need for maintaining historical costs on plant is somewhat less.

Why don't we just expense plant as we buy it?

MR. DEFLIESE: Well, because our concepts of income require a certain matching of costs and revenue.

DEAN DAVIDSON: Ah, yes, of values expired, and revenues produced.

MR. DEFLIESE: Right.

DEAN DAVIDSON: And so I can't help but wonder, if we're seeking to measure income in this realistic sense, if we may not be better off with current values than historical costs. Let me ask you if you do not feel that it would be useful to always ask ourselves this: Whenever we say something about current value, to ask ourselves the same question about historic cost.

MR. DEFLIESE: Yes. I have no problem with that. But I think that to amplify my comment concerning plant--and this relates to other things too, such as other intangibles,

R&D, and the like; to upgrade, or to revalue upward---

DEAN DAVIDSON: ...or downward--

MR. DEFLIESE: ...or downward--those items which essentially are going to enter into the income stream on that basis--that is, they are not going to be realized at a higher value--to then insist on a higher value being entered into the income stream, thereby, perhaps, in the case of a plant that's appreciated, to reduce income--is not realistic in terms of our realization concepts of income.

Now, maybe in the process of your long-range goals you are going to change some of that, but I think until you do you can't automatically assume that current values should be applied across the board.

DEAN DAVIDSON: I would always say "or historic cost."

CHAIRMAN TRUEBLOOD: Well, I think the point was made somewhat this morning--and yesterday too, Phil--that part of our preoccupation with historic cost has to do with its convenience as a proxy for some kind of value. So if you go Sid's suggested route, I fully agree that it's interrelated with our realization concept.

But many of the things you suggested it seems to me by way of example would require some significant change of our objective with respect to realization, at least on an industry-by-industry basis.

MR. DEFLIESE: Absolutely. I think we have already done that, for example in industries like land development, where there is a realization concept quite different from, let's say, retail sales, or oil and gas, or any other industry--

the recognition of the fact that income is predicated basically on the result of an effort; even though you might inject the statistical evaluations of that effort, the fact remains that to apply any other industry concept of realization to that situation creates distorted results.

For example, if you were to apply installment accounting to that situation, we know that it would be unrealistic, in terms of what the actual efforts and results of that company may be.

CHAIRMAN TRUEBLOOD: Do you suspect that this may go so far as to have different realization standards for various industries?

MR. DEFLIESE: Precisely. That's why I feel that the realization concepts have to be reassessed industry by industry.

Certainly, we have three basic areas in the extractive industry--oil and gas, mining, and timber land. And to say that the same realization concepts should be applied to all three, within almost the same industry, is not recognizing their totally different ways of operating.

These things need to be reassessed. When is income realized in these industries? In timber, you have a growth situation. In mining, you have a combination of processing and discovery. And in oil, principally you have the discovery aspect, which is the major element, and then of course it's combined with a refining and marketing operation. So we have in that area alone reason to depart from any pervasive concept of realization.

CHAIRMAN TRUEBLOOD: But I still would personally grope for some overriding concept of realization which would be applied industry by industry, with differing practices as distinguished from differing objectives.

MR. DEFLIESE: I understand what you are saying, yes.

CHAIRMAN TRUEBLOOD: Oscar?

MR. GELLEIN: Phil, you have been on the Board for a number of years when it's gone through the resolution of some pretty difficult problems, and I frankly think--considering the circumstances--in a very satisfactory way. My tenure on the Board has been shorter, but I have seen some of these things happen, and this is what I wanted to ask about. I don't expect a specific answer, but I think any comments you would have would be helpful.

Regarding every important issue that's been up before the Board, in my judgement--the diverse views that were there were in part attributable to deep seated, honest, sincere differences of opinions on conceptual matters. You can go right straight through. I think in all the important opinions that the Board has issued, from the accounting for pension costs, to allocating income taxes, to business combinations, to good will--right through the list--there were deep seated, sincere, honest differences of opinion, all within the framework, you see, of a historical cost framework.

I don't want to ask a question. I just want to ask whether you have some observations--because I don't think there is an answer to the question, really. What would have been

helpful to the Board within the historical cost framework to have minimized some of these deep seated conceptual differences in views?

MR. DEFLIESE: Well, I agree with you, Oscar. I have lived through all of these; and as I have, I have, shall we say, developed my own philosophy, and I think I have sort of emphasized it briefly this morning. Let me emphasize it again.

I think our hangup has been our concern over the articulation between the balance sheet and the income statement, particularly by calling the balance sheet a statement of financial position, which we know it is not. Let's face it, the balance sheet originated as nothing more than a trial balance of what was left over after somebody determined what profit and loss was; and that's all it ever should be in the present context of historical cost accounting.

The result is, we have developed some rather fine-spun theories--take income tax allocation--as to whether or not the deferred tax account is a liability, or whether it's a deferred credit, or whether it's a net-of-tax approach, a reduction of the asset to which it may pertain, or whether it's equity. And, frankly, I don't care which you call it. It could be any of them or all of them. The fact is, what we are attempting to do is determine income--periodic income--properly; and to that extent we match our taxes with our accounting, and as a result of that, whatever is left goes into the balance sheet as a balancing factor.

That is why, I think whether or not the deferred tax account is a current liability or a noncurrent liability is not a big issue. If I restructure the balance sheet and eliminate that problem, I'll get to the heart of the question of whether the company has some liquidity, which right now isn't shown.

It is the same as to our debt-equity ratio, which a lot of people have made into a sacred cow. Billions of dollars today are being financed in Wall Street today on the basis of a debt-equity ratio, when we recognize that we don't include all of the true debts, such as the leasing aspects, but at the same time we don't include all the assets, like the oil and gas under the ground, which essentially is part of equity.

To create a debt-equity ratio, for example, for an oil and gas company that might be leasing to a large extent, is a real abortion of any concept that you can make from an accounting theoretical standpoint.

And so we have made a real fetish of getting this balance sheet to show assets on the left side, which really aren't assets in many cases, and liabilities on the right side which aren't in many cases liabilities, and then omitting many assets and liabilities. We need to stop concerning ourselves about this articulation between the income statement and the balance sheet. I think that's been the major hangup, rather than the question of historical cost.

We keep blaming historical cost only because we have nothing better, and of course it's an easy thing. It's a good whipping boy. But we're trying to keep our theories straight

as between the statements, because we have a feeling that the balance sheet should present financial position.

The question is, should it? And if so, how can it? And we certainly ought to reexamine the question of the balance sheet function.

CHAIRMAN TRUEBLOOD: Before I recognize Don and Reed, who want to be heard, some of the things you said in this last statement relate directly to a question from the floor which I want to recognize. In effect, it says: Is there some definition of periodic net income unrelated to value change?

And if I may go on from there to indicate that (as I understand) what you are saying is that there is on the asset side--whatever they are, in our present practice--a different series of values; in the current section, more or less the lower of cost or market; in the fixed asset section, some kind of amortized cost; and then all of those things which aren't there at all.

So we have a completely inconsistent valuation.

MR. DEFLIESE: Right.

CHAIRMAN TRUEBLOOD: So you would answer this question that periodic income can best be determined if we have a more consistent valuation scheme?

MR. DEFLIESE: Not necessarily.

CHAIRMAN TRUEBLOOD: Not necessarily?

MR. DEFLIESE: No. Absolutely not.

CHAIRMAN TRUEBLOOD: And how do you get to that conclusion?

MR. DEFLIESE: Because if I concern myself about consistency in the balance sheet, I'll never get anywhere in my income statement. I think the income statement has to be dealt with, and whatever is left--throw it into the balance sheet. Then you let the reader know what the purpose of the balance sheet is--not to present him with a picture of financial position, because it's never going to show that (at least in historical cost) but will merely show him those assets that are available to pay off debts, and the debts he has to pay off. And that gets to the viability and the liquidity of the company, which is the other thing he's looking for.

He's looking for two things--income, which is going to produce his yield, one way or another, and the viability-liquidity of the company. Is it going to stand up and live forever, or is it going to die within a year or two, on the basis of what he sees?

To me, the balance sheet should be nothing more than the repository of our income statement determinations.

CHAIRMAN TRUEBLOOD: So, then, you put your emphasis on realization and matching...

MR. DEFLIESE: Right.

CHAIRMAN TRUEBLOOD: ...as distinguished from valuation?

MR. DEFLIESE: Right.

DEAN DAVIDSON: That's what guides you in the income statement?

MR. DEFLIESE: That's what guides me.

DEAN DAVIDSON: Realization and matching.

DEAN EDWARDS: Phil, what pervasive objective might you have which would permit you to develop realization concepts industry by industry, and would permit you to keep this separation of the current financial reporting structure?

MR. DEFLIESE: I think you have to start with the mode of operation of the industry; in other words, when do they think that they have made their money? When an insurance company invests in equity securities and has billions of dollars in portfolios along this line, we have to ask: When do they think they have made their money that results from the appreciation of those securities?

It's not easy, but if they think hard and long about it, they'll come through and say: Well, we expect this to grow over a period of time, on some basis. In fact, they have all told me: We invest for a five-to seven-year pull, and it's over that period of time that we expect to make the money.

Now we all know they don't make it the day they sell the security, and the question is: When and how? That has to be determined; so you have to take each industry and decide how it applies its resources and what its intentions are, and then analyze it from a realization concept.

It's not easy, but it needs some rather deep study.

DEAN EDWARDS: We realize it's difficult, Phil. If we didn't in the beginning, we do now. But what set of objec-

tives would you establish for any one of these industries? Maybe, going back to my original question--is there any all-pervasive objective for financial accounting and reporting that would permit you to develop these industry by industry? Are you saying there is none?

MR. DEFLIESE: I say that the realism within the industry practice is the only guideline that you could set from a top theory standpoint.

MR. PARKER: I wonder if you haven't in some ways given a partial answer to Don's question. I gather from what you said that the income statement is the more important, and we sublimate the balance sheet to that. And accordingly, we start presumptively with historic cost, because historic cost does represent one thing all the time, which current cost may never do, and that is an actual cash outflow from the company.

MR. DEFLIESE: It's an absolute investment of resources, yes.

MR. PARKER: It sounded to me like what you might have been saying, then, is that the time when you begin to look to current value is when it tends to become significantly different from original cost, but most importantly when it attaches to an asset which is severable, and by golly is almost assuredly going to be severed sooner or later. This fits the marketable security in the insurance company. It fits the tree in the forest. It fits a number of these things.

MR. DEFLIESE: Yes.

MR. PARKER: You operate on the historic cost assumption, because it does represent the cash flowed out, and that's what has to get related in the income statement when the cash is flowing in from revenues.

MR. DEFLIESE: Right.

MR. PARKER: And only if and when you begin to develop some values on assets that are all but assuredly going to be sold, and revenues flow in therefore---

MR. DEFLIESE: Right. Realized by sale or production.

MR. PARKER: That's right--which significantly differs from the original cost thing.

Now, that begins--doesn't it, Don--to be some kind of a test as to when you begin to apply this?

One question beyond that would be: How do we handle these things in the income statement--the marketable security, or one of these things--that is, the change in value? It happens on the balance sheet. What do you do with it in the income statement?

MR. DEFLIESE: Well, that's the real hangup, this articulation that I mentioned before. Do you have the balance sheet reflect historical cost at all times, or fair value at all times, or something in between? And I have no problem with something in between, if in the process you get a better determination of income.

MR. PARKER: But would you segregate this, at least on the income...?

MR. DEFLIESE: Oh, I think disclosure is another question. I haven't touched upon disclosure. Certainly I think that once you move to any basis other than historical cost, you have a number of disclosure problems.

MR. GELLEIN: Phil, is it fair to say--you know, I sense this running through this, and I just wanted to know how you would react to it--that perhaps accounting ought to get geared more to the way in which decisions are made.

In other words, take leverage leases. Even take the matter of depreciation. Maybe it's, you know, a rate of return sort of approach. So maybe the sinking-fund method is the better method, because it gets geared more to the way people make decisions in business.

MR. DEFLIESE: Absolutely.

MR. GELLEIN: This seems to be running through what you are saying.

MR. DEFLIESE: Absolutely, and I'll take that one step further. You mentioned leveraged leases. Real estate in particular today--the financial statements of investment real estate companies, those that invest in apartment houses, office buildings, and the like are totally unrealistic as to what their income truly is, because they are required to use standard depreciation concepts which, coupled with high interest in early years, give distorted results, when we recognize that in many cases in the early years those buildings are appreciating rather than depreciating.

There's no real indicator of income in that instance,

and yet they are locked into an all pervasive concept of depreciation giving no cognizance to industry characteristics.

So it's for this reason that I say we have to examine the realization concepts and the approaches for each industry, and give them a more realistic portrayal of what income is for that company.

CHAIRMAN TRUEBLOOD: One more question. Dick?

DEAN CYERT: It seems to me that a good bit of what you are saying, and your whole position, really comes out of any lack of definition of what income is.

MR. DEFLIESE: Yes.

DEAN CYERT: You are really saying income is what the particular industry, through practice, happens to say...

MR. DEFLIESE: Well, that's putting a loose interpretation on it. I think it's what we say an industry should reflect as income. Let's put it that way.

DEAN DAVIDSON: Yes, but what guides us in saying that?

DEAN CYERT: You see, this is the thing that I'm searching for. It seems to me that what we should be looking for is an over all definition, and then try to apply that in the particular case of the industry.

MR. DEFLIESE: Well, I think we have an over all definition in the matching of costs and revenues. I think we start with that as a basic premise.

DEAN CYERT: I'm not sure that gives you a definition of income.

MR. DEFLIESE: Income is the result of what you spend versus what you receive--that's income. We're never really going to determine periodic income on a realistic basis until a company liquidates. Until then, anything else is nothing more than an estimate. And so, as long as we're estimating, let's estimate as pragmatically as we can, and not concern ourselves about the conflicting theories that we frequently have. That really results through the articulation problem with the balance sheet.

CHAIRMAN TRUEBLOOD: We have one seriously written, formal input which would cure all of our problems, Phil. It says: Forget quarterly statements. Annual statements are impossible. Pick a cycle of fifteen to twenty years, and you don't have any accounting problem.

MR. DEFLIESE: Well, I think that the example of Lloyd's of London is a good case. To say that the one year cycle is a good one for the measurement of income is really unrealistic. They operate on a three year cycle, and that makes more sense.

CHAIRMAN TRUEBLOOD: Well, helpful as this may be, I think we must move on. Thank you very much, Phil.

MR. DEFLIESE: Thank you.

CHAIRMAN TRUEBLOOD: Accept our gratefulness for your extended service on the Board and your considerable accomplishments. Thank you.

The American Valuation Consultants next. Will you introduce yourselves, please?

MR. DONALD R. BRINKMAN: Certainly, Mr. Trueblood.

I'm Don Brinkman, President of American Valuation Consultants, and joining me today is Lawrence Gooch. Larry is our Manager of Valuation Services, and of course one of our more in-depth inputters to the materials we have available today.

Our purpose here, basically, is not to discuss or debate the pros--and cons, of course--of using current values, or not using current values, versus those of historical costs. We're here only to present at least an approach that is used currently in the valuation business to measuring current values if that becomes a need or something that the accounting profession feels that it can use.

In reviewing the presentations that have been scheduled for these hearings, it was interesting to note that of the twenty four presentations, we reviewed seventeen written papers and found that they broke down somewhat as follows: Six presenters said there was a definite need for current value information. Four, including ourselves, requested further research into this area. Four requested the status quo. And three said "No comment."

That means that out of seventeen, at least ten are suggesting that something be done in this area. We fall into that category of asking for further research.

Here I reiterate our purpose. It's just simply to ask that research be considered before any venture be made into

this area, since it obviously gets to be a very complex question.

In terms of our definition, we like to think of current values in terms of what might be synonymous with a market value; but let's try and bring it down to more specifics. In trying to value things, we think of valuing, let's say, fixed assets in terms of a market value--or, let's say, a current value. So we are not really concerning ourselves immediately with liabilities, current assets, et cetera.

And, of course, in these hearings it's been said many times that this whole valuation question surrounds the question of time; that is, the reporting time period, and also the time period or life of the assets being questioned. If we take a closer look at this in terms of coming up with current value measurements, we find that current values within an enterprise constitute three different types of measurement, which obviously operate over a time continuum.

The first of these is: If I am under a time pressure to dispose of something, I have to consider current value in terms of forced liquidation, or the current period of time. Second, I think of something in terms of orderly disposal, I can consider it in terms of a time continuum, and of course the value will change as that time frame changes. And third, of course no assets within an enterprise can exceed the value of the entire enterprise. So that puts a maximum on in terms of the measurement question, when it comes to current value mea-

surement.

In the valuation business, for years there have been procedures developing--probably most heavily in the last three to four decades--that start putting a measurement technique together based on three approaches to value. These values can basically be summarized as what we consider replacement cost less depreciation, discounted cash flow, and market comparables. You have all heard these terms before. I'd like to define them briefly.

Replacement cost less depreciation means to figure out what it would take to replace the asset, and then consider depreciation from all causes, whether they be economic, obsolescence factors, et cetera.

In terms of discounted cash flow, Mr. Sprouse and Mr. Moonitz put it very well in earlier years when they said that the value of an asset is the future economic benefits to be derived, or what you might say the present worth of the future economic benefits to be derived that can be measured.

That really gives us the impetus for measuring, based on discounted cash flow.

In the market comparable area, of course, we're just talking about simply that--trades in the open market.

Individual assets, of course, can be valued on these bases, using one--or all three of them, hopefully--depending on the type of data that's available, and depending on the techniques or the numbers available, to derive the answers.

But in any case as we have briefly said, the assets themselves cannot exceed the total value of the enterprise. Therefore, in order to make true measurements, we really have to take into consideration what the value of the entire enterprise is at that point in time.

If we expand the three techniques of valuation, we can simply say that the replacement cost less depreciation technique becomes, in effect, the current value of underlying assets measured by the previous technique. The discounted cash flow technique is the discounted cash flow technique applied to the entire enterprise. And the market comparable technique can be derived from financial information on the open markets, the securities market, and sales of similar companies in an open economic environment.

Then, and only then, can we really support the underlying asset values, if we are going to measure them based on current values; but before we do that, a critical question arises. In measuring the value of the enterprise, we have to consider risk factors, because unless we can quantify the risk analysis, we are going to find that our measurements are going to be very volatile.

We can measure that risk by breaking it down into its finer components. Basically, we talk about the three components being the risk-free, which is synonymous with government securities; the business risk rate, which is really the risk of being in a given business; and the financial risk, which is the risk of having a given financial structure.

Then we can apply that risk analysis to come up with the value of the enterprise, to check the current value measurements of the underlying assets within the enterprise. I might point out that these techniques are currently being utilized quite widely. They are quite accepted in terms of generating what we call market values and current values for, let's say, tax purposes. In terms of purchase accounting, sometimes they are being used in coming up with current values of assets.

If they are being used now, why couldn't they be further refined and researched, and possibly the accounting profession if they wanted to employ them could use them?

Along with that, though, we find that there are also other uses of this information once it becomes available; and a dichotomy exists now, in the sense that management is measuring its investments on one basis and reporting on another basis. It's measuring whether or not it should invest in a new business or a new plant, based upon the return it's going to get from that investment; and yet, in looking back on its old investment, it says: What is the current investment that I've got? So the numbers are generated to try to generate a current value, and then investment analysis is generally made on that base. Yet the balance sheet does not reflect this, and the reports, as we know, do not reflect this type of information.

Another area of usage, if these numbers were employed, would be in the taxation area. We're all aware of what municipi-

palties and other governments do in terms of ad valorem taxation. Most of these laws have a myriad of interwoven problems because of the question of value, and most of them are based, or should be based, on what is considered fair value, current value, market value; but all generally should have the same definitions.

So here we see that there are three major uses of this type of information, if it were generally available.

We here again reiterate that this information, because of the current situation, needs further research and further refinement, and we have heard everyone speaking relative to long-range and short-range goals, in terms of putting together the requirements and the needs for accounting. And we would say that, in terms of doing the research, in this area at least, steps should be taken to determine implementation. We all are aware that specific price indices exist for given types of assets that can be employed in generating replacement values, but further research is required to define these more specifically and to simulate their effects, to try to put them together.

In the building cost area there are available in this country many data banks already on computer to generate current replacement values of buildings based upon detailed labor and material rates, and this information requires further research into its potential use.

The third key area in terms of an implementation step for research is that in common property items. Of course,

if you begin looking through the myriads of types of assets that industries are now using, you will see that there are common assets among all industry, there are noncommon assets among all industry, but there needs to be a further refinement relative to where the significant cost items are, and the number of frequencies of their usage, et cetera. Once that information were available, we could have the market data comparable information available for measuring current values on that basis.

Of course, I'm not an accountant. I'm really an aeronautical engineer. In designing a new aircraft system, we find that designers simulate the effects of what's going to happen when that design is completed. They will input their basic parameters to a computer, build a model of that aircraft, and then make variations--or, you might say, a sensitivity analysis--to see whether the plane is going to crash or not, in terms of putting that system together.

So we say here that this same thing is possible, using these tools in terms of the research area, to answer a lot of questions which have been asked of the witnesses so far in these hearings, to find out whether or not these things are feasible and what their effect would be. There would be no reason why, for instance, a given company or a given industry could not be put onto a computer model, and that information could be modeled and simulated and sensitivity checked to see: what if this happens? what if that happens? And it should be able to be determined what these effects are before imple-

mentation is proceeded with.

You never fly an airplane until you have checked all these things to make sure it's not going to fly apart while you are in the air in it, and I think the same thing applies here with the accounting business.

In summary, what we are saying is that current value-measurement techniques are available. They are being widely used nowadays; and as such, we feel that further research is required into this area. Of course, one of the key areas of research would be, simply, economic feasibility. Maybe it's not economically feasible to ask a company to be making these measurements, but why not test that and determine what the economics of it are?

The second area, of course, is in determining objectivity and whether or not these quantifications are available to a degree that we can objectively measure them, so the accounting profession would be able to audit them in terms of completing their audit function.

Those are, basically, the conclusion of our remarks; we have submitted our formal paper dealing with all these areas in more specific detail for further reference.

MR. GELLEIN: Thank you, Mr. Brinkman. This is the sort of input this Group needs--among others you know--and we appreciate very much your well prepared and organized paper.

Let me start the questioning with this approach. Among the overall objectives that have been stated for finan-

cial statements, the one of verifiability--meaning that two experts independently take the same data with an understanding of purpose and come up with somewhat similar numbers...let's take replacement cost new, less depreciation, as a measure of a current value. What would be your observation about the range of values that might be developed by two experts in your field with the same data, the same purpose, independently?

MR. BRINKMAN: Well, it's been my experience, in terms of actually using that kind of data, that if they are using the same sets of data in terms of replacement cost new, less depreciation, if they are using the same mathematical or arithmetic formula, that they generally will come out with the same answer, unless somebody has changed the numbers or changed the formulas.

MR. GELLEIN: But doesn't the market value feature enter into the depreciation, as you view it?

MR. BRINKMAN: Yes. In fact, I was just going to allude to that part of it, and the other part of it is in terms of what we consider economic obsolescence. That is where the variability arises in the differences of opinion.

If you took three experts in a given area of valuation and asked them basically the same question, they generally are within a range of five to ten percent on that answer. If you then said, well is it possible to further quantify this information?--you will find that it is, when we take into account the other techniques of valuation. If we use three approaches to valuation, if one of them is way out in left

field somewhere, we know we have done something wrong in that technique, and we go back and recheck it thoroughly to be certain.

Once the three approaches are brought together, obviously the answers should reconcile and be similar or the same.

MR. GELLEIN: Do you find great variations in your experience in this regard, depending upon the type of property involved?

MR. BRINKMAN: Well, there has been a lot of research done in this area. The Group that's currently looking at the question of variability is the Appraisal Institute--which is concerned basically with real estate appraisal; and they have over the years been taking every court case where they have appeared as witnesses, and trying to put together a compendium of the types of variability that arise. And whenever there is a variation of, I guess, more than 10%, they have to reconcile those differences out of court, to determine whether or not they used the same techniques, and invariably they have been finding a very nice incidence of these things being in error in cases where they are off. Consequently, they have been trying to pull these together. This is the best research I know in this area of trying to reconcile this variability, because it does exist. There is variation, obviously.

MR. GELLEIN: Would there be anything in the way of, let's say, written papers and studies that you might make available to this Group that would help us--for the record,

at least--in terms of the variability factor, that would not be in the general literature?

MR. BRINKMAN: Only what the Appraisal Institute is doing. I don't know of any other studies that have been done in this area. And that would be a matter of collecting all their information that they would have available.

MR. PARKER: You made a point that management uses the techniques that you described when they are contemplating a purchase, but isn't it true that when they do that, they make the valuation for the purpose of that purchase and add that purchase to the existing business?

Accordingly, you have to consider any synergistic things that can come out of the purchase. They don't go through this kind of study to work on the on-going results of their own business.

And if that be so, then what would be the utility of these procedures in working with a business not contemplating purchase?

MR. LAWRENCE GOOCH: Well, first of all, management currently uses this information on an on-going basis because they need to get insurance coverage, so they have to have insurance appraisals.

MR. PARKER: Well, they make that for the purpose of the insurance appraisal, though, not for the purpose of making that a value of the business for any other purpose, do they?

MR. GOOCH: Well, your point is well taken. There

is a difference in let's say, fair market value. One company may have greater value in buying it than another company because of profit protection, for instance.

MR. PARKER: Or because they have some cash that they could use some place, or a plant they could use some place--all of which is unique to that particular valuation of that new company versus this existing company.

MR. GOOCH: Well, this is true. Primarily, what we are talking about is fixed asset valuation, and not so much valuation of the entire enterprise.

MR. PARKER: Is that what all of your comments were devoted to--fixed asset valuation?

MR. GOOCH: Primarily fixed asset, although, as we mentioned, to value fixed assets you have to look at the value of the enterprise as a whole, because obviously some one is not going to make an investment in fixed assets unless they get a return commensurate with their investment. So you have to look at the total enterprise value to be able to prudently value fixed assets.

MR. PARKER: How do you get to this total enterprise value? I thought you were talking about using the same techniques to get that.

MR. GOOCH: The main thing is that fair market value means that there would be many buyers, or many sellers, at this value; and this is the criterion that you have to use. If there is only one buyer that would buy it at this value, then

that doesn't constitute fair market value.

MR. PARKER: Well, let's get to another part of this. You said that these techniques were applicable for valuing the whole enterprise--this market comparable technique, which sounds very interesting. For publicly traded companies, of course, each one has one already established in the market. Do you suggest that the proper valuation for, let's say, the Ford Motor Company is based on extrapolation from the stock market price of General Motors?

General Motors sells twice as many cars, and General Motors sells for a total market value of thus-and-so-much. Therefore, Ford should be worth half that amount. But, of course, that isn't true, because Ford happens to make much less money per car than does General Motors, and Ford's aggregate market value is actually much less than one-half that of General Motors.

But that market price is already there. The market comparables are right in front of people. So how would this market comparable technique in valuing the whole company for publicly owned enterprises advance our process here of accounting and financial statements?

MR. GOOCH: Well, first of all, there are really two components to consider that would go into a market comparable approach; and we did talk about financial risk and business risk.

Now, obviously the business risk of General Motors

is less than that of Ford, because of the fact that they are a larger corporation--more secure.

MR. PARKER: Why would that necessarily be so? In some cases, the second company in the industry is the more profitable one, and the more secure.

MR. GOOCH: Well, these are the factors in each case that would have to be considered. In other words, there are certain parameters that would go into business risk--financial size, operating margins, items of this nature that would change the business risk factor.

Now, as you say, there may be companies that are...

MR. PARKER: But these are already reported in the financial statements--the size of their revenues and their operating margins.

MR. GOOCH: Well, as far as doing the market comparable, you are correct, but they are not put together in terms in which the user is going to need them.

MR. PARKER: Well, the user is quite interested in the stock price, because that's exactly what he's going to buy or sell.

MR. GOOCH: Okay. I agree with you. How does this affect our situation here?

In other words, what we are trying to say is that we can come up, using various valuation techniques, with current or market values for fixed assets.

MR. PARKER: Now we're back to just the fixed assets

part.

MR. GOOCH: Well, as I say, we have to look at the value of the enterprise to be able to determine the value of the fixed assets, because you can't say that the value of the fixed assets exceeds the value of the enterprise. That wouldn't make sense.

MR. PARKER: I guess my question is: How is it that you've prepared to develop the value of the total enterprise, in a way that's different from what's being done already?

MR. GOOCH: Well, I think, realistically, we're not going to be able to come up with a market comparable approach for an enterprise, and probably not for a number of specific other types of assets. For example, is it feasible to value land by having a massive data bank, and just plugging in? The answer to that question may be no.

MR. PARKER: Well, then, you say that the market-comparable technique, then, is out for valuing the total enterprise?

MR. GOOCH: Probably, because there are too many subjective factors that would enter in; but what we're talking about is the fact that for many types of assets, like buildings and machinery and equipment, this would be feasible.

DEAN CYERT: "This" being what? The market comparable approach?

MR. GOOCH: The market comparable approach. Now, as I say, the market comparable approach is only one approach to value, because there is current replacement cost less de-

preciation as another, and also an income approach.

MR. PARKER: Current replacement cost less depreciation sounds to me very much like just fixed assets.

MR. GOOCH: Yes. That's what we're primarily directing our presentation toward, the fixed asset side.

MR. BRINKMAN: Reed, I might also comment there. You could apply this across the board, and you could actually do it even in terms of management, or a research group--what it would take to replace that group--the training-development costs, the recoupment costs, and everything else, if you wanted to apply it. We're just saying that these theories and these techniques have to be refined, to even eventually use them in some of these other areas.

We have seen this done in some purchase acquisitions where the company would actually value things on that basis.

MR. PARKER: Do you have any idea to suggest as to what the relevance of that would be, though, to the figures we're talking about here?

MR. BRINKMAN: Well, in terms of coming up with current values, we're just talking about the means of measurement. We are saying here--and we have prefaced in this manner--that if you want to use current values, the means of measurement are available, but even they need more research.

MR. PARKER: But you have nothing to suggest as to whether they would or would not be relevant?

MR. BRINKMAN: No.

MR. WESTON: This may sound like more of the same,

but on pages 38 and 39 of your paper you display a series of formulas which start with enterprise valuation, and as I understand them, deduct the present value of the cash flow of various items--receivables and cash and inventory--and then you get down to the area that we have been concerned with for a couple of days, the fixed assets, or the land and buildings, machinery and equipment, and you deduct the present value of the cash flow of those.

Now, I have two questions, I guess: How do you determine the cash flow of particular machinery or equipment, or a building? And if you then go to replacement cost, as you have just alluded, do you replace the service utility of the item, or do you price level the purchase cost, based on price changes?

I guess the first part is, I don't understand on page 38 how you determine the present value of the cash flow of a building, apart from the other assets.

MR. BRINKMAN: Basically, Mr. Weston, what we're doing here is, we're imputing that; and that is to say that if you look at any given building or piece of land or equipment, it can be leased and you could generate from that an imputed lease cash flow. Basically, we would be applying that same technique here to look at these kinds of assets.

Within an enterprise, though, we would find that we could impute this as, hopefully, a group, for a given type of company; and these are some of the areas requiring some further research in developing a mathematical model for pulling

these together and seeing how these variabilities would work, if we made certain fluctuations or sensitivity analyses in this area.

MR. PARKER: Well, to help on Frank's question, how would you impute the lease value of U. S. Steel's complex of steel mills?

MR. BRINKMAN: That's a good question. I don't know.

MR. GELLEIN: Is it an incremental approach, basically, or...?

MR. BRINKMAN: What we are, in effect, doing in this set of equations on page 38 is, we are presupposing we can generate an imputed lease flow, and then go through the present worth analysis for the present worth of the future discounted cash flow, plus a residual at the end, to come up with the current value.

Now, we really don't even know how these things interrelate, until you put this on a computer and start modeling these effects and figuring out what's going to happen when you start making these variations. This is an area which requires further research, and that's why it appeared at one of the last pages of our paper.

MR. GELLEIN: If I could go back to a point that Reed made, the thing that's kind of concerning us a little bit--and I'm not asking for an answer to it, but an observation--is that if current value becomes a determinant of income,

but if in turn income is a determinant of the current value-- having to look to the value of the business as a whole then we're in sort of a vicious circle.

MR. BRINKMAN: That's right. Yes, that's why what we say is that if we look at it on the basis of applying three approaches in every case, in once case you are looking at history, which is replacement cost, and which you would be generating from past history; in another case you would be looking at a discounted cash flow, which is future information; and in the third case it's market comparability, which is what's happening today. And you do all three of them--past, present and future--in that analysis.

MR. GELLEIN: (Temporarily assuming the chair) Are there any other questions from members of the panel? (There were none.)

Thank you very much for a very fine presentation.

MR. BRINKMAN: We appreciate the time of you gentlemen.

CHAIRMAN TRUEBLOOD: All right, Arthur Young & Company. We'll let Mr. Gillette go right ahead.

MR. CHARLES G. GILLETTE: Well, Mr. Trueblood and gentlemen of the Group, you are in possession of our written statement, and we won't take time to repeat it or summarize it today. Rather, we would like to comment on a few points on which there seemed to be conflict of views among those who have made written submissions.

Some of the papers you have received, generally those which are considered conservative, have emphasized the stewardship of management and management's fiduciary duty to its stockholders. There is an implication in this view that financial reporting should not concern itself with prospective investors, stockholders or creditors, as distinguished from present stockholders. By contrast, our explicit view is that financial reporting should be responsive without discrimination to both present stockholders and future stockholders, as well as to present and future creditors.

We think a realistic view of today's corporate life, with a billion shares of stock changing hands every year and public offerings being ground out by the hundred, must recognize that management constantly has its eye on the marketplace, populated by the prospective investor, and whatever anyone may say about how it should be, financial reporting is, in fact, directed to that audience.

That being so, financial reporting should serve that audience well rather than poorly. Management has a public responsibility to the investing public as well as a fiduciary responsibility to its shareholders.

This leads us to the different question of public-interest reporting. Public interest, as that term is being used in the 1970's, means something very different from the interest of the investing public. There is a widespread concern about the impact of large corporations upon those with whom they do not do business, concern about the impact of those corporations

upon air, water, elections, and many other things. Those who pursue these subjects naturally want all the tools they can get, and the Study Group is importuned with proposals either to broaden the scope of financial reporting to deal with such matters, or otherwise to apply the skills of the accounting profession.

We would like to note that there is a major distinction between broadening the scope of financial reporting to encompass such matters and applying the skills of accountants to those matters outside the context of financial reporting. We reject the idea of including such matters within financial reporting, first because it is a distraction from the primary objective of financial statements, as we see it, and second, because we do not believe that financial statements have been demonstrated to be the appropriate vehicle for reporting on such matters.

The profitability of a company and its impact upon our environment are both fruits of the corporate activities, but they are fruits no more alike than apples and bananas, and each should be handled differently, just as apples and bananas are.

As to whether the skills of accountants should be applied to measuring and reporting on such matters outside the financial statements, we doubt that there is a single general answer. Some of the questions involved may be matters that we accountants could handle skillfully, and some of them certainly are not. Our profession should not be hesitant to

tackle new problems, but neither should we be flattered into the belief that we are the world's leading experts in all types of measurement and reporting.

It is interesting to note that those critics who are quickest to question our motivations, or our morals, at the same time express the most unqualified, blind faith in our great skill. Apparently, we, the accountants, are capable of anything, in both the favorable sense of that phrase and the derogatory sense.

Another issue which seems to cause some division, or at least some confusion, is the matter of comparability; that is, the question of whether comparability should be an objective of accounting. There are those who call for uniform rules of accounting in order to establish comparability, and on the other hand, there are those who say a shipyard is so different from a grocery chain that the two cannot be compared, and therefore that comparability is a false goal.

We believe that the truth lies between these two positions. It is true that a shipyard and a grocery store are different in many ways, and comparisons are difficult; but it is also true that they have certain attributes in common. They both require capital. They both strive for profit. And they both compete in the marketplace for the investor's dollar.

The investment community decides if and under what terms it will invest in one or the other, and this necessarily means that they are compared. Thus it is a proper and necessary objective of accounting to minimize the difficulties of

this comparison, insofar as possible.

To this end, the accounting concepts applied to one should be compatible with the concepts applied to the other. In spite of the fact that net income is an imprecise concept, it should be an objective of accounting to make net income mean the same thing for a shipyard as it does for a grocery chain, insofar as that is possible. The result will of course be imprecise, but it will be better than if we don't try.

We therefore reject the idea that accounting principles should be developed independently, industry by industry, without conceptual consistency.

Now I would like to talk briefly about the merits of using replacement value in lieu of historical cost. You heard a few minutes ago both the hopes for and the limitations on the appraisal techniques of the appraisal industry. Other advocates of replacement value have suggested that replacement value can be provided, and can provide more relevant data, avoiding the uncertainties of the appraisal process by determining replacement values through the application of price indices. This may be true with respect to certain types of capital goods, such as trucks, buildings and freight cars. We submit, however, that price indices are totally useless for determining the current value of many other categories of long-term assets, which in the aggregate represent a major portion of the nation's capital resources.

Examples of assets whose current values cannot be determined by price indices include the following short but

important list: natural resources in the ground, Series 360 computers, goodwill, a 14-story midtown hotel, patents, Disneyland, East or West, franchises, a transcontinental railroad track, land anywhere, a DC-8, or deferred R&D. For assets such as these, replacement cost, determined by index numbers, does nothing for the investor.

In addition, there is a class of assets for which price indices, however precise, are irrelevant, because the financial significance of those assets is determined by specific sales contracts rather than by the open marketplace. This class of assets consists of all the work in process, including building construction in process, which is being performed pursuant to sales contracts. If a construction contractor has a half-completed dam being built at a fixed price, it is totally irrelevant to his financial reporting whether an index of dam construction costs is up 20% since he incurred his costs, or whether the index is flat. His profit will be measured by the difference between his expenditures and his price, and not by somebody else's expenditures at a different time and place.

As indicated in our written presentation, we do not advocate attempting to state a company's assets at current values, whether by appraisal, by the application of price indices, or otherwise; but we do advocate the use of indices to adjust past expenditures, in order to express them in terms of current dollars. In other words, we believe that a set of financial statements should be expressed through a single, uniform unit of measure, the current dollar. This means that

in the presence of inflationary conditions, such as have prevailed in this country, it is desirable to adjust historical dollar amounts to express them in terms of today's less valuable dollars. This, of course, is not current value accounting; it is simply historical cost accounting measured by today's money.

There have been some discussions, both private and public, on whether the presentations to the Study Group are conservative. Those who are radical deplore the presentations which are conservative. The presentation to you by Mr. Henry Hill, of Price, Waterhouse & Co., opens with the words: "This is a conservative paper."

We are pleased to associate ourselves with the conservative view. Our paper is also a conservative paper, though perhaps a little less so than Mr. Hill's.

Conservatism, as we are using the word, means preserving those values which have developed over time. In this sense, the Sierra Club is conservative, and so is Arthur Young & Company. We believe that the transaction based, investor oriented accounting practices that have evolved in the English-speaking world are as valuable to the nation as our giant redwood trees, and we hope that you gentlemen will not chop them down to make way for an experimental farm.

And now we are available for questions.

CHAIRMAN TRUEBLOOD: Very well done, Charlie. And thank you very much.

And lest I forget, let me compliment you on your

beautifully and very lucidly done monograph.

MR. GILLETTE: Thank you, sir.

CHAIRMAN TRUEBLOOD: Excellent reading.

I was interested particularly in a statement you made which relates back to some of the other things that were said earlier this afternoon and, I believe, this morning. I did properly understand that you are saying that there may well be different requirements, in the sense of practice or procedure, industry by industry, but you are looking for a consistent, conceptual umbrella. Is that the way you put it?

MR. GILLETTE: The latter part is the way I put it, and I have no quarrel with the first part.

CHAIRMAN TRUEBLOOD: Now, one further question. Are you ready, Reed? Go ahead.

MR. PARKER: On the adjustment for changes in the value of money, how would you do this on the income statement? Would you just adjust net earnings, net per share, and dividends per share, or how would that work?

MR. ERNEST HICKS: What we envision here is what I call a full adjustment procedure. It's been described in a number of contexts. It was described generally in one of the research studies.

I think we're not talking about just a one item kind of adjustment, but a process of adjusting all the costs in a set of financial statements for changes in the price level, which process would produce profit-and-loss numbers that are different from those that now appear.

MR. PARKER: Would every single item be adjusted by the same amount? That is, a change in the Consumer Price Index--apply that from top to bottom?

MR. HICKS: Yes. It's difficult to look into your mind, or you look into mine, and see what one envisions, but I think generally the answer would be yes.

MR. PARKER: You would find some measure of change in the value of money, and it might be the Consumer Price Index, or it might be---

MR. HICKS: That's right.

MR. PARKER: ...and whatever it is, it's applied from top to bottom.

MR. HICKS: That's right.

MR. GILLETTE: Well, I'm not sure we are talking about the same thing. Depreciation would not be adjusted by the same factor as last month's sales, because depreciation would be adjusted by the change in the value of the dollar between the date the costs were incurred and the date they are being amortized.

MR. PARKER: So this would result in a different net income figure than would simply result from taking all past ten years' net income and adjusting them?

MR. GILLETTE: Absolutely. If it didn't have that result, we probably wouldn't bother to advocate it.

MR. PARKER: What figure would you use for the price adjustment of the dividends that were actually paid?

MR. HICKS: Well, it would depend on how recently

they were paid, and what change there has been in the index since the date of payment. In the current year, the adjustment of dividends would be minimal. On the other hand, dividends that were paid out a number of years ago, if I remember the mathematics of the process--and I haven't thought about it for a long time---

MR. GILLETTE: Ernie, wouldn't the APB Statement on this subject...

MR. HICKS: Well, that's right. I didn't refer to the Statement. I referred to the research study, but I overlooked the Statement. The Statement also deals with this explicitly.

MR. PARKER: Well, as a financial analyst I was just thinking of my treasured tool of payout ratio. If I am now going to get a set of figures that adjusts the dividends that have actually been paid in the past, by one set of figures, and the earnings that were originally reported in the year they were reported, and against which you measured the dividend payout once upon a time, by a different set of factors, what do I have?

CHAIRMAN TRUEBLOOD: Well, I think, Reed, whether you buy it or whether you don't buy it, they are suggesting essentially the techniques fully described in ARS No. 6. They might have their own adjustments, but in effect it would be a pervasive change.

MR. PARKER: The dividends and earnings would be adjusted by exactly the same amount?

CHAIRMAN TRUEBLOOD: No, that doesn't follow. We're talking about...

MR. PARKER: Yes. Well, this, then, begins to present some real problems for the investor, I would think. How does he use this historic record for looking into the future, if you have been adjusting every piece of the income statement by a different percentage?

MR. GILLETTE: I'm not completely clear on my technology on this, but I think that your ratios in a prior year's income probably would not be changed, but if it were something that last year was also on this method--assuming that this method had been in existence over a period of time--the ratios you determined from the income statement of 1965 would remain the same.

MR. PARKER: Pretax margin and...?

MR. GILLETTE: But all of the figures in that 1965 statement would be different than if unadjusted historical cost accounting had been applied.

MR. PARKER: I guess the last question I'd have is: I wonder, if the basic purpose is to help the investor understand what the process of inflation has been doing, why it wouldn't suffice simply to adjust, say, the earnings per share and the dividends per share figures themselves, and let it go at that? Because otherwise you are restating things the way they didn't happen in the first place, and if there is any variation up and down the line, you would be affecting the

ratio calculations.

CHAIRMAN TRUEBLOOD: Reed, I think it's much simpler than that. I think you are trying to get around to a common dollar approach which would not affect his ratio analysis. Is that not correct, Charlie?

MR. GILLETTE: It wouldn't keep changing it year by year with respect to any given year. It would change it as distinguished from not using a common dollar figure.

MR. GELLEIN: Just one last comment. Wouldn't it help, Reed, just simply to say that everything would be stated in terms of a current common dollar? Everything.

MR. PARKER: Well, if so, then why not just restate the last two figures.

I gathered there was some part of the statement that said pretty soon you might find that you didn't need to report the historic dollar figures any more--the original ones.

DEAN EDWARDS: In your Item 4, Mr. Gillette, in your statement there's a reference there to the utilization of current, or economic values; that these would be preferable, were there a practical way of measuring them. Although you go on and elaborate further in your document, would you visualize this as being an objective, subject to measurement processes, that would accommodate your criticism?

MR. GILLETTE: No, we do not, because we think that the basic difficulties in determining current values are so overriding that we are unable to visualize the development of technology which would change this.

We are willing to concede the possibility that our vision of the future is not perfect and complete, and some day it might happen, but we don't regard it as a realistic and practical goal for which to strive.

DEAN EDWARDS: I think you said "foreseeable future"; so your timing is, in the life of the redwood tree you don't see it as a foreseeable obstacle to be overcome.

MR. GILLETTE: Well, I understand the redwood trees are in a lot of trouble; but subject to that, yes.

DEAN EDWARDS: One other question that you referred to--including forecasts or excluding them from financial statements. Would you like to comment? I think that was under your Item 6. Should forecasts be a part of the basic financial statements?

Would you visualize the basic financial statements remaining as they are, as a part of the objectives of accounting and financial reporting, or would you visualize them changing? Do you visualize this accomplishing the objectives within these constraints?

MR. HICKS: Well, we don't envision changing the structure to the point of saying that the basic financial statements would not be the balance sheet, the income statement, the changes in financial position, and a forecast. We think the financial statements ought to continue to be the first three, plus--in some cases--a couple that I didn't mention, and we think that in some cases it would also be useful to present a forecast; but we think this is a different process

than reporting on the past, and partly for that reason and partly because we don't believe that in every case it would be useful to present a forecast, we don't believe that the forecast should become one of the basic financial statements.

CHAIRMAN TRUEBLOOD: This gives me a chance to bring up a question which I had to pass over this morning, because it didn't quite fit the conversation then.

The question that came from the floor was: When we do talk loosely about forecasts--and we have talked somewhat loosely in these meetings about forecasts--are we really talking about earnings per share, sales, or net income, or are we contemplating, even though it's not a part of the basic set--which terminology I think I understand--a rather detailed breakdown of revenues, costs, expenses, and so on?

MR. HICKS: Well, for one thing, I think it would vary from case to case, depending on what is practical to present. As we point out in the paper, for some companies what would amount to a full forecast profit-and-loss statement could usefully be prepared; and the question of whether it's useful or not depends upon how reliable it can be. Other companies could perhaps reliably predict sales, but wouldn't be able to predict other factors.

So we don't have in mind any single format, such as earnings per share or net income, or a complete statement. And yet it would just seem to me that if a relatively complete statement could be prepared, this would be the more useful format, for perhaps the same reason that a full income state-

ment is--in the minds of all of us, I guess--better than a single figure of earnings per share.

DEAN DAVIDSON: Well, I applaud your conservative stance and your reference to the redwoods and your unwillingness to depart from the time honored historical cost and completed transactions approach, even though there have been some difficulties in recent years.

It reminds me of a session that I attended at Oxford College a few years back where there was some discussion about the financial plight of the University. Someone had given them a fairly large gift, at least for those days, back in the 1600's, and it had been invested in agricultural land in the north of England. This had not been producing very much income for them, and there was a fairly general berating of the man who had made this decision, until finally someone rose to his defense and said: But isn't it true that the last 300 years have been unusual?

Now, it seems to me that aside from what's time honored and been acceptable, I'm made uneasy by your statement, and maybe I'm quoting you out of context here, but your statement where you say: "Even if we accepted the current value goal, however, we would think it inappropriate to pursue that goal piecemeal." That is, whether we ought not to be substituting current values wherever we can get reliable estimations of these amounts, even though we do do it in a piecemeal fashion.

In a way, it almost seemed to me that that phrase was inconsistent with what appeared on the page before; and so I would really ask, if we get demonstrated dissatisfaction--perhaps not 300 years of it, but some reasonable period--whether we ought not to seek piecemeal substitutions of current value.

MR. GILLETTE: Well, we certainly have no objection to partial solutions to problems. Our objections to a piecemeal approach in this particular context relate primarily to the difficulties of separating the values of individual assets from the enterprise value. We think in many cases there is very little meaning to going through an elaborate ritual to restate depreciation on a plant whose real significance to the investor is that it is an integrated part of a business process.

The unattainable goal that we think would be very helpful to the investor would be to tell him exactly the value of that process, but we are not satisfied that he is helped by tagging appraisals on bits and pieces of that process. The appraisal experts that talked to you just a little while ago talked about relating the value of components of an enterprise to the whole, and said that the values of the components must not exceed the whole--and that's a valid test they are proposing--but I don't think they told you how to apply that test when some of the components of the value of the enterprise as a whole aren't on the balance sheet. I just don't visualize how you go about saying that this asset now has a

value of X dollars more than its cost, but we don't know how that relates to the total value of the enterprise, because I think that relationship is essential to the validity of the original statement.

DEAN DAVIDSON: I'm not sure I follow all of that, Charlie.

MR. GILLETTE: I'm not sure I could repeat it.

DEAN DAVIDSON: I'm not sure I'd ask you to.

DEAN CYERT: I think we should reverse the process. You give an answer now, and see if he can give a question.

DEAN DAVIDSON: But I do not understand your uneasiness where we can get reasonably satisfactory reproduction costs, current value numbers to substitute for the historic cost numbers.

To take an easy example, take the case, say, of a trucking company, which does have some trucks which have an unmistakable market value in a period of relatively rapid price change that might occur. It would seem to me you would be much better off in analyzing that firm if you had the current values of the trucks, rather than the historic costs, and those current values could be substantiated by reference market figures.

MR. GILLETTE: If the company was a trucking contractor, I will agree with you. If the company was a franchised interstate trucking company, I would not agree. And I suggest that 90-some percent of U. S. industry is in this situation, more like the franchised interstate company than the company that enters into short term contracts to lease

heavy equipment.

So I think there could be--and are--cases where replacement cost is enough more significant that it should be used. I suggest that that is such a tiny segment of industry that making it a general practice to use that data would cause more confusion than enlightenment.

MR. GELLEIN: I think I was most intrigued in your paper, which I thought was very well written too,...

MR. GILLETTE: Thank you.

MR. GELLEIN: ...by part of your point No. 2 where you really make the point, and I really think it gives us food for thought--maybe it needs considerable elaboration, this whole question of whether the changing nature of distributions by corporations from dividends to financing that comes from ploughing back earnings--whether, in terms of objectives of accounting, that causes a change, or a shift in the emphasis away from what you call the classical measures--book value, dividends, earnings.

Now, you conclude that this manifests itself in heightened interest for forecasts, presumably on the ground that, well, they are going to look more to appreciation than to dividends; I take this to be the analysis. And therefore the ploughing back of the earnings, and therefore the forecast of the earnings, becomes much more important in connection with appreciation versus dividends.

I don't know whether you want to elaborate on it now, but I would think this would be worthy of some elaboration at

some point in time.

MR. HICKS: Well, Charlie may have a comment. I would like to add only to what you said--and I think I agree with it--that the emphasis this gives is certainly to the question of forecasts, as we discussed it a few minutes ago, but it also runs to the predicative value of the financial statements. And that's perhaps the same thing, and perhaps a little different.

Do you want to add to that?

MR. GILLETTE: No, I don't think I'd add to that. I agree with what you said.

MR. REINHART: I'd like to know if you could perhaps give us some specific instances of where your proposed method of using these present values, however they are constituted, would have affected the allocation of resources in the United States, or would have resulted in lower cost products to the consumer.

MR. GILLETTE: I don't understand the question.

MR. REINHART: Well, the purpose of change is usually to do something better. We presumably are changing the accounting in order to determine a better allocation of resources to various and sundry businesses, who are then going to supply, presumably, product to the consumer. So what I was curious about was, by making these changes you are describing, where is an instance where they would have affected that basic situation?--which is, I think, what we are driving toward, is it not?

MR. GILLETTE: Well, I think Mr. Defliese mentioned a little earlier a category of companies where this would be applicable. I think that you would get very different results on companies with long term real estate holdings if you took inflation into account, as we suggest, and most particularly where those real estate holdings are leveraged.

Our present accounting doesn't reveal the benefits of leverage until disposition. It reveals only the cost of leverage. And that would continue to be true, but it would be mitigated.

MR. REINHART: Is it principally, however, in a very limited area, though, that you are talking about?

MR. GILLETTE: No, I think we're talking about effects of a greater or less degree.

CHAIRMAN TRUEBLOOD: I think Howie answered that statement in terms of the other side of the coin this morning. He indicated that they did an extensive price level adjustment in his company; and I believe you said that no internal decision would have been changed.

MR. WAGNER: ...would have been made otherwise, in a different fashion, because of the price level changes that we have structured into our statements.

CHAIRMAN TRUEBLOOD: One more question, Dick, if you still have one.

DEAN CYERT: I was interested in your statement here that financial statements must, to the extent practicable, be responsive to the equity security investor's interests. And

you had three things listed here. No. 2 was in evaluating risk factors which may affect future earnings; and I didn't see--perhaps I missed it in the statement--any elaboration of that.

I was interested in knowing how far you would go in the report in evaluating or giving information that would help the prospective investor evaluate risk factors. Would you compute variances, or beta factors, or what would you do?

MR. HICKS: Well--I don't mean this to be flip, although it may sound flip--I think we'd tend to leave that to the Standards Board.

But thinking in terms of some things that might accomplish this objective, the simple matter, for instance, of concentration of either sales or purchases in a single customer or supplier is a risk factor. I don't think of any others just offhand. Perhaps Charlie does; but it's that kind of thing.

DEAN CYERT: Would you want to say something about some measure of the volatility of earnings over time, or earnings in particular divisions?

MR. HICKS: Reasonably so. I think the line of business information falls into this category. There may be some blurring of lines here between the first and the second one in this tabulation, but I think, for instance, line of business information falls probably into the second category.

DEAN CYERT: Well, if we are going to set that as an objective, we would need to spell out some guidelines there, wouldn't we? Or else, we are again just in something where it

depends on particular judgment.

MR. HICKS: Well, that's a very interesting question, as to the extent of detail to which the Group would decide that it wants to go in making its recommendations.

CHAIRMAN TRUEBLOOD: I'm not sure it's quite cricket, but Frank wants to speak to his partners. And then we will close this discussion.

MR. WESTON: Back to the question of the trucking industry which Sid raised--it was suggested to us this morning that the reporting by that industry, for example, in total, in terms of financial reporting and allocation of resources, would be much more useful to investors, and would result in a better allocation of resources if the entire industry were reporting on a replacement cost basis. Would you have any views on that? That is, wouldn't it be more useful to have the whole industry on a sound replacement cost reporting method?

MR. GILLETTE: Are you an expert on the trucking industry?

MR. HICKS: No, I'm not.

MR. GILLETTE: I'm not either, but...

CHAIRMAN TRUEBLOOD: You'll have to defer to Sid.

MR. GILLETTE: I don't know the data that was submitted to you this morning when I wasn't here in support of that proposition, but it would seem to me that franchises are so important in a major segment of the trucking industry, and the lives of its fixed assets are so relatively short, that accounting on a replacement cost basis would have a relatively small

effect as compared to the factors that really make or break a trucking company. But I have to again disclaim an in-depth knowledge of that industry.

MR. WESTON: Well, it's not particularly the industry. The franchises also would presumably be on a replacement cost basis; the idea being that any industry using replacement cost does report a more realistic, and therefore more comparable, and therefore more useful financial presentation than one using historic cost.

MR. HICKS: The industry doesn't matter basically.

MR. GILLETTE: When you talk about franchises, our views on reporting replacement cost--which has to be, I guess, the equivalent of market value--gets us back into the area we were talking about earlier, where fair value or replacement cost is so difficult of determination that we would question the reliability, and therefore the utility of the results.

And there again, I don't know whether there is an open market on truck franchises or not, but I didn't think there was. Is there?

CHAIRMAN TRUEBLOOD: Thank you very much.

We're going to do a bit of rescheduling because of problems we have tomorrow afternoon, and we're going to call now on Mr. Koons of Shell Oil. We will then proceed to the National Investor Relations Institute, which means that we're apt to run over a bit, and we may have to cut our questioning a little, but we would like to make this scheduling change if it's convenient with Mr. Koons.

I know you have been here since yesterday morning, so you know the procedure.

MR. ROBERT L. KOONS: That's quite all right.

Mr. Trueblood, members of the Accounting Objectives Study Group: I'm appearing here today on behalf of Shell Oil Company, with which I have been associated for twenty five years. During this time I have had numerous financial assignments which in total represent practical working experience in essentially every aspect of the business.

I'm presently a consultant accountant to the Company. I am a CPA, have been for twenty years, and am a member of many professional organizations, including the American Institute of Certified Public Accountants.

These prepared remarks have the explicit concurrence and approval of Shell's executive management, and therefore are to be considered as my Company's recommendations to this Study Group.

By way of background, Shell Oil Company is an integrated oil enterprise which has operated primarily in the United States for over fifty years. Last year our sales and total assets of \$4.6 billion each rank us in size among the top industrial firms. We have over 33,000 shareholders, and our stock is listed on the New York Stock Exchange and other exchanges in the United States and Canada.

With this brief background on Shell Oil I turn now to the subject of this hearing. First, I wish to discuss the objective of general purpose financial statements and, second,

the broader area of financial accounting.

We and other responsible parties believe that the objective of general purpose financial statements is to report to investors on the use of funds invested in the enterprise. In our opinion, this objective of financial statements is immutable, and, although some may argue that new developments may call for modification of standards or of the items to be disclosed, the main purpose will remain the same. I question the wisdom of any drastic changes.

Today there seems to be an increasing tendency to place a disproportionate interest on ills and problems rather than achievement and progress. The daily fare of the news media is far more concerned with violence, disorder and those who have violated laws or a sense of fair play than it is with the common, daily accomplishments of the vast majority of society. Similarly, attention is disproportionately focused upon business ills rather than achievements. One aspect of this is a view that financial reports are woefully inadequate and that a crash program is necessary to reorient the objectives. We reject this view and question the need of changing the objective of financial statements, for it seems that in practice the present objective has worked very well indeed.

There is always the possibility of abuse or intent to mislead. This does not mean that the system is wrong but merely that the standards are not properly applied. I do not believe there is an extension of Gresham's Law whereby bad accounting drives out good accounting. There are in fact very

significant safeguards for preventing abuse. First among these is management's legal responsibility to present financial statements fairly. Second, the integrity of the independent accountants' audit and opinion is a most positive safeguard. In the rare cases where these fail, punitive action should be taken.

The importance of public confidence in financial statements must not be underrated. It is earned by integrity, consistent action, comparable treatment and a record of behavior that merits faith. Therefore, in considering something as significant as a reordering of objectives, it is vital to consider what any basic change would do to confidence. If the situation were out of control or operating very poorly, then a change in objectives might be in order. Such is not the case. A high degree of confidence in financial statements does exist. To give an example from our own recent experience, we believe that the facility with which we have successfully raised over \$1 billion by debt and equity offerings in the last decade was made possible by the widespread confidence investors have in our financial statements. I am sure many others have experienced the same effectiveness of the capital markets. The confidence upon which the system works is basic to our free enterprise economy. Because a significant change in the objectives of financial statements, or in the basis of accounting, has the potential for irreparable harm to investor confidence, it must be approached with extreme care.

Accounting Principles Board Statement No. 4 states, "The responsibility for the reliability of an enterprise's financial statements rests with its management. This responsibility is discharged by applying generally accepted accounting principles that are appropriate to the enterprise's circumstances, by maintaining effective systems of accounts and internal control, and by preparing adequate financial statements." We agree with this principle. We cannot envision management abdicating responsibility for its reports or standing by and letting a third party assume this responsibility, particularly in light of the accompanying obligation and potential liabilities.

Since management is ultimately responsible for reporting on its stewardship, it must have an important voice in establishing accounting standards. There are ample legal precedents to support this opinion. A great amount of assistance is required from the public accountant both in the setting of standards and, more importantly, in ascertaining that they are correctly applied. However, we feel that those responsible for financial reports should participate in the standard setting process at least equally with the public accountants who express an opinion thereon and with the investors who use the reports. In many respects management is in a unique position to exercise a role of leadership in considering new standards because of its knowledge of the business and the accounting system. Management has an even greater contribution to make in setting the standards because

the financial statements should reflect the judgments and the decisions that management has made. While Shell results to date have not been materially affected by Opinions of the present Accounting Principles Board, we have been active in the accounting profession's endeavors to establish acceptable accounting standards. Assuming the Accounting Principles Study Group recommendations are accepted, there presumably will be an opportunity for even greater management participation in the standard setting process. We expect to contribute because we believe, as managers, we have something essential to offer, and because in the final analysis the system will not run very well if we who are responsible for making it work do not have a strong voice in the design. It is through this process of research and collective participation that further positive improvement of basic financial statements can be made.

I turn now from responsibility for general purpose financial statements to the standards followed in their preparation. The more significant accounting standards are historical cost, realization, conservatism, and consistency with prior reporting periods. We believe any statement on objectives should include an unequivocal affirmation of these standards. They provide the most reliable criteria for meeting the seven qualitative objectives of relevance, understandability, verifiability, neutrality, timeliness, comparability and completeness. While it is difficult to judge specific standards in such abstract terms, the present stan-

dards have these qualities in greater measure than any alternative. Assuredly, historical cost is more understandable, verifiable, neutral, and timely than, say, a present value or price level adjusted basis. Some specialist users of financial statements may find these other bases relevant for some purposes, but I do not believe the primary report users find profit based upon historical cost irrelevant. Because the present conventions are rooted in recording actual transactions, they do not involve the subjectivity of other bases. While there are minor conflicts between qualitative objectives, it seems highly desirable that we retain the objectivity of historical cost as a benchmark.

There have been a number of proposals to adopt present value rather than historical cost as the basis for financial statements. I believe this is impractical. Who should be the judge of value? Different users have a different time preference for money and different degrees of aversion to risk. Any serious attempt to rigorously and systematically obtain the present value of the many varied assets of a major corporation would involve a significant delay and cost incommensurate with the subjective results. While I have doubts whether a present value basis of accounting will work in any industry, I know that in the petroleum industry it presents insurmountable problems. With respect to undeveloped properties and unmined reserves, opinions as to the difference between the highest two bids can run into the millions of dollars. With the passage of time the property may ultimately prove to be worthless or it may be worth many times

the initial outlay. The exploration and the development period could take a decade and require further significant capital outlays. The determination of value is hardly easier after initial development is completed. Additional capital will be required for secondary recovery. Determination of reserves is an inexact science. Aside from incomplete geological knowledge, ultimate recovery is affected by future technology, price and governmental policy. Even if unmined reserves could be accurately determined, value is highly influenced by both rate of production and price. These are affected by general economic conditions, competitive action, and governmental controls or restraints. It is understandable that investors might desire to know the future in these respects. However, any attempt to furnish an estimate of the value of unmined reserves would not meet a single one of the seven qualitative criteria. Any attempt to ascertain short run changes in value of a petroleum company's assets would be irrelevant and misleading.

Once accounting departs from actual transactions and attempts to measure all changes of value, there are essentially no constraints upon the subjective nature of reports. In addition, the accountants' attestation role appears quite difficult. As noted earlier, investor confidence cannot be earned without disciplines and controls. The reservations as to a value basis for accounting have been well documented in accounting literature.

Any significant change in accounting standards would create most serious problems and the distortion of many relationships and contractual arrangements based upon present standards. Indenture restrictions, debt-equity ratios, union contracts, and bonus or incentive formulas could all be significantly affected. These long standing arrangements were not arrived at capriciously

without regard to the present accounting standards being used. For example, a different standard might produce a result that would either eliminate or double what would otherwise be the permissible amount of an incentive bonus. Because of the contractual arrangement undoubtedly presumed consistent application of the existing accounting standard, a change would produce an unjust reduction or a potential windfall. In other words, changes in accounting standards can materially affect the substance of contractual arrangements. The possibility of producing multiple financial statements in order to adhere to both the present and a new standard would only create confusion and loss of confidence. In addition, the cost of presenting multiple statements is a clear burden on investors and consumers interested in efficiency and cost reduction.

Up to this point my comments have been limited to general purpose financial statements and have been based on the following broad principles which we recommend to this Committee:

1. General purpose statements are reports to investors of funds invested.
2. It is management's responsibility to prepare these reports.
3. Exercise of this responsibility requires management to use accounting standards compatible with the way management reaches business decisions.

4. The independent accountant's responsibility should be clearly defined in order that objectivity and independence are maintained.

5. Investor confidence in general purpose statements is vital to our free enterprise economy. That confidence could be irreparably damaged by a radical new basis of accounting, and, finally, the conventional standards of historical cost, realization, consistency, and conservatism are so widely used and proven that they could not be discarded without confusion resulting.

This Committee is also concerned with financial reporting, which of course is a far broader area than general purpose financial statements. In Shell Oil we receive many requests for information of a financial nature. Our financial officers, and indeed all senior management, are involved in the broad area of financial reporting. While many desires for data have little, if anything, to do with financial statements, they are legitimate requests for information. When it is reasonable to do so, the data are supplied outside the financial statements. If request cannot be reasonably met, valid reasons for not meeting them are normally given.

Because the nature of requests is changing quite rapidly, it is not possible to state as an objective precisely what should be supplied. It seems obvious that some desires are short lived, and new ones constantly arise. If this Committee feels it incumbent on them to deal with this area at all, we suggest that the objective should be to meet

all reasonable requests for financial information outside the general purpose financial statements. Such disclosure might include price level adjustments and other objective data that a reasonably prudent investor could utilize in making his evaluations.

There have been various proposals that financial statements should include forecasts or predictions of future results. We oppose this view. We believe that investors are better served if they are provided past results and information on firm decisions that affect the future, so that each can form his own judgment as to how the future may unfold. The obvious objection to presenting either a specific or a generalized forecast is that the forecast is subject to being proven wrong, to the detriment of the reader who may have relied upon it. By way of illustration, oil industry profits are quite sensitive to price, and gasoline prices are subject to frequent wide fluctuations. Last year we sold over 9 billion gallons of gasoline. A change of one cent per gallon in the price amounts to \$90 million. After taxes that one penny a gallon in price amounts to about 20% of net income. I am sure you as a motorist are aware that prices fluctuate more than a penny a gallon. Would you care to forecast net income? As an auditor, can an opinion on a forecast be unqualified? The addition of premises, strategies and a basis for a forecast might place it in a better perspective. However, premature publicity and disclosure could be detrimental to investors because competitor action would virtually guarantee specific plans could not be carried out.

Aside from the practical problems inherent in forecasting, there is a potential liability that could arise if an investor is injured because he accepted a forecast to his detriment that had been proven to be in error. Accordingly, it should not be an objective of financial accounting to publish either a specific or a generalized profit forecast. Each investor is placed on an even basis when he is given factual information and left to form his own judgment as to the future. Factual information might include, in addition to general purpose financial statements, an approved capital expenditure budget, order backlogs, news of firm decision to build a major new facility, or a major new contract.

A recurrent theme has been that financial statements should be in tune with the way business operates and reaches major decisions. In that connection, income from operations is one of the most useful performance indicators that can be easily disclosed, but is not now generally given sufficient prominence in financial statements. In general terms, income from operations means gross revenue minus all costs except property provisions or depreciation and deferred taxes. In theory, interest, expensed research, and expensed exploration costs might also be added back or, if you will, not deducted along with the operating costs. Income from operations is widely used internally for project evaluation in discounted rate of return or present value computations. Because shareholders and creditors should likewise find this indicator of performance or investment worth useful, it could be given greater prominence

in financial reports by setting it out in the income statement and in per share data.

Gentlemen, I thank you for your patience and consideration and the opportunity to appear. The basic message I wish to convey is that management is responsible for accounting to investors for its stewardship. Exercise of this important responsibility requires consistent application of factual financial accounting. The present basis has been proven to be capable of working very well. The remedy for prevention of abuse is management acceptance of its responsibility, disclosure, and competent independent audit. Additionally, we favor research and review directed towards continuing the evolutionary improvement of financial statements. Both the marketplace and the courts will punish those few who abuse their trust or perform carelessly. It is desirable to codify or reaffirm objectives. Such process does not encompass any major reordering of objectives, as such a radical step could impair investor confidence. To the extent that the financial reporting process can be improved within this framework, we offer our knowledge and experience. This is important because we in management believe we have a vital stake in establishing sound accounting principles.

CHAIRMAN TRUEBLOOD: Thank you very much, Mr. Koons. We have heard directly from only two representatives of industry-- Mr. Walter yesterday, who represents an industry that might be regarded as somewhat evolving in terms of accounting concepts. Yours is a unique industry, but not a new or evolving one.

MR. KOONS: We feel on the firing line.

CHAIRMAN TRUEBLOOD: I have a question which I think particularly relates to your situation, in the sense that we must consistently consider cost-benefit ratios; that is, we must be very concerned about additional data if it requires additional cost.

But one of the questions I have about your presentation is that it seems to me that all the data you are saying should not be disclosed must be available internally, so I do not understand the additional cost.

MR. KOONS: Which data are you talking about?

CHAIRMAN TRUEBLOOD: The data on reserves.

MR. KOONS: Well, we disclose our data on reserves and the percent to which it's developed, so I still don't understand.

CHAIRMAN TRUEBLOOD: But not in dollars.

MR. KOONS: Well, I deny that we have that data internally, that we use it for anything, or that it has any relevance.

CHAIRMAN TRUEBLOOD: If we have inventory on hand, and it is widgets, there is a way of pricing it, and we do price it in a manufacturing concern. Now, what is the vast difference?

MR. KOONS: Well, I recited in my prepared text the problem in estimating the quantity of unmined reserves, the very long gestation period, the difficulty in estimating the volume. Even more important than the volume is the price.

These reserves may last many years. We're producing oil fields now that were discovered back in 1920.

What is relevant is: What is what we are producing today worth? But that ties in with realization.

CHAIRMAN TRUEBLOOD: Well am I hung up on the question of precision or parameters of approximation? As you know, I fully admit that there can be nothing precise about this kind of valuation, but in broad parameters, or reasonable approximations, is it not possible to state known reserves in terms of approximate dollar values?

MR. KOONS: Mr. Trueblood, I have spent quite a number of years working in this area. I have testified before the Federal Power Commission. I'm quite knowledgeable. Let me just give you an example. This goes back to studies over twenty years.

First, the estimate of unmined reserves on a new field ultimately turns out to be roughly nine times the initial estimate. That's just in terms of the sheer physical volume.

Second, it takes quite a long period of time to produce. The decline pattern--the value depends on when you get it; and obviously something received tomorrow is worth more than something received in twenty years.

The rate of production is influenced by the geological conditions, politics--both international and national, and the price. Oil was worth 10¢ a barrel when some of these were discovered. Maybe we won't see that again, but price is a two-way

street, and we aren't always climbing uphill.

CHAIRMAN TRUEBLOOD: I understand...

MR. KOONS: I can go on.

CHAIRMAN TRUEBLOOD: ...not completely, but I think maybe Reed can help clarify the problem here.

MR. PARKER: I had some other questions, Bob, but I think that on your point the time factor, it seems to me, is one of the most important, because this oil sits down there. Suppose there are ten barrels down at the bottom of the hole, but just one way or another, by practicality, one barrel is available this year, one next year, one the next year. And you can state its present value, but there's no way that the company can ever sell all of it at one time, and when it does sell it, it sells what it can sell at the prices it can sell it for, with the costs of distribution that then exist.

MR. KOONS: There's one other important point on this, Mr. Trueblood. I think the industry averages are that something on the order of 20 or 25% of the oil that is found is ultimately produced. What is produced is a function of the price.

Now, if because of demand, the international situation, the military situation, or what have you, the price were to be 10¢ or a dollar a barrel more, most assuredly we could produce much more. So when you say the volume, I must ask, the volume at what price? And if the market is willing to pay a higher price, more could be forthcoming.

MR. PARKER: At what price and what cost levels?

You can't have one change without the other changing.

MR. KOONS: That is correct. I mean, a real increase in price. But when do you abandon a well? You abandon it when the cost of lifting it exceeds what you can get for it today. If you could get another 25¢, you might postpone the abandonment for another year.

DEAN DAVIDSON: But doesn't the investor have to go through these calculations too, in deciding whether he wants to buy Shell? And would not he be helped by yours? Admittedly, your estimates are imperfect, but would they be worse than those arrived at by someone who doesn't know as much about it?

MR. KOONS: I think the investors are all placed on an even basis when they are all provided the volume of reserves, to the extent that they are developed, what our plans are for expenditure, or development--all of which we disclose. But these I would put in the realm of factual, solid, hard, transaction type data.

I think when you get down to value, each investor is going to have his own judgment or feel for value; and he should make that judgment, not the management--and least of all, its auditor.

MR. PARKER: You mentioned earlier in your comments that you don't really believe in a Gresham's Law for accounting. And I think rather than talking about good accounting or bad accounting, usually when people talk about the idea of Gresham's Law of accounting, it's accounting that realizes

income sooner rather than later; and it seems to me we have an awful lot of evidence that suggests that there is such a law.

If we take depreciation accounting, the shift in reporting to stockholders from accelerated to straight line; if we take the idea of interest charged to construction, it used to be used only in the utility industry, and now moves to other industries; if we take the installment method of reporting for installment sales type of things, and shift over to recognizing all the profit at the time the sale takes place; if we take shifts from LIFO to FIFO inventory accounting; if we take shifts from chargeoffs of research and development to capitalizing; if we take the investment tax credit--on every single one of these there have been numbers and numbers of shifts in accounting policy by companies from one to the other, almost invariably from the one that realizes the income later to the one that records it sooner.

Some of these have been stopped by the Accounting Principles Board Opinions, but unless and until the Opinion comes along, this phenomenon seems to take place predominantly in the same direction, and I think that's what most people are thinking about when they state a Gresham's Law of accounting.

Would you really disagree that such a thing exists?

MR. KOONS: Well, I presume first, that you are innocent until proven guilty; but let me say this--that Shell Oil Company has not made any changes in accounting whatsoever, and as stated in our audited and certified financial statements--

MR. PARKER: Well, I gathered your opinion applied to all industry and not just to Shell.

MR. KOONS: Well, by the same token, I gather when you say people use these--maybe you didn't use the word "gimmicks", but changes, or shifts, or adjustments--that you were applying that to all; and I'm saying it doesn't apply to all, and I think we're not the only company who takes very seriously their responsibility to consistently and fairly report their results.

MR. PARKER: Well, I don't question that.

MR. KOONS: Okay. Well, I think the only point is, if the bad drove out the good, why have we not changed? Or why have not many other companies? It is not us alone.

MR. PARKER: Another question--you rather suggest that forecasting, or public forecasting by the company--and particularly, in this case, for Shell--is difficult because of the sizable changes that take place in gasoline prices at the pump. I don't have a perfect memory on this, but how many times over the past twenty years, let's say, has Shell Oil's net earnings changed by as much as 10% in a given year, and how many times over the past twenty years has there been a decline rather than an increase?

MR. KOONS: Well, in two out of the last three years there has been a decline of over 10%.

MR. PARKER: How many times over twenty years?

MR. KOONS: Well, the figures are stated in our annual report, but I would say--just to venture a guess--at

least half. I know they were either up or down over 10% in probably eight out of the last ten years.

MR. WESTON: One more brief point on reserves. I guess we all appreciate the difficulty of estimating them, but isn't it true that the American Petroleum Institute definition, which I believe the industry uses, of proven reserves for depletion computations encompasses those reserves which are economically producible under today's conditions, so that each company presumably makes an economic computation to determine the depletion base for its accounting?

Why shouldn't that be made a part of the public record in terms of the valuation of those reserves?

MR. KOONS: Well, you don't need the valuation of the reserves to make a depletion computation, and we do make the physical volume a part of the public record.

MR. WESTON: No, but you do make an economic computation which shows lifting costs and sales prices, to determine the reserves which can be economically produced.

MR. KOONS: No, we do not.

MR. WESTON: Well, that's my understanding of the definition--you must make a computation of those reserves which can be economically produced. That is the definition of proven reserves, and all companies--as I understand it--make that computation, because if you can't produce them economically, they are not part of the depletion computation.

Therefore I wonder why that information at least, which as I understand it--is computed by most companies,

shouldn't be made a part of the record in terms of the valuation of reserves which can economically be produced.

MR. KOONS: You say "economically produced." The amount of reserves that we are going to produce is anything for which the cost will not exceed the current selling price.

MR. WESTON: That's right.

MR. KOONS: Now, if these reserves are going to be produced a way down the road, you get involved in when they are going to be produced, and then you get the question of discounting.

MR. WESTON: That's right.

MR. KOONS: But you don't have to compute the dollar value of the reserves.

MR. WESTON: But I understand you do, to make this computation. You get the dollar value by computing the lifting cost and the sales price, present valued, in order to determine what reserves are economically producible for depletion purposes.

This is from the API literature describing how depletion is computed, and it's my understanding all the companies follow this. My question then is, why should not that element of value at least be disclosed?

MR. KOONS: Because we do not, and I do not believe that any other companies make such a computation.

MR. WESTON: Then we should change the API's public information, because they imply otherwise.

MR. KOONS: I don't think there is a fundamental difference there. I think it is a matter of a play on words, or of understanding.

CHAIRMAN TRUEBLOOD: Thank you very much. We will now hear from National Investor Relations Institute.

MR. ARTHUR R. ROALMAN: By way of introduction, I'm Arthur Roalman, and to my left is Marvin Chatinover, and to his left is Gerald Parsons.

By way of precision, I would just like to mention that Mr. Parsons' company is no longer U. S. Plywood-Champion Papers, but it is now--as of last Thursday and by action of their Board of Directors--Champion International Corporation; additionally, he's a member of the Executive Committee of the Investor Relations Association of New York.

With those two corrections in the presentation, I would spend just a few moments here attempting to underscore a few points in the presentation. We're here to talk about the practical problems involved in transmitting financial information developed by accountants. We're concerned with clarity, and we would hope that material that is scheduled for, or intended for, broad scale distribution might be journalistically sound.

I think that's the sense of our presentation here. It should be understandable. I'm sure you are all aware of the problems of trying to make complex information understandable and meaningful to large numbers of people.

We think this is going to apply more and more to

news releases, annual reports, and proxy statements. All of our conversations with the SEC suggest that those are a thing of the past.

Two points that I would mention, in addition to what's in the presentation here: I think there is an opportunity and a need for more aggressive information exchange between accountants and what I would call the mass media. Peat Marwick, to cite one, is embarking on a series of seminars with the Financial Writers Association. I think they are to be commended for that. I think there's an appetite on the part of the Financial Writers Association for the information that they obtain from those meetings.

There's another organization--Irving Trust--which for years has been holding seminars for financial officers, and recently began including the financial editors of large newspapers. As a member of NIRI, I participated in those meetings, and was enlightened, to put it mildly, to see the interest on the part of the financial press, and also the appetite for knowledge that they had in the areas that the Irving Trust people were talking about.

We would like to underscore the importance of continuity and the ready availability of information. We think those are fundamental to any information program of any corporation, and we think that there is a substantial need, particularly in the communications process, for integrity, about which, as many of you who have been reading the financial press know, some of the people who are communicating financial information

have placed themselves in a questionable position. We think that's a subject that needs deep and intensive exploration and concern.

That highlights most of the points that I would try to underscore except that I would hope that someone around the table here might ask us about predictions, because it's a subject that we think has very practical problems, and I think we're in a position to address ourselves to. With that I'll stop.

CHAIRMAN TRUEBLOOD: Do your peers wish to speak individually at this point? (There was no response.)

On this business of financial seminars, there has been a rather long history directed directly to the financial press, as distinguished from public relations people within corporations. They go back as much as five or six years.

I'm sure more could be done, but the Institute itself has run seminars running for two to three days in all sections of the country with all major media.

Now it may be time to recycle that process.

MR. ROALMAN: I might add, incidentally, if you would be interested in seminars in which the investor relations people might participate, I think we could be active in encouraging your participation in those seminars. There might be values in that.

CHAIRMAN TRUEBLOOD: I'm just not certain of the Institute's current program. Maybe, Paul, you might check into it. I have a feeling that it peaked, and most regions

and most major media were hit, and that now we probably have a new crop, and we should be doing it again.

I would say that this public hearing is our last major formal input, but we have been working closely with the media, and we intend, in this process to interview major media on a group basis, for which we have their commitment.

I did not catch, or did not understand, one allusion or reference you made to integrity--was it of information, or of the presenters of financial information? Just what did you mean by that?

MR. ROALMAN: Not of the information itself, but of people who are transmitting the information. I think it's in the information process.

There have been a certain number of celebrated cases recently in which people transmitting information have been accused by the SEC or others of not being precise, to put it mildly. I think it's a matter of serious concern, both to you and to us. I think the subject of confidence on the part of the investor is at stake in that particular situation, and I think that both of us need to be seriously concerned about furthering the subject of integrity.

CHAIRMAN TRUEBLOOD: Here we have a channels problem as it were, in that--given the affairs of a client, or the results of his affairs--we do not participate--and may not participate--in the communication of that data.

Now, are you suggesting that there is something that we could do?

MR. ROALMAN: No. No.

CHAIRMAN TRUEBLOOD: Except to exhort our clientele?

MR. ROALMAN: No, I would not suggest that you would have a piece in that process, no. I'm just saying that it's a matter of concern, in the sense that, to the degree the process of transmitting of information is undermined, I think that you do have a concern there. That's all.

MR. GELLEIN: Is it possible that we do have an educational task to perform, though? I mean, maybe that's our responsibility.

MR. ROALMAN: Marvin, would you care to comment on that?

MR. MARVIN CHATINOVER: Yes, I would like to address myself to that among other things, and I have a particular concern here. I edit a publication known as The Investor Relations Newsletter. I also teach investment analysis, and I'm extremely concerned about meaningful communication of accounting data. I attended one of these seminars this morning, attended by Peat Marwick, and I believe that one of the things the accounting profession has to be terribly concerned about is the fact that the nature of the accountants' letter in an annual report is, I think, basically misunderstood, and by and large, a great deal more imputed liability may be attached to that than should be.

Now, I think that's part of an overall problem that concerns you. I understand the nature of these forms, and I think you are going to lose something in the process. I know

that you have to pay very clear attention to the formulation and review of accounting principles, but I think that you have to be terribly concerned as to how these are viewed in the public eye, and particularly in the investor eye.

While you may not have, for example, particular and direct responsibility for the contents of the President's letter in an annual report, I know that very frequently in personal contact I have found the cooperation of professional accounting personnel to be a very valuable weapon in hitting management over the head and saying: Now, look here! It is one thing to have meaningful communication of data qua data. In other words, many of the pieces of literature here have said the numbers are the important thing.

Gentlemen, I agree with you that this is a first professional obligation. I suggest to you that there is another very significant corollary that you may not be directly engaged in, but in which you have a vital personal and professional as well as public interest; and that is that the public understand what the meaning of the data is.

I am considerably disturbed by comments I hear to the effect that: Well, they won't understand the complicated matters. Baloney. That is usually an excuse which means, (1) I as a professional communicator am too lazy, or have not the capacity to understand it; and (2) I do not have the self-discipline to sit down and put it into a meaningful and interesting form.

I suggest that much can and has been done in this field. I'd like to cite one example I gave this morning in discussion over at Peat Marwick.

The 1955 Annual Report of General Electric--and this year progress certainly was one of their most important products--had a five paragraph discussion in English--not simply in numbers--as to the difference between LIFO and FIFO, the fact that the Company was changing their accounting method of inventory valuation, and what that meant. It was equally meaningful to a sophisticated investor, a professional security analyst and any layman who had had a high school education.

It's that sort of thing that I think we together, as professional men and women, have to strive to work for, because I think we all have a vital interest in that--a sense of public integrity, and awareness of it.

CHAIRMAN TRUEBLOOD: I couldn't agree with you more, and I happened to read just last evening a speech by Mr. Casey which hits upon this point. I don't know if you saw it or not. It's right off the press.

He is saying in effect that we have had forty years of too much legal haggling over weasel words. It's now time to start saying what people can understand. So we're certainly with you.

MR. PARKER: I don't know whether this is a fair question to put to you, but we have had some discussion earlier in the hearings and in the papers that have been submitted

to us about the auditors' certificate and whether perhaps it should be revised to say that the statements are a fair presentation of the transactions they record, rather than a fair presentation in line with generally accepted accounting principles.

Would any of you have a comment to make on that subject?

MR. CHATINOVER: I would answer to this. I don't see any need for a change. I think there is a definite need for communication as to what GAAP is and what the nature and limitations of accounting statements are.

I want to say that here again, I must address myself to substance rather than form. I listened very closely to the discussions today on present value auditing of forecasts, historical costs versus present values, current values, et cetera. I appreciate all of the difficulties involved in the formulation and resolution of these problems.

But again I'm suggesting that, underlying this, I felt a sense of: But you'll deceive people.

You know, it's very interesting that the SEC has all of a sudden awakened this past year and is ahead of all of us, because all of a sudden Alan Levenson in three speeches has indicated that the SEC is now sensitized to the criticism that heretofore their administration of the disclosure provisions of the '33 Act has been more negative than positive; that it would appear to be that the administrative intent has been: Guard the average, unsophisticated investor against

his or her speculative proclivities; do not allow him to be unduly titillated by information which they definitely want at certain times, like, what is the company going to earn when you are putting out a new issue?

In England they told me: My God! We have been doing this for years.

Now, I suggest that you have got to give them the information that they need. By all means qualify it. Yes, there are legal liability questions. The SEC has also said: We recognize this, and we're going to work toward it.

I say that now is the time to look forward rather than backward, and I'm going to suggest to you that there are many dangers--many dangers indeed!--but I think now is the time to make open book, because I'm going to suggest that your profession is on the pan.

I think also that the legal profession is on the pan. As I am reading securities decisions of the courts lately I can see they are really going to be on the pan. And we, as you know, go on the basis of the Pig'n'Whistle pan. Our responsibility is now increasing at an exponential rate, and I'm for it, but what I am demanding is: I want the commensurate authority.

And I will work with you, with attorneys, and with financial executives; but I am suggesting that it will be very dangerous for you--not as a matter of my professional pride--but to call me in as the skilled communicator after the important decisions have been made or, as the language

of the trade goes, to "polish up" the message.

MR. PARKER: You are using "you" to mean the accounting profession?

MR. CHATINOVER: The investor relations professional. Also you.

MR. ROALMAN: I think, when he was referring to coming in and cleaning up, he was referring to the investor relations professional.

MR. CHATINOVER: To the investor relations professional, but we have---

MR. PARKER: But not the accounting profession.

MR. CHATINOVER: Well, no--not just the accounting profession. But very often we are confronted with situations where we will be called in after all decisions have been made. We will not be asked for an opinion as to whether the matter will be easy to communicate, what the public relations implications are. I'm not suggesting to you that I or anybody in my field is professionally qualified to give an accounting judgment as to what a decision should have been. But I am professionally qualified to indicate what the public relations implication of an accounting decision may be. And in that case, I think I can be of constructive help.

MR. GERALD A. PARSONS: Could I speak to Reed's question?

In answer to your specific question, Reed, it seems to me that I agree basically with what Mr. Koons of Shell

said, and that is: It's management's job to communicate with shareholders, the public, and so forth. It's the auditors' job to certify that everything is done according to Hoyle. It's not the auditors' job to do management's job, which is to put additional values and judgment values on that information.

I don't think I have anything more to say.

MR. ROALMAN: Reed, referring to your point, recently an analyst was in visiting with the president of a relatively small corporation, and picked up what he considered material information. He was concerned because he possessed it, that he alone had it, considering it was something that just happened to be dropped in the conversation. So he asked if the company would issue a news release.

What they put together was confusing. It was difficult, and it would just not be acceptable to any respectable publication. It was not used, was not picked up by anybody. And he continued to be very seriously concerned that he was walking around with information that had not been adequately communicated.

I think that's a kind of problem that may be in existence.

CHAIRMAN TRUEBLOOD: Reed, does that take care of you? Dick? Oscar?

MR. GELLEIN: I have nothing more.

MR. ROALMAN: May I make a comment on the practical problems of communicating forecasts?

CHAIRMAN TRUEBLOOD: Yes, go ahead.

MR. ROALMAN: That is, simply, we have had--as you have had, I'm sure--a number of conversations with representatives of the SEC on this point, trying to get at what, really, they hope to see produced. And what we sense is that they are looking for gross volume; they are looking for profits; and they are looking for per-share earnings.

We're dreadfully concerned with the practical problems in communicating that to large numbers of people. Do you do it in the annual report? Because if you do, I think you have substantial problems of secrecy. That's going to be a much sought after number.

If you do it in a news release, I doubt in practical terms that the news media are going to use it--anything but the per-share earnings; and they are not going to use all the assumptions that go into that per-share earnings figure. I think it could be grossly misleading to a number of people.

I don't say that we shouldn't use projections, but I think these are practical problems that ought to be looked at. How do you communicate this information to large numbers of people, and not give them a very, very small piece of the iceberg, in the hope that they are going to make a rational investment decision on the basis of that very, very small piece of the iceberg?

MR. PARKER: Mr. Roalman, I think that's a very important problem. It seems as though there has got to be some way out from under the problem as it now exists, where the

sophisticated analyst does communicate with management representatives about this, and to greater or lesser extent, ideas that are in the form of forecasts and assumptions that support them are communicated orally.

Looking at a lot of the material in our shop with my brothers, who then, report in writing what they have heard--almost invariably this can be squeezed into a paragraph or two that, at least on the surface, looks to be representative of the basic points that were discussed, and it's certainly an amount of material that could be included easily in almost any quarterly report to shareholders that I have seen.

And I just wonder if it wouldn't make it easier, both as regards the legal liabilities of the company and for the analysts involved, and for the general commonweal, if this kind of material couldn't be presented.

I think I would be one who would argue that elaborate rules for presenting it should not be prepared, but it should just be attacked from the point of view of the management who does feel it wants to communicate something and wants to communicate it in a fair and complete fashion to all comers. Isn't there some way that your communicating art can do that, and get it in the quarterly report?

MR. ROALMAN: I would suggest that you may be asking the impossible there, from a very practical standpoint. I think it is dangerous to give away a little bit of information and hide a lot of it; and, I think, unless you are going to...

MR. PARKER: But usually the management only wants to give a little. For example, a company may be willing to say to an analyst who calls: Yes, we feel the odds are that our revenues will in fact rise this year eight to ten percent, and as long as three or four things that can be said in five or six words each don't happen, we would expect the natural result of this would be for our earnings to rise from ten to fifteen percent.

At other times you get down to the end, and they say: Well, we do not forecast earnings, but our reasonable feelings about what normal, ballpark estimates would be is for earnings to be up ten or fifteen percent.

It seems to me there's no great difficulty in communicating that, in writing...

MR. ROALMAN: To whom, however? Are you suggesting that each time there is a material change in the earnings forecast, there be a comprehensive mailing to each shareholder? How about those people who are potential shareholders?

MR. PARKER: I don't know that there would be anything drastically wrong with doing it once a quarter, and not more often.

MR. ROALMAN: To each shareholder?

MR. PARKER: Well, with his quarterly shareholders, communication that you already mail to him.

MR. CHATINOVER: I wonder if I might add a note here. I know the practical problem you are citing, and I wonder, though, if it's any worse than what we live with right now as

professional communicators.

One of our great problems--and we have discussed this with the SEC--is the absolute shortage of media space in getting material news out. It's almost an irony, and I don't blame the media for this, but maximum news space is allocated to those corporations which obviously have the greatest number of shareholders, and which generally are in the highest public view. And that's understandable from a news standpoint.

I don't think there is any answer to that, whether we are dealing with earnings predictions or any other corporate matter, but on the subject of earnings predictions per se, I think there is a qualitative area in which we can do some very, very responsible baselining. Whether we ever get to codified standards of audited forecasting--and I don't know how soon we are going to get there--I do have the feeling, and I garner from the remarks of SEC officials on this subject in the past few months, that what they are really telling us quite explicitly is: We'd like to see you do what you are doing anyway, in a slightly more responsible fashion--specifically an allusion to the ballpark remark.

And I think that one of the things I'm forcing down clients' throats in news releases, for example, is non-quantitative material--in other words, an explanation of why the earnings are going to be what we think they are going to be, even if we don't use a prediction.

I had this just yesterday: Because the company is going to have larger earnings this year due to acquisitions

made on a proper accounting basis last September, nevertheless it should be realized that most of the profit realization--because of the nature of the operations--is going to be shifted to the last half of the fiscal year.

It's rather important that that be put down in writing. I don't know how much space it's going to get in the newspapers. There is that problem. I think we have it with all news.

But I think that we should start indicating to people what the trends are that affect earnings, whether we are dealing with numbers or not. In other words, again I say: The numbers are one thing. But understanding how the numbers get there is the most important thing that you and I have to be concerned with ultimately, because it's upon that that we are going to be judged by the public, justifiably or otherwise.

Pete poses an absolute dilemma but I think it's one we've got to wrestle with anyway.

MR. PARSONS: I want to give an example in our company. We do just about follow the concept that Reed suggested in our quarterly statements; but as an example, last summer our Chairman spoke before the Los Angeles Society of Security Analysts, and he talked about 1972 possibly being a record year. He reiterated this in the quarterly for the third quarter.

In the month of December we realized that one segment of our business--namely, the paper business--had fallen out of bed in November. It was completely unforeseen. We knew it was bad, but we didn't think it was going to get any worse.

We got out a news release to this effect. Our stock price was adversely affected. We had to conduct a communications campaign to get people to begin to estimate lower earnings for 1972. They overcorrected.

Now we're in a position where we have seen a turnaround in the paper business, and we're faced with the dilemma of: How good is it going to be? And we do our forecasting on a monthly basis.

I have a feeling that our company does a fairly good job of measuring and forecasting, but we don't know the future. I work for a multi-billion dollar company that is par excellence in professional management. The executive office had a pool on the earnings, and the Chairman, the President, the Treasurer, and the Comptroller never won it.

CHAIRMAN TRUEBLOOD: I want to ask one more question which may help us in terms of our ultimate objectives.

I think you alluded to the problem--listening to some of the mass of jargon on our technical issues about: We can't do it because we can't achieve precision.

Now, when we get to our overall objectives, I think we are going to have to come to some statement about: The accounting process can yield only certain approximations.

And, whether we turn statistical on this, or whether we do it by an educational process, I do not know. But do you not agree that we ourselves have a significant communication problem in terms of our entire audience?

MR. PARSONS: I neglected to mention one thing, which I believe is the basic concept of our organization--that is, the National Investor Relations Institute--that it is in the best interests of the company and the public investors in general, to have a good understanding of what's going on in any given business in which they may wish to invest, and that is our job to communicate the kind of information that will give them a good, balanced judgment on what the outlook is for our respective companies.

And that's the business we're in, day in and day out. We're trying to do the best job we can with the tools we have at hand. We'd like to see the tools improve, and we would like to have a better flow of information.

CHAIRMAN TRUEBLOOD: But even amongst ourselves you would agree that a deterrent to evolution--not revolution--is a preoccupation with precision which does not really exist.

MR. PARSONS: I agree.

MR. ROALMAN: But I think what is being offered to investors as a potential is being held up to investors as something that might be made available to them. And, Reed, I think that's the thing that we would be very much concerned about. We would be very much interested in making available the assumption that the agency investors make their decisions solely on the basis of earnings per share.

MR. CHATINOVER: Can I offer a note? It may not be much solace, but we all have a shared problem.

Your specific question really addresses itself to a

problem that a lot of us face. Unfortunately, we live in a socioeconomic climate in which everybody, for reasons we don't have to discuss, is reaching for certitude whenever or wherever he or she can find it, and you happen to be suffering in that it's at a particularly inopportune time.

The rash of court suits leveled at accounting firms... we know the public relations implications of this, but I think you are going to have to tell the public in your own way what the SEC is finally admitting in their own way, that the '33 Act was not an insurance policy, but a disclosure act that would give everybody a fair chance, but they could still strike out themselves.

You are going to have to say accounting is very important--and, indeed, it is--but is like so many other things in life. It cannot be all things to all men and women. It's a limited tool, and it's a very valuable one, and I can only tell you what I'm going to tell my students in about fifteen minutes. There is no one answer. There are a lot of things that determine the multiple, and don't ask me how to get to it, because that's what you are supposed to spend fifteen weeks in here trying to find out how to do, all by yourself.

CHAIRMAN TRUEBLOOD: Thank you very much.

(The session adjourned at five twenty o'clock.)

WEDNESDAY MORNING SESSION

May 17, 1972

The meeting reconvened in the Imperial Ballroom at nine-twenty o'clock, Chairman Trueblood presiding.

CHAIRMAN TRUEBLOOD: We will continue to follow our operating plan of the past two days with questions to come to the table from the floor.

We found yesterday that a full 45 minutes was not required in each case, possibly in large part because we're getting to some point of redundancy on the questioning; and so we are going to try to reschedule today just a little bit, if it is convenient with Price Waterhouse and the Technical Audit Associates. We're going to hold each segment down to 40 minutes and run through until one o'clock, with no scheduled afternoon session, if it all works out.

We have not yet been able to reach Price Waterhouse. They have been in the meetings every day, and I'm sure they'll be around and be available. We're not certain about Mr. Jewett of Technical Audit Associates but we'll try to get that settled.

So tentatively, we will run to conclusion this morning which we expect will be about one o'clock, and then the Study Group will meet in a contemplated session immediately after lunch. But so far as the public hearings are concerned, we're anticipating ending them without the scheduled twelve-thirty break.

First on the schedule, the New York Stock Exchange --we have Mr. Wick and Mr. Foster.

MR. WILLIAM FOSTER: Thank you, Mr. Trueblood.

The New York Stock Exchange is pleased to participate in the deliberations of the Accounting Objectives Study Group. We wish to commend the American Institute of Certified Public Accountants for rising to the challenge, forming the two Study Groups, and attacking the credibility gap head on.

We had communicated our grave concern about the credibility gap to the American Institute for a number of years. The gap was manifested overtly by the increasing legal involvement and court involvement of the accounting profession. It was also, from our perspective, manifested--perhaps subtly--in the relative lack of participation of the individual investor in the securities markets.

Len Savoie characterized the problem as one of a craving for credibility. Now, however, a superior process for developing standards has been set forth by the Wheat Study Group.

We endorse the Wheat Study Group recommendations. We will do all in our power to aid the Financial Accounting Standards Board in its work.

With this as an introduction, we can now turn to the second half of the problem, namely, the objectives of financial statements.

We believe that the primary objective of financial statements has not changed since the 1860's. In 1860 the New York Stock Exchange first sought publication of certain financial information from its listed companies. In 1890 its persistence was rewarded by the appearance of a balance sheet in an original listing application.

In 1909 the annual report became a requirement. In 1933 the New York Stock Exchange and the American Institute of Certified Public Accountants hammered out the current, standard short-form auditors' report. The New York Stock Exchange was the first to suggest--and later to require--quarterly reporting, consolidated financial statements, and comparative financial statements.

Drawing upon our historical experience, it is our conclusion that the primary objective of financial statements is to inform investors fully and fairly. We emphasize "all investors." We reject the notion--that the financial statements should be geared to only certain investors, like financial analysts and institutions.

We hark back to the original purpose of the annual report, which was in essence to inform all investors fully and fairly.

In order to fulfill the objective of informing all investors fully and fairly, it is necessary to achieve certain specific objectives. The specific objectives I have in mind are somewhat as follows. There is a great need to

define materiality. What transpires under the banner of immateriality is a source of great concern to us at the New York Stock Exchange.

There is a great need to improve product line reporting. We believe that financial management can do better in this area.

There is a great need to resolve the deferred charge issue. We believe the public is tired of the huge writeoffs that seem to be reported daily in the Wall Street Journal and other publications. As a matter of fact, we believe this has contributed significantly to the growing credibility gap.

We believe it is necessary to define extraordinary items. We believe it is necessary to divorce financial reporting from political and other pressures. We believe there is a great need to improve quarterly reporting. Finally, it would seem that it is well within the province of the accountants and management to provide simpler footnotes.

The topic of fair value accounting has occupied the minds of accountants in recent months and years. We believe, however, that more heat than light has been shed on the subject. Fair value accounting does not seem to us to be a panacea. It does not seem to be the solution to all the problems of the accounting profession. In this area we would counsel the profession to make haste slowly.

This is probably the last opportunity to keep the formulation of standards and objectives in the private sector. It is our earnest hope that management and the accounting profession will work together better in the future than they have in the past.

Given superior standards, which we believe will be forthcoming as a result of the labors of the Wheat Committee and the Financial Accounting Standards Board, and superior objectives which we believe will be forthcoming as a result of the labors of the Trueblood Committee, we believe there is one problem--one grave problem--that still needs to be resolved and to which neither Committee has really addressed itself fully. The need that we see is for superior enforcement to go along with superior standards and superior objectives.

We believe that all will be lost if superior standards and objectives are formulated and they are not implemented and enforced.

To discuss this topic more fully, I'll turn the microphone over to Merle Wick, Vice President of the New York Stock Exchange.

MR. MERLE WICK: Well I certainly think that Bill's characterization of the progress that has been made thus far and seems to be en route is an accurate one, and we're delighted to see these things going on.

I guess that the essence of our strongest recommendation today is that a new, third committee is probably indi-

cated, a committee on enforcement; and this committee naturally needs to be somewhat broader than just the profession because the profession cannot be blamed for all of the problems that we find in the financial reporting area.

On the other hand, certainly enforcement has to start with the profession, and there is certainly a grave deficiency in its performance in this area at the present time. As a matter of fact, there is almost no performance within the profession in this area, to the best of our knowledge.

Actually, we don't think that accounting principles are as bad as the principles of the accountants and some of the other users of these so-called accounting principles. I guess that maybe the profession needs to move the same way that the Stock Exchange has, in terms of setting up a staff group that has the power to conduct hearings, assess fines, and mete out discipline, and give publicity thereto. For it to be handled by a committee of practitioners is likely not to lead to any better results in this area than it has in other areas.

As a matter of fact, in some ways the profession seems to be following the precedent of the Exchange. The Exchange used to operate, basically, under the direction of committees of the Board of Governors which were composed of members of the business and members of the Exchange, just as the Institute has operated in the past, basically, with the authority vested in Institute committees.

In times gone by perhaps one could depend on the puritanical morality and the relatively conservative viewpoint of management, but if this hasn't disappeared, it has become a relatively rare characteristic these days. The rule of the road seems to be: If you can get it by your accountants; if you can get it by the SEC; if you can get it by the stock exchanges; and I suppose, in the final analysis, if you can get it by the stockholders, why, anything that goes is fair. It's someone else's responsibility, not management's.

I was particularly struck by Jim Needham's comments when he was addressing the Financial Executives Institute. He said: If you keep up your pressure the way you did with the investment credit, I guarantee you that you will have a federal agency writing the rules.

One of the comments--analysis of what has been happening in the profession--is that there was a gradual change in the composition of the APB from the managing partners to the policy partners composing the Board; and I suppose there's no question but that this brought a greater technical knowledge to the deliberations of the Board. The question is whether it didn't at the same time undercut somewhat its support within the profession. At times, in our experience, it seems like some of the policy partners are like voices crying in the wilderness within their own firm. And so maybe they are prophets without honor in their own city.

But, on the other hand, certainly, we can't make this

a one-way criticism of the accounting profession, and I thought that the quote in the Robert Morris paper to the effect that "It is our opinion that the selection of the best and most appropriate general accounting principles to be used ought to be determined by the independent auditor" was an interesting one. They went on to say: "In our opinion, there can be and often is an inherent conflict between the executive's role as a manager and the task of measuring his own performance." And most of the cries that have arisen about the rules and policies of the APB from the public sector have been about those which would restrict the reporting of higher profits. I don't recall any great issue being raised on something that would allow higher profits to be reported.

Now, to go from the formal financial statements to another area which also needs attention by our suggested Committee No. 3, there is the question of the accounting principles used in the financial statements being largely disregarded in the historical summaries and the President's letter. I suppose that the worst examples involve the use of unusual and nonrecurring charges, to which Bill has previously made reference and I think it well could be that 1972 might be the last year that private industry is going to have an opportunity to redeem itself in this area. When one looks at the reporting of a lot of companies in the nature of the items included in unusual, extraordinary, nonrecurring, nonoperational charges, one gets the impression that anything that represents progress

--that is, new products, improved efficiency, better plant operation--anything of that nature must necessarily be regarded as unexpected, unusual, and nonrecurring. And so maybe, unlike GE, progress is an unexpected quality or product of many of these companies, if you are judging it on the basis of the financial reports and the President's or Chairman's comments thereon.

With a few companies, whose names will go unmentioned, the one certainty is that each year will see another unusual, nonrecurring charge occupying a prominent place at the bottom of the income account.

Just a little over a month ago the SEC made a release which suggested greater diligence in the release of quarterly and annual results, and pointed particularly to the area of unusual, nonrecurring, after-operations-level charges. And I might remind the accountants that as far as listed companies are concerned there is a requirement in the listing agreement with the Stock Exchange that these items be reported and given some prominence in the reports to shareholders in quarterly releases; also that one of the actions that we found necessary to take with respect to financial reporting resulted in the president spending some time in jail.

Now I have been making some rather broad accusations here. It's clear that the comments that I have relate to a relatively small percentage of both the accountants and the companies--relatively small, to be sure. I don't know what it

is--10%, 20%. On the other hand, I'm sure that the percentage is far too big to be acceptable to the public, and thus the results of these two committees are going to be weighed in the scale of public opinion.

One of the approaches to give greater independence to the accountants might be the endorsement of the idea of audit committees, to which the accountants would report, those committees to be comprised exclusively of outside directors of the corporation. I think that it might be appropriate to point out that not all of the top management people are the kind of sophisticated financial executives that people often say are necessary--that that kind of knowledge is necessary to have in order to be able to interpret financial statements properly--and there has been more than one management that has been led down the primrose path into disaster by virtue of its lack of understanding of the financial results being reported to it by its own internal accounting people with the blessing of its outside auditors. So it's not just the public that gets involved; it's the internal management of at least some companies.

Also in the area which is somewhat outside the scope of influence of the profession, although we obviously have something to say about it, is the question of product line reporting; Bill made reference to that previously. I think that the recommendation of the Financial Executives Institute in this respect was made in good faith. I think that the results, though, of the reporting--particularly by some of the

conglomerates--has been worse than useless. I've always resisted the use of the word "misleading." I think it's one of the most misused words that one hears with respect to financial reporting and accounting. It's often used to dismiss any kind of an argument that the speaker doesn't particularly take kindly to. But if there is one area where I see some misleading information being perpetrated on the public, I think that last year's and some of what we see this year of product line reporting is a good example.

I think Bill and I both felt that coming down to the operating level represented a good solution originally, because there are obvious problems in allocating a lot of the expenses below that line. But what has been done with these above-the-line figures is something that I don't see how we can continue to countenance. I don't see how the SEC can continue to countenance it, and it looks like the only answer is to come right down to a net income figure across the board, with all of the caveats that have to be expressed as to how certain of the nonoperating figures are arrived at.

And the last point is that something needs to be done about forecasts, future plans. Just what can be accomplished in this area is a little bit difficult to pin down, but certainly investors make their decisions based more on what is anticipated for the future than what has been accomplished in the past and some method needs to be developed to get this word to the public.

There's no question but that it's used any time there is an offering of securities. The underwriters have to be furnished with the information. Any time there is a borrowing from a bank or insurance company, or something like that, those people insist on the information, find it useful and necessary in arriving at their decision; and while we recognize the problem that exists, a way has got to be found to meet it.

Now I could go on, obviously, for a long period discussing a lot more of these specific things, but the purpose of this study is neither to exhaust the subject nor the participants, and so I want to conclude at this point with the statement that, as far as we're concerned at the Stock Exchange, we intend to take a more active role in the future than we have in the past. Our management has just authorized some additional help in terms of staff to make it possible for us to do this and instructed us that they want it done, and so we intend to do our part and to support in the future as we have in the past the efforts of the Institute and of these fine committees that have been working so hard.

CHAIRMAN TRUEBLOOD: Thank you very much, Merle and Bill. We certainly do appreciate not only your appearance here this morning, but also the several meetings that you have had with us, and we appreciate very much, professionally, the sharing of our common problems over the past.

It's unfortunate that we haven't done better with

them but I am hopeful, as you are, that maybe we are getting with it and will move a little bit faster from here on in.

We, I'm sure, on the Study Group share your hopes for the FASB recommended by the Wheat Committee when it becomes operational.

The enforcement concern you have continuously had. In my personal view, it's completely correct. One step has been taken, of which you may or may not be aware: The re-stated Code of Ethics, which will go to the membership this fall, now incorporates explicitly a requirement for conformity and application of all technical standards, however developed.

I think there is another important forward step in which we can jointly take part. I see much more activation of research and study and discussion of problems like forecasting, interim reports, and so on, by other groups, particularly FEI and NAA, than I have been aware of in the past; and I think that the interfeeding in that coordination is good; it may well help us in getting to solutions faster than we did in the past. But it is painfully slow.

I think many of the things you suggest, current value, for example, has been clearly a matter of concern without agreement for the past two days, with much discussion in much depth. I don't think there is going to be any immediate adoption of it. It must be looked at very carefully, and the implementation problems are extreme.

But we look forward hopefully, to coming out with

some overriding structure into which some of these day-to-day problems may be more easily fitted than they have in the past. Whether we will be successful, I don't know. With your help and the help of all of the others who have participated, maybe we'll make it. We can hope.

MR. PARKER: Merle, in your statement you mentioned that you have some criticism for radical departures from the cash basis in the name of accrual accounting. I wonder if you could expand on that point a little bit.

MR. WICK: Well, I guess this comes back to a point that I made about the little objection to anything that would permit the reporting of higher profits. All of the push at the corporate level seems to have been in this line, and the industries that have gotten into serious trouble over the years have most frequently been those where reported income got substantially ahead of cash income. Accrual income got ahead of cash income substantially.

And we're seeing it right now, for example, in some of the real estate fields, in the computer field. It certainly occurred some years back in the real estate syndications.

I suppose that it has been the single most damaging problem as far as investors have been concerned in the last 10 or 20 years, and that's just why we react to it, because too many investors have been taken to the cleaners as a result of it.

We have a pretty good batting average in terms of

the companies which we approve for listing not getting into financial earnings problems later on. In the last 15 years we have listed about a thousand new companies. I think that it's fair to say that less than 20 of those have gotten into financial difficulties that resulted in their falling below our delisting criteria. Most of the problems that we have run into have been either in the area of deferred charges which eventually came to create a liquidity problem, or this advanced recognition of income in advance of the cash receipt thereof.

MR. PARKER: Thank you.

MR. WESTON: I expect your staff probably see and review more financial statements than any other group. I wonder if you could be helpful to us in terms of refining the objectives of accounting a little more--maybe on a second level from your broad statement that statements should be useful to investors--and taking the area of deferred charges, and if you will, property, plant, and equipment, could you give us some idea of what you believe the objectives of accounting should be in that area?

That is, how can the objectives be phrased in deferred charges, property, plant, and equipment, the computer field, real estate--whatever you want to call it--to be more useful to investors, both the buying investor and the selling investor?

What could the objective be, or what should the objective be?

MR. WICK: Well, in the deferred charge area, as far as established companies are concerned, I think that there is only one answer and that is that they ought to be eliminated. We have for a number of years now suggested to each one of the major accounting firms that if they would take a look at the experience of their own attesting experience with deferred charges, we feel sure that they would adopt an internal principle which would outlaw them within their own firm.

There are some problems as far as companies in the development stage which are somewhat different. But if we had to put it in the balance, we would say the abolition of the deferred charge concept would probably be a significant service to investors, because it has been the subject of extensive abuse.

MR. WESTON: Would that move in the computer field in terms of equipment as well? That is, what would be the objective there? Not to show anything as an asset as to which there is any doubt of recovering?

I'm trying to find an objective that would obtain that result without being unfair to a present holder of securities.

MR. WICK: Well I suppose that you can't be that dogmatic; but certainly, a much more rigorous test than has ever been applied in the past is clearly indicated by the experience.

MR. WESTON: But how would you phrase such a test? The possibility of recovery?

What I'm getting at is that much of this is based on judgment, and if we have an arbitrary rule that all of these debits must be written off, then that result would be less useful to investors than an objective which would, say, try to describe the inherent value in these various projects the best way you can.

Now I think part of the problem is that this does involve judgment and some of these writeoffs happen because people made judgments which turned out to be wrong. On the other hand, many of them turned out to be right. And still on the other hand, many of the items that were written off--color television, for example--turned out to be tremendously valuable items, and those costs were never properly deferred and accounted for, in the view of many.

So what I'm trying to find is an objective which will handle a very difficult discretionary area without being arbitrary and penalizing the good with the bad, I guess. Is there any way we can phrase an objective that will reach that goal?

MR. WICK: Well, I guess that what is needed is greater assurance as to the future recovery of those costs than has been available--than has been called for in the past.

CHAIRMAN TRUEBLOOD: Are you finished on that point, Frank? Howie Wagner?

MR. WAGNER: Well, I'm not a financial analyst, nor

am I an attester, but my concern about financial statements is in terms of being a preparer.

I gather from your paper that your feeling is that financial statements ought to be set up in such a way as to be understandable to what we commonly refer to as the "Aunt Janes" in our country. We have had lots of discussion about this over the past few days, and many people have expressed the view that financial statements cannot be directed to the "Aunt Janes" in our country, despite the fact that they are shareholders in our economy.

Many companies' annual reports contain--generally on the inside front cover, or right at the very outset--a very condensed statistical summary called "Highlights of the Year" or "Results in Brief." This has the purpose of making a very quick summary available for the one who doesn't go beyond page 1 of the annual report, but also to make it simple for the "Aunt Janes" to grasp what we think are the key numbers which she might be interested in.

My first question, therefore, is: Is this the kind of information, or is information presented in this fashion, in this abbreviated form, what you would feel would appeal to the unsophisticated investor, the one who doesn't understand the details of financial statements?

And then the second question relates to page 4 of your presentation, where you explain that the quality and information content of quarterly reports must be examined and

improved. I would appreciate it if you could amplify to some extent this summary statement also.

MR. WICK: Well, as to your first question, so far as the formal financial statements are concerned, we feel that they should be addressed to the intelligent investor, not necessarily to the "Aunt Jane." This doesn't mean that the investor needs to be a sophisticated accountant. That's not the level. But it obviously cannot be so simplified that it loses content.

But there is the opportunity for management to present in the highlights a condensed portrayal of what actually happened, and many managements do this very well, and that's the point at which the Aunt Janes can be addressed along with the sophisticated investors as well, because what needs to be said and portrayed is basic enough that everybody ought to be interested in it.

Our main problem with those highlights has been the tendency on the part of a few companies to ignore those things which reflected somewhat unfavorably on their performance. But the highlights and the President's letter, properly prepared, is a valuable addition to the formal financial statements.

CHAIRMAN TRUEBLOOD: Do you want to proceed with a comment about your intention on the quarterly statement?

MR. WICK: Oh, yes.

Well the requirements that we presently have are limited to quarterly reporting of profits before and after taxes. We've also for a long time recommended the reporting of sales

volume. The new SEC forms call for more information than that in the quarterly reports. And so the question comes as to how much should be given.

Here, once again, we get back to these unusual, non-recurring charges, changes in accounting, and things like that occur during the interim period, which often are ignored in the release. There's a limited amount of space available in the newspaper for these quarterly reports. Smaller companies have difficulty getting even their summary figures reported. And it could very well be that the time is coming when quarterly reports in greater detail need to be mailed to shareholders, in order to keep them informed.

MR. REINHART: Merle, I hate to go back to an earlier point, but just one quick question: Would your proposal to eliminate deferred charges extend to goodwill?

MR. WICK: Andy knows that's a tough one.

Well now, as to the future, goodwill is under some sort of control. The question is what to do with all of the goodwill of the past.

Some of the goodwill figures that are vigorously defended as being very valuable are in areas where more stable companies with equally goodwill assets have written them off when it was convenient for them to do so, for various reasons.

I don't have a good answer to that one. If I were operating as a security analyst, recommending things to people, I would take a very hard look at those goodwill figures, and

either eliminate them or put my own valuation on them. I have a great deal of difficulty with some of the companies reporting some of the results that they do, and they and their accountants agreeing that there has been no diminution in the value of that goodwill. I find the logic to that kind of position very elusive.

MR. FOSTER: I think, Mr. Reinhart, if you're worried about what to do with goodwill, you could write off retroactively over forty years. That might be a good solution.

MR. REINHART: Retroactively over forty years?

MR. FOSTER: That's right. Any goodwill that was acquired prior to 10/31/70.

MR. REINHART: I'd be happy to write off anything retroactively.

MR. FOSTER: That's been one of our problems too.

Also, in the annual report area, I think that one point we made was simpler footnotes, and I think this might even help the intelligent Aunt Janes. I think the management and officers can write simpler footnotes, and I think, upon occasion, an effort is made to write them particularly complex and long so that the reader will only spend fifteen minutes.

CHAIRMAN TRUEBLOOD: Any other questions around the table? (There were none.) Thank you very, very much.

May I ask again if Frank Jewett, of Technical Audit Associates is in the room, or any representative of that group? (No one responded.)

We'll move then to MAPI's presentation.

MR. GELLEIN: (Temporarily taking the Chair.) Would you introduce yourselves, please?

MR. CHARLES I. DERR: Mr. Chairman, shall I proceed?

MR. GELLEIN: Yes, please.

MR. DERR: Members of the Study Group on Accounting Objectives: My name is Charles Derr. I'm Senior Vice President of the Machinery and Allied Products Institute. My associate at the witness table is Mr. Frank C. Roberts, Vice President and Controller of the Eaton Corporation.

With your permission, I should like to tell you very briefly something of the Machinery and Allied Products Institute--that is, MAPI--and of its interest in the very important work of this Committee. MAPI is a national organization of capital goods and allied industrial product manufacturers. The output of such companies consists for the most part of highly engineered, high-technology products ranging from off-the-shelf consumables to entire manufacturing plants, such as steel mills, petroleum refineries, or chemical plants with a very long production or construction cycle.

As will be apparent to the members of this Committee, this means that our membership includes both high volume, mass production companies and low-unit-volume-job shop operations with all that that range implies for differences in accounting practice.

The Institute and its members have long participated

in the consultative process of the Accounting Principles Board and to the extent that the Securities and Exchange Commission has chosen to exercise its authority for the prescription of financial accounting and reporting procedures, we have also reviewed and commented on proposed regulations of that agency.

In view of all this, MAPI welcomed the initiative of the American Institute of Certified Public Accountants in establishing the Wheat Committee to conduct a study on establishment of accounting principles, and this, the so-called Trueblood Committee, to undertake a study of accounting objectives. In our judgment, the stakes are very high. The failure of reforms sought to be obtained by these two studies could well lead to increasing governmental intervention, with disastrous results on the necessarily evolutionary character of accounting principles and practices.

Such a result, with all that it would likely involve in the loss of managerial discretion, would be equally calamitous from the standpoint of industrial management. The creation by federal statute of a cost accounting standards board to prescribe and enforce cost accounting standards for application to the bulk of negotiated government contracts suggests to us that this is not an empty threat.

The Wheat Committee has completed its study and has published its report and its recommendations. We have generally endorsed the Wheat Committee's report in a recent letter to the President of AICPA. Because of our deep interest in both of these studies, and because of the inescapable interrelation-

ship between the two, I now ask leave of the Chair to file a copy of that letter, along with our other testimony, as part of the Committee's record of this hearing.

(Mr. Gellein nodded his head to indicate acceptance.)

MR. DERR: Thank you, sir.

As you know, MAPI responded to this, the Trueblood Committee's invitation for comments, by filing a written statement of our views on the subject, under date of January 28, 1972. My oral comments today will be very brief, with the bulk of our testimony presented by Mr. Roberts.

Our earlier written statement emphasized our view that the principal purpose of the corporate financial statements is, and should be, to report clear and reliable financial information to the shareholders concerning the results of the corporation's operations, its financial position, and its prospects. I want to reemphasize that central point and add very briefly to it.

The need for reemphasis is suggested in part by one central proposition in an otherwise excellent and most useful statement to this Committee by the Financial Analysts Federation. That proposition holds: "The objective of accounting and financial statements should be to serve the needs of equity investors, actual and potential." In a limited sense this is, of course, true, but we do not believe that potential investors do, or should have, the same standing as actual investors. As Ernst & Ernst has said in its written statement to this Com-

mittee: "The requirements of potential or only possible interests must be regarded as secondary." There may, in fact, be a genuine conflict of interest that must, in our judgment, be resolved in favor of the actual investor; the present shareholder, one of the owners of the company, has his investment at risk.

Reporting disclosures of the type sought by non-shareholding users of financial statements--product line reporting is a good example--may adversely affect the competitive position of the company, and by that very fact discourage investment by the potential investor or by the financial analyst who acts as his servant. We believe the principle should be clearly adopted that regular financial reports of a corporation are designed primarily for stockholders, and secondarily for bankers, security analysts, and others.

Adoption of that guiding principle at once suggests a need for brevity, simplicity, and clarity in the basic financial reports, with supplementary detail and analysis of the type sought by other users of corporate financial statements relegated to appendices and supporting schedules but not included in the regular financial reports.

In his remarks at the Annual Meeting of AICPA last October, the distinguished Chairman of this Committee said: "So far we have formally invited each state society, over fifty governmental and professional organizations, 100 international accounting organizations, 100 institute member firms, all com-

panies listed on the New York and American Stock Exchanges, and scores of universities to participate in our work." This is an impressive roster of participants, and characteristic of the painstaking care which the Committee has approached its most important assignment.

But there appears to us to be one significant omission: the common garden variety of shareholder, the man who has put up his money to finance the enterprise. We think the Committee should consider questioning, by interview or questionnaire or both, a cross section of stockholders, in order to see what it is that they desire in financial reports.

In that same progress report to AICPA last October, the Chairman of the Committee indicated, among other things, that the Study Group was considering objectives that might sanction "disclosure of the impact of social costs and social benefits in financial statements." We would oppose the engraftation of any such disclosure requirement on the established pattern of financial reporting. The impact of such costs and benefits is necessarily conjectural, and therefore not susceptible to measurement in financial terms.

If need for the reporting of such matters can be justified--and, frankly, we see no justification for it--then such reporting should be excluded from the principal financial statements and included only as a supplement to such statements.

Similarly, we oppose the inclusion of forecasts and

budgets in basic financial statements, a suggestion to which our next witness will devote principal attention. As I said before, our next witness is Mr. Frank C. Roberts, Vice-President and Controller of the Eaton Corporation who, incidentally, played a major role in the preparation of our earlier written statement. It will be his purpose to extend and elaborate upon certain of the points made in that earlier statement. As I have suggested, he intends to emphasize and to relate to the study of accounting objectives his company's work in forecasting, budgeting, and in the use of financial controls as an example of how such matters are dealt with in a typical capital goods manufacturing company. If you please, Frank.

MR. FRANK C. ROBERTS: Thank you, Charlie.

Good morning, gentlemen. Preceding the comments I am about to make, I would like to make clear that I am not an accounting professional in the public accounting area. I am not a CPA, nor do I have any public accounting experience. When I need this type of guidance, I contact our independent accountants and rely upon their advice. I am here today because I am concerned about some of the changes being considered in the information normally included in published statements and the potential impact these changes could have on Eaton Corporation.

I ask that you accept that I am not opposed to change or innovation as such. Change is a way of life in our company, and since we are well aware of the necessity for providing ade-

quate, understandable information in our published reports, we welcome any constructive suggestions which will help us achieve this objective.

While most of what I have to say may appear negative--and I realize this is not helpful to your Committee as it will not help develop a positive response to your commitments--I feel strongly enough about certain of the proposals that I am willing to appear here today and discuss the subject.

For a number of years, Eaton has prepared forecasts as a means of ensuring that the various segments of the business prepare detailed operating plans and use such plans as an operating tool. We feel that this practice has given us a reasonably good capability to recognize the strengths and weaknesses of forecasting techniques.

To develop our forecasts, we draw upon the expertise of our customers, our outside professionals, and internal experts. It is our considered opinion that forecasting, properly used, is an excellent operating control. Our experience also leads us to believe that inclusion of forecasting in the accounting statements issued to shareholders and the public may not only be inadvertently misleading, but actually can provide the vehicle through which overly optimistic opportunists can reach the investor when they feel that the recorded historical performance is not sufficient to maintain the investor's interest at the desired level.

To illustrate my point, I will give a brief description of the forecasting techniques used by Eaton, and review

the degree of accuracy which we have been able to attain while using this information as internal control. Since this information has been regarded as strictly confidential by management, it has not been influenced by any consideration which might have crept into it if it had been subject to public disclosure.

Obviously, the more accurate such a planning and control tool can be made, the more useful it will be to management.

Our forecasting starts with a five year forecast which is prepared in the spring of each year. We have quite a detailed procedure on how that is to be accomplished by each operating division or subsidiary. This plan encompasses all aspects of the business. The plan is evaluated by applying values to each element of the plan, but the true emphasis of this program is placed on the planning of strategies.

These plans are first reviewed at a meeting of the group vice president with the general manager and the general manager's staff; so it does get into some degree of depth within the organization. If it's acceptable to the group vice-president, a second critical review meeting is held which includes the corporate Executive Policy Committee and appropriate members of the corporate staff.

The second major step in our procedure is the development of a one year profit plan, which is prepared in the fall of the following year, or covering about a six months' span. And here again we have quite a detailed, elaborate procedure that goes out to each operation. If these would be helpful, we

can leave them for the record.

MR. GELLEIN: Yes, they would. Would you, please.

MR. ROBERTS: The emphasis here in the one year plan is on the financial results, with assurance that the underlying strategies developed in the five year plan are being implemented. This one year plan is compared with the previous forecast for the same period as included in the five year plan, and deviations must be explained.

As a part of this plan, we include what we refer to as turnaround plans. Now if we were dead certain that we could set up a plan that was truly going to hold throughout the coming year, there would be no need for such a thing as a turnaround plan. This type of plan, again, is formalized, with specific instructions as to what is to be developed. It outlines specific actions which are to be taken in the event that the actual economic conditions differ from the planned level.

Generally, the program provides for about a $7\frac{1}{2}$ and a 15% increase and decrease from the planned level, so we are considering a possible 30% range of deviation. Occasionally, a special turnaround plan must be prepared for a division or subsidiary which falls outside of this range.

Using the financial data developed for these five levels of activity, we develop break-even charts which can be used to measure the anticipated profit at any sales volume. Deviations from the profit level are explained in a monthly analysis report submitted by each operation. Each volume level of the plan is subdivided into a monthly schedule, so as to

permit monitoring the monthly results.

The third step in our forecasting procedure involves what we refer to as a monthly rolling forecast. I have samples of those particular forms here for that subject.

This consists of a four month projection by month of sales, profits, and inventory levels. It also includes our current projections for the full calendar year. It shows variance from plan and from the previous year's actual for both the full year and the current year to date through the period included in the four month projection. For the full year, it shows the variance from the prior month's projection, and notes and comments are required for significant changes.

A comparison is made of the three months previously reported in prior months, as a means of ascertaining the trend and whether the reporting operation is consistently optimistic or pessimistic about the future. We do run credibility checks on the figures that are submitted.

Explanations and comments for any significant deviation from prior forecasts and plans are again required.

The last step in our forecasting procedures is referred to as an interim forecast. Three times during the month, sales, profits, and inventory levels are projected for each division and subsidiary. The first forecast is due at World Headquarters on the fifth working day of the month, the second on the sixteenth, coinciding with the rolling forecast, and the final on the fourth working day of the following month.

This final forecast is expected to be very close to the actual book results which will be reported later in the month. Again, pertinent comments on deviations are a part of the information submitted.

I believe the comments I have just made indicate that we have a rather thorough approach, and do not take the subject of forecasting lightly. Now let's examine how well we have been able to meet the forecasting objectives.

You will recall that I mentioned that the preparation of our five year forecast took place in the spring, and a closer look at the next year was taken in the fall of the same year, or about six months later. I have here some charts. It might be helpful if you had these as I talk. (Papers were distributed to the Study Group.)

This first chart shows the deviation from the following year's forecast, as prepared first in the spring of the preceding year, and then in the fall of the preceding year. To illustrate, in the 1970 year sales actually were projected to be a little higher in the second forecasting, but profits were quite a bit lower.

In 1971 we were off roughly 8% in sales in that period, and about 19% in profits.

I have also charted our actual performance against the one year plan for the period 1967 through 1971. I believe the results are indicative of the difficulty and potential misunderstanding which could result from disclosure of the forecast

figures. In 1967 sales were off about 16%, and profits were off something in excess of 40%. Our profit leverage to sales is quite extensive.

Another interesting chart indicates the trend followed by our monthly rolling forecast, which indicates an updated forecast of the annual results as it is viewed each month. In other words, we have updated our annual forecast and matched that against our original profit plans. On the third chart we have a profit plan which said that we thought our sales were going to be \$1,155,000,000. As of February, that had declined 3%. These figures do not show on your chart; they were an afterthought on my way down here.

In March they had declined by 5%; in April, by about

.....

MR. GELLEIN: I think we can see it here.

MR. ROBERTS: O.K. In any event, we're off 10% when we get down to the bottom.

Looking at the next chart, we see what happened to the profits during the same period, and again it was much more pronounced. Profits were off about 26% when we finally came down to a realistic level.

One of the interesting things in looking at this particular chart is that once we had recognized a downward trend, we didn't stop till we went completely under what we finally actually attained.

MR. GELLEIN: Mr. Roberts, I don't want to cut it off,

but thinking of our schedule, could you some way kind of bring it down to...

MR. ROBERTS: Yes. O.K.

MR. GELLEIN: ...perhaps highlights?

MR. ROBERTS: Based on the information available during the development of some of these figures, I don't believe independent auditors would have revised the forecasted figures. And yet, look at what happened.

In our reporting we have at times attempted to satisfy the need for forecasted information by including in the reports a simple statement as to the anticipated business trends. Following are some typical examples of comments made and a comparison of the implications of the comments with the results later obtained.

Back in 1965 the annual report noted that the backlog of unfilled orders on December 31, 1965 was at record levels, and 40% greater than the total of 1964. The 1966 actual results did include an increase of 13% in sales, and 17% in profits.

In the 1966 annual report you will find the comment: "Although sales are favorable for 1967 to date, profits have declined in part due" -- etc. "For these reasons, as well as the possibility of a higher tax rate, we cannot accurately predict what 1967 will bring for your Company." The actual results for 1967 were a 6% decline in sales and a 38% decline in profits

We have similar statements in our interim and annual reports of subsequent years. Our current first quarter for '72

contains a statement that we think business looks much better this year.

Statements such as those quoted indicate that, despite our best efforts, we cannot predict the future with any great degree of reliability, but an honest effort is made to indicate the economic trend, as it affects Eaton. Any requirement to make such statements more precise and to express such observations in specific economic values can only lead to a growing credibility gap between business and the investing community.

I have a couple of comments that I'd like to make on fair-value accounting, although I must confess that at this point I'm thoroughly confused.

MR. GELLEIN: About how much time do you think you'd need for this, now, Mr. Roberts?

MR. ROBERTS: A minute or so.

MR. GELLEIN: Oh, fine.

MR. ROBERTS: With the variety of current value concepts from which to choose, it is apparent that no one presentation is going to satisfy all the users of accounting statement. In fact, it appears that none of the restatement of value plans has any great number of converts. There are apparently few users of accounting reports that feel handicapped by the lack of a restatement of historical values. I find it especially difficult to understand the need for a more precise measurement, when the fixed assets -- which in many instances constitute a major

portion of any such adjustment -- are appropriately depreciated using a wide range of rates and methods. While a depreciation charge against operations may be proper under those circumstances, it does not necessarily follow that the residual net book value is in any way typical of the market value of the fixed assets involved.

Under these circumstances, the use of a conversion factor to determine the fair value will not bring the net book value back to market value, and any attempt to adjust to market on a specific appraisal basis will defeat the original intent of charging cost with what was deemed to be an appropriate depreciation cost.

All of the revaluation methods have a specific purpose, and are used in various types of special studies. It is doubtful that the cost of making such conversions on a continuing basis can be justified through practical application. Most of us are not in the business of going out of business.

While a case can be made that cost in an inflationary economy may be understated in terms of current value, the gradual adjustments of selling prices over the period do reflect the cost imposed by normal equipment replacement. Admittedly, this is not a timely cost-price relationship, but it has been a reasonably constant relationship and as such has influenced the profit margins required for a satisfactory performance.

Eaton's capital expenditures in the last ten years equal about 70% of our fixed asset value. If we are truly con-

cerned about a continuing inflationary impact, then it would appear that our attention should be focused on tomorrow's costs, and even current values would not be an appropriate measure for guiding the investor.

I wonder if we are not overreacting to criticisms which really should be directed at specific instances of faulty and misleading reporting.

I'll chop it off there.

MR. GELLEIN: Thank you, Mr. Derr and Mr. Roberts. We especially appreciate your well-prepared paper that you put into the record, and the case study that you presented will be helpful. Reed?

MR. PARKER: I noticed you indicated that one of the primary purposes of statements ought to be to clarify and simplify financial information for the unsophisticated primary user; and yet in another part of the statement you seem somewhat sensitive on the idea of further improvement in the comparability of accounting data from one company to another. And yet, perhaps, the primary objective for the investor is to be able to compare one company with another, and it rather suggests to me that, rather than trying to be of maximum help to the unsophisticated holder, you would rather like to leave more advantage with the sophisticated financial analyst on this score.

Could you comment on that?

MR. DERR: Do I detect that you are accusing us of inconsistency, Mr. Parker?

Well, perhaps it is inconsistent, because life is inconsistent.

No, I think I would answer this in this fashion that we have some very serious doubts as to how much real comparability can be achieved without straightjacketing management by prescribed, unvarying, inflexible accounting rules and procedures. This, we think, in the larger scheme of things is probably undesirable. Certainly it is necessary to achieve comparability, but as I understand it--and I am not an accountant--there are two kinds of comparability. There is comparability as between Company A and Company B. There is comparability within Company A as between Accounting Period A and Accounting Period B and Accounting Period C.

It is my impression that the accounting profession has sought thus far to achieve the latter form of comparability, and achieve so far as possible the first form. This is not, perhaps, a very good answer, but I think this is what you were getting at.

MR. PARKER: Well, I'm not an accountant either, so we can talk on equal terms. But in areas like depreciation, installment sales, inventory accounting, and investment-tax credit, consolidation, the present status of generally accepted accounting principles allows a very considerable degree of latitude, and it seems difficult, I think, especially for the unsophisticated investor, to understand why one company can use a thus-and-so kind of depreciation method, and another one another,

when they have relatively similar kinds of assets.

It's this kind of problem that we're facing, and it has become a fairly serious one for the investor trying to compare across company lines, and one wonders what the usefulness of this extreme amount of flexibility is to management, especially if the management finally wants to compete in the capital markets and wants to have the confidence and the understanding of both the unsophisticated investor and those of us who can be hired by institutional people and take care of all this complexity and undo it for them.

MR. DERR: Let me add one further comment, if I may, Mr. Chairman. As most of the people on this Committee undoubtedly do, I own a few shares of stock, and on occasion I receive these annual reports of corporations. I am probably an unsophisticated investor, so I qualify for the character that we are talking about.

It seems to me that most of the annual reports I receive exhaust me before I exhaust them. I wonder, really, if the typical unsophisticated investor is really capable of making the comparisons. I would prefer to have a sophisticated financial officer comment.

Frank, have you a comment on this question?

MR. ROBERTS: An unsophisticated one.

I think the study of depreciation, of course, is a problem all unto itself. Over the years nobody has satisfactorily come to grips with it. There are certain times when de-

preciating an item at an accelerated basis is more than justified. If you have a product line that appears could become obsolete, but you don't definitely know that it's going to become obsolete, you are confronted with a judgment problem as to how fast you write off that particular investment.

I don't think these cases are unusual in our business, and I doubt if they are unusual in many businesses.

MR. PARKER: It was pretty unusual, though, to have large numbers of businesses shift from accelerated methods to straight line methods in a single year when there wasn't a great deal of change in the economy or in the status of technology.

MR. ROBERTS: I agree.

CHAIRMAN TRUEBLOOD: Frank, you had a question, I believe.

MR. WESTON: Well, I was interested in a comment in your written paper that the rights of the shareholder--the existing shareholder--take precedence over those of any other claimant to the use of corporate financial information. Many people in talking to our Group have observed that once a corporation lists its securities and goes public, in a sense, potential investors have as much right to that type of information as existing investors, and there is a section of the Securities and Exchange Act which many lawyers say also contains the thought.

Do you believe that the present shareholder should in effect get information that others do not receive? It's on page 5 of your paper.

MR. ROBERTS: I believe that any information which is made public must be made public in a way that it's available to all people who are interested. Any time that we issue any information in our discussions with security analysts, for example -- we will say nothing that we are not willing to quote to the Wall Street Journal.

MR. WESTON: What do you mean on page 5 in your paper when you say that the rights of the shareholder take precedence over those of any other claimants to the use of corporate financial information?

MR. ROBERTS: We're talking specifically about the design of the statement itself, and this would mean that in certain instances we think the shareholder can be injured by the publication of given information in situations where it might aid a competitor of the company or put us in an awkward position with our customers. And we think those interests come first before any others, and therefore we wouldn't expect to publish that information in a statement.

MR. WESTON: Even though a potential investor should be alerted to this adverse type of situation?

MR. ROBERTS: The existing investor is not alerted to it.

MR. WESTON: You do on that page, just to take one more second on that particular issue, recommend the use of a rule of reason to decide what sort of information shall be made public and what is detrimental. Who, in your view, would be

the arbiter for determining such a rule of reason? Who would make that decision?

MR. ROBERTS: I think it's a management decision that would have to be concurred in by the independent accountants.

MR. WESTON: Do you think both of those parties are capable of making those decisions today?

MR. ROBERTS: I have never encountered a case where I didn't feel that was so.

MR. WESTON: In the public interest, I'm saying.

MR. DERR: Could I comment further on that, Mr. Weston?

I think, unquestionably, the ultimate responsibility for the determination of accounting principles and practices has to rest with the professional accounting societies, the American Institute, and so forth. I think what we were suggesting here with reference to a rule of reason was addressed primarily to the accounting profession, suggesting that the primary purpose of financial statements, in our opinion, is to report to the share owners. Obviously, there is no intent to exclude appropriate disclosure to everyone else in the public who may be entitled to it. Certainly bankers, creditors, government agencies by law, potential investors, and what have you, as Mr. Roberts said--if any public disclosure of a fact is made, it ought to be available to everyone.

But the guiding principle that we were suggesting, and the step toward the rule of reason, which we leave to you

to devise, is that primarily financial statements are for the share owner. In our judgment he is the person first to be served--let me put it that way.

CHAIRMAN TRUEBLOOD: We will take one more question. Andy?

MR. REINHART: I was curious, Mr. Roberts--when you deal with security analysts, all of whom generally would make forecasts with regard to what your company will earn, how do you deal with their forecasts?

I mean, we all have this problem. They will come in and say "I'm going to forecast that you will make X dollars." Do you say "Gee, that's a little high," or "gee, that's a little low"? How do you react to forecasts that they make?

MR. ROBERTS: Generally, if we find an analyst whose forecast we think is way out of the ballpark, compared to the things that we are looking at, we will ask him to give us his reasons for arriving at such a forecast.

If he has things in mind which we think are based on misconceptions, we may discuss the misconceptions, but we leave the arriving at the final forecast to him. And if he wants to put out a forecast that we would not put out, and he has good reason for doing so, we think that's up to the financial analyst.

MR. GELLEIN: Mr. Roberts, it's clear that your experience in forecasting is extensive, and I'm sure that the members of the panel would like to ask further questions. I would like to hope that we might come back to you after we look at

this material, in the event we would want to talk with you about certain aspects of it.

MR. ROBERTS: Feel free at any time.

MR. GELLEIN: Thank you very much.

MR. DERR: Thank you kindly.

MR. GELLEIN: Mr. Borst, of Inland Steel Corporation.

MR. DUANE R. BORST: Gentlemen, let me introduce myself. I'm Duane Borst, Comptroller of Inland Steel. My friends prefer to call me Dewey. And generally, when they are friendly, they call me Dewey; when they are hostile, they call me Duane. Perhaps I'll get an indication in the response to my comments.

Now, my company is--and I personally am--very pleased to be invited here today and have the opportunity to comment further on the current status and the future course of corporate financial reporting. Considering all the confusion and controversy surrounding financial reporting today, we were delighted with the bold step taken by the AICPA last year in establishing the Wheat Committee and the Trueblood Committee.

In passing, we would like to express our strong support for the recommendations of the Wheat Committee, as it has in our opinion successfully accomplished a very difficult task. The proposed structure for establishing accounting principals, or standards -- if you like -- is a good plan. It achieves balance among all of the concerned groups, and should work well..

We, like many of our associates in the non-CPA field, felt the previous Board was too heavily weighted with the CPA

profession. They are pleased that the AICPA has now approved this proposal--as I understand, just last week--because it can prove to those not directly involved that the accounting profession can develop a system of self-policing that will serve the public interest. We hope the new Standards Board will receive strong support from all quarters of our society.

And I'm delighted to inform you that our Chairman, Mr. Fred Jaicks, has publicly pledged financial support of our company to the new Board in a speech he made to the FEI group just last week.

Now I'd like to turn to this Committee's task of establishing the objectives of financial reporting. We submitted a brief position paper, and we deliberately made it brief; but I would like, in turn, as background, just to brief that brief report, covering simply some of the conclusions that we arrived at, without going through all the rationale.

First, we feel that the basic goal of reporting is communication between management and the various publics it serves. It seems from the testimony I have heard and the other position papers that there is considerable unanimity on this point, with the possible exception of the points raised in their previous discussion.

Second, since communication is directed to diverse interests in these various publics, we have come to the conclusion, as preparers of reports, that no single one type of reporting is appropriate for all these needs. Therefore, we think

management has a primary responsibility to its owners, both present and prospective; and perhaps I disagree with my colleagues in MAPI in this respect.

Third, reporting should realistically reflect management's actions, plans, and performance, and we think some of the things that have happened in the past few years are departing from that trend -- which I will comment on later.

Fourth, the concept of value, we think, is fundamental for your Study Group. Should value be based on actual, or historical cost, or on some theoretical or economic value. We have concluded from our studies that a departure from historical cost, at this time at least, is fraught with more problems than it would solve. Here I would agree with the testimony of the MAPI people. More research is needed before the profession should move in the direction of current value accounting.

Fifth, the philosophy of conservatism should be re-examined and evaluated. We support the continuation of the conservative convention which our company has historically always supported. However, in reading over the papers, I think it was one of the Big Eight firms that made the point of objectiveness rather than conservatism, and I rather liked that. As another devotee of profit planning and budgeting who has spent many years in this field, I have always answered the question of the users of our system, "Which way should we lean in the forecast?" by saying: " Call it what you really think it's going to be, as

close as you can do it. Don't lean to one side or the other."

However, we do lean in the direction of booking losses as soon as we see any trouble up ahead, and not of anticipating profits. We have followed that, and continue to believe that is the valid approach.

Sixth, the role of social costs, which is a hot subject today, should be evaluated in terms of its relevance to financial reporting objectives. We are very concerned with the whole social area in our company, and have been for many years, but we don't see at this point that financial reporting is a proper place for this to be included. However, we would recommend major research of this issue be completed before anything is done adopting this as a requirement in corporate reporting.

Further, we don't believe accountants, particularly, are qualified to make the measurements of this social cost area.

An article just out in the Conference Board by George Steiner, at UCLA, on social audits is interesting. He doesn't even include accountants at all in his list of people who have the expertise to do this job. And I think accountants should have a place in the setup, but I don't think it should be a predominant role.

The role of flexibility must be examined. This has bothered our friends in the Financial Analysts Federation, and the public at large, and I think with good reason in some cases. But, perhaps to the point of considering a different approach to public accountants' attestation function, we are particularly in-

trigued by the proposal made by Mr. Tietjen, of Price Waterhouse, in his recent paper in the January issue of Price Waterhouse Review, in which he stakes out a different posture for the CPA. I think that's really for the Committee's investigation.

Now, we also recognize the need for narrower limits in accounting standards. We agree there is far too much latitude in current practice, but experience within our own family of companies--and this may surprise many of you, that our company, along with most of the other major steel companies are now becoming more conglomerates than they are steel companies. It's just that the steel companies are still an overwhelmingly large part of the total numbers. We're everything from housing, and the whole spectrum of housing and mobile homes, to large condominium and apartment-type projects, we're in the machine-tool business in a small way, in service centers and warehouses, as well as basic steel and mining.

In all these there are tremendously different accounting problems, and we have had very little luck in trying to get uniformity even within our own accounting structure in the family of companies.

I find very hard to refute the argument for reporting earnings forecasts. Especially, as some of my friends who are in this audience are aware, I was espousing this in the very early days, along with Dave Green and Sid Davidson of the University of Chicago.

However, I have had a change of heart since assum-

ing my present position, where I feel the weight of responsibility as the chief accounting officer of my company, not as just the budget director, and, particularly, I look at the lawsuits, both litigated and those that have been threatened, and this gives me great pause, for reasons that were pointed out in the previous testimony by the MAPI people. At this stage of the game, until we can solve the potential liability problem, we better be careful because the best of us are going to miss our forecasts by a wide margin in some years.

Therefore I'd recommend additional research and a great effort in public education, at least to the investing public, before we adopt this risky step.

All of these points were discussed in our position paper, and we urge that the Committee consider them most carefully.

Now I'd like to turn to one particular point touched on in our paper, and elaborate on it what I call the role of management in financial reporting.

I believe management's primary responsibility is to utilize the resources entrusted to it by its stockholders in the most effective and efficient manner possible, in order to produce the best possible return on the investment of the owners. Now, I deliberately eliminated the words "maximize" or "optimize," because in our company we recognize our social and public responsibilities, which are constraints on maximization; but our emphasis is still there.

If this were not true, we feel there would be no corporation, because -- after all -- profits are the engine that drives the economy, and without them we couldn't do all these nice things for the community and the public at large.

Of course, we recognize secondary responsibility to the other publics, including the employees and their labor unions which represent them, our customers, the communities in which our Corporation operates, and the public at large. Responsibility to these groups may require reporting, as I have commented, on social costs in particular, but not necessarily financial reporting. We don't think financial reporting is the appropriate vehicle for dealing with the social costs that are coming up out of society. We think such an application would cloud and distort the basic purpose of financial reporting. Therefore in our minds, this leads logically to the statement that financial reporting should be oriented toward management's primary responsibility -- its stewardship.

The value of the investment to the investor, potential or present, lies primarily in management's skills and expertise and the company's future earning potential. Therefore, the reporting should first be relevant and, second, a reflection of reality, and not some what-may-be, what-might-have-been situation.

As one illustration of a lack of realism, I'd like to cite the experience at our company and another one -- a neighbor of ours -- and what's happened with the allocation of taxes, or deferred tax liabilities, on the timing differences of taxable and book items -- the principal one being depreciation, of course.

You are all familiar with that technique.

Now, we believe that those items with a timing problem, relatively short run items--say, one to five years--that this makes sense, and we don't quarrel with that logic. A good example of that is the now defunct treatment of production, payments, or so-called carved out mineral properties which most steel companies and petroleum companies have engaged in over the years. It is now outlawed by the Treasury.

But for other items, and particularly depreciation, the difference between accelerated and book depreciation, where you are using the two different methods, has created, I think, just a disastrous situation. This creates a growing mountain of liability in the balance sheet that is meaningless in an on-going business. As long as the business continues to prosper, investments in new plant and facilities will continue to be made in an amount that will grow.

Our company, like MAPI cited, or the Eaton Corporation, has had a similar experience. We have replaced about 75% of our assets in the past decade, spent over a billion dollars in capital expenditures on gross values of \$1.5 billion. So we think that minimized that problem.

Reflecting this accounting opinion, we now have a liability on our balance sheet at 12/31/71 of \$65 million, and we project it will reach \$100 million by 1974 or 1975. This is becoming a very significant liability, and, in our minds, will never be paid, and is completely meaningless.

Sears Roebuck, a neighbor of ours, one of Sid Davidson's favorite citations on this subject, had \$680 million at 1/31/72, the end of its fiscal year. I don't know about their forecasts, but certainly they are going to reach a billion-dollar level by the end of this decade. Again I ask: "Is this meaningful or realistic information?"

Now, you might ask: What happens if the capital inputs decline--actually slow down or decline? Well, my observation of the business world in the past 25 years is that companies either grow or they die, and I think all you have got to do is look at some of the companies that have gone under in the past few years, and you will see what I'm talking about. Before that liability would ever become due, the company is going to be running large losses--taxable losses--that will more than offset potential liability. So here is one of these "what if" things that I think are not defensible.

The result is that annual profits are understated. We have all been concerned by overstatement. Here's a classic case of understatement, and management reporting on its stewardship--is required to state that it is doing a poorer job than it realistically thinks it's doing.

Is this a proper objective of financial reporting? We don't think so.

Another example of this sort of thing came up in the Price Waterhouse paper, which I would like to quote, because it also confirms our own experience in our housing business.

One of the anomalies of the business world that is a source for mistrust of the accounting process is the wide discrepancy between the considerations that enter into decisions to commit corporate resources to a project and the accounting conventions that measure its results. The manner in which the most successful real estate investments regularly report a loss in an accounting report is a scandal.

That's a strong statement, but one of the problems we're wrestling with is that very one. We run financial models for potential investors which show the tremendous economic advantage to them and to us, and yet we have great difficulty reporting book income on these large syndications.

My next point is that financial reporting should measure management performance. There seems to be general agreement on that in the papers. The only question is: Who should do the measuring? We feel that this is management's primary job, although we do not object to other people stating their own opinions, much as a critic does of a play, or other composition.

Regarding earnings performance, I have said earlier that this is a most important consideration, in our view, that the investor takes into account in making his investment decision. In this context, the valuations on the balance sheet are basically irrelevant to an evaluation of how well the business is being operated.

Now, I was troubled with this statement, and I got some help just last night when I caught up with an article that

my friend, George Sorter, wrote in a recent issue of Journal of Business, and I have been trying to come to grips with the same kind of idea that he is--that of some way reflecting the change in economic value, if you are going to go that way, as separate from measuring the earnings performance of the enterprise for the year. Perhaps that's an avenue for further research.

The objective of financial reporting should be to provide the most realistic report possible on the operation of the business. My particular pet peeve, if I may say so, in my advocacy today, is the lack of recognition of the tremendously growing use in American business of what I will call managerial accounting.

I don't want to get into a hassle on direct costing versus full costing. We have been arguing this for 20 years, and we aren't going to argue about inventory valuation when that's irrelevant to my point. My point is that today our company, for instance--and it has occurred in the past decade--has swung almost completely away from a management of the old style. We came up the hard way. Now something like 80 to 85% of the top 400 managers in our company are MBA's or MBA equivalents, and they think in these terms. They make their analyses this way, and their decisions. We run our accounting reports entirely in this fashion, and we measure the results in this fashion.

Now, what do I mean by managerial accounting? Some of the most central things are the recognition of fixed and variable costs. In filling this in for the P&L statement, I

think it would be a great help to the analyst in particular to separate these, and not lump everything into a typical 10-K format, as we tend to do.

Then the use of marginal profit concepts, incremental value, contribution margins, and return on invested capital--these are the tools and the criteria that managements are using more and more.

I have observed that many analysts--and I will editorially say the good analysts--attempt to recast our statements in this format, and I have one particular favorite that I won't name who is a steel analyst, who does this, and he comes amazingly close to our criteria. Many analysts are now attempting to recast their analysis information from the published statements into managerial accounting format, in trying to forecast earnings based on their own forecasts of what's going to happen. And one or two of these fellows have been amazingly close to our own internal forecasts and to our own results.

Therefore, this encourages me to believe that the use of the managerial accounting approach would serve the needs not only of management but of the primary users; that is, the owners, the investors, the investment analysts who help the investors, and even lenders.

To illustrate some of the distortions that occur under present day accounting, I will say I'm much dismayed by the direction that the APB, the SEC and the Treasury are going in this direction. They are moving more toward full costing, rather

than direct costing.

As you know, absorption costing includes fixed costs in manufacturing overhead in the inventory value. There's an argument on the inventory valuation side that I won't go into here, but my point is that from a managerial standpoint and from an analyst's standpoint in periods of low sales volume management can make its earnings look better by running high production and gambling on building inventory, because these credit costs are being capitalized into the inventory account.

But an even more serious problem is the misleading nature of total unit costs on management's strategies and alternatives. Accountants are telling the manager that under full costing his prices are too low, at the very time that he should be cutting prices because the market demand is soft, and vice versa.

Of course, direct costing avoids this problem by not capitalizing fixed costs as inventory. Thus in a period of low sales volume the fixed costs fall down to the bottom line of the earnings statement, and in my opinion reflect what's really happening.

Therefore, following this through, the valuation of inventory and what I call opportunity costs--or the marginal costs of production--would fit the managerial accounting structure of the income statement. I believe this approach would provide more relevant data for economists, analysts, and even the government agencies interested in tracking the movements

of the total economy.

In conclusion, I'd like to say that in our brief presentation today we have tried to point out that management's primary responsibility is to produce superior earnings commensurate with risk. The objectives of corporate financial reporting should be to report on how well management is doing that job. Financial reporting must be relevant and realistic to provide interested users with appropriate information for their own investment decisions.

Thank you very much, gentlemen.

MR. GELLEIN: Thank you, Mr. Borst. Thank you for a well-written paper, and for a very fine and clear presentation. I found it quite stimulating.

I know we don't propose to debate--and I know you don't want to debate--Opinion 11, and tax allocation, but I want to use your illustration to pose my first question.

You referred to these so-called liabilities--I'll call them balance-sheet credits--as being unreal, and to the fact that the growing magnitude of them was an indication of the lack of reality. You know, what seems to be real unreal so often seems to rest in the eyes of the beholder. Some say they are real, and some say they are unreal.

So my question really is this. We here, of course, are concerned with the development, the statement, the articulation of the objectives which in turn, we assume, would lead to reality in accounting. Using tax allocation as an illustra-

tion, would you have any comments on how we might state an objective of accounting which would eliminate the unreality to which you referred?

MR. BORST: I can only...

MR. GELLEIN: By the way, if you can answer that one, we've got our report written.

MR. BORST: Well, one way of looking at it that I thought of, kind of inspired by George Sorter's approach to the thing, is that if you use the discounted-value concept--and I'm talking about going concerns--nowadays large corporations are virtually immortal, as someone said--even if you agreed that that liability would occur some time in the future the discounted value is so far out that its present value would be practically zero.

MR. PARKER: On this question of deferred items on the balance sheet--if I remember correctly, following the passage of the Revenue Act of 1954, the Inland Steel Management felt that the accelerated method of depreciation was the proper way to report income to its stockholders. And after the revenue Act of 1962, when guidelines were established, that indicated going to the shorter guidelines as an appropriate way, and that it was appropriate to spread the investment-tax credit. In 1968, as I remember, the management decided that straight-line depreciation was right for the stockholder, and that it was now right to flow through the investment-tax credit.

Do I understand now that you feel that even the other half of the difference between what you report on your tax books

as depreciation and what you report to your stock-holders should also flowed through to income? Do your ideas about the economics of the business, or the rate at which assets depreciate, change that much over less than ten years' time? And how is this to be helpful to the stockholder-to make your method of computing depreciation more and more different from, say, competitors for the investors' dollar, such as Caterpillar and General Motors, who still report to their stockholders the same way they always have, using the accelerated method of depreciation? And how do we frame an objective that makes things fair in this area for the stockholder, who, I gather you feel, is the primary person who is supposed to be helped by this reporting?

MR. BORST: Right. Well, that's an excellent question. In fact, our Chairman dealt with this very question briefly in his speech last week, and the Chicago newsmen devoted two columns of a four-column story to a two sentence statement, and reopened this whole issue; so I welcome the opportunity to talk about it.

The answer is: Yes, we did change our minds about what is valid depreciation. As you pointed out, in 1954 we felt that we were getting less of tax-deductible depreciation than was warranted from a competitive standpoint, and of course this situation was worsened in the international steel market, as you know.

MR. PARKER: As I remember, the reference also was not only not enough for tax purposes, but not enough to reflect the economic facts of life either.

MR. BORST: Yes. Let me get to that.

You remember in 1954 we were still using, up till then, Bulletin F lives, which were relatively long. As time has marched on though, the lives have been cut, including the new ADR, which is helping to correct the original situation.

At the time we did feel that accelerated depreciation would be a better economic measure in 1954, but in the experience that I just described, where we invested a billion dollars in capital goods and equipment in the past decade--as we tracked this experience, we found that we were pyramiding our costs--not just depreciation--very heavily in the short run, and we thought this was distortive in the matching concept of costs and revenues.

For one, we found start-up costs were very, very much more expensive than we expected, and this has been noted in the press. And, reflecting our conservatism--and I think the whole industry does this--these were all expensed. So you not only have the heavy costs, but you have the low-volume production, because you couldn't get the unit up to speed, which raised the unit cost once again.

So we charted these things, and we saw tremendous balloons of cost in these early years. Also, even though we know from experience that obsolescence is a technical factor and an economic factor, in reality our blast furnaces are over 40 years old. Our newest one was built during World War II. We have increased the productivity of those blast furnaces about 300% in the last decade.

Should we say that that should have all been accelerated--written off in its early years--when it's still performing the function now? Is this the total matching-of-costs-and-dividends concept that I have described?

It's true that our move was triggered by the actions of the marketplace, particularly when other steel companies were moving in this direction. I don't know their reasons, but we wound up with only one other company in our whole industry that was filing accelerated depreciation and amortizing the investment credit. We felt that this was not being properly evaluated in the marketplace, and therefore as responsible managers to our stockholders, we felt that we had to become comparable.

This led to the study which in turn, in my mind, convinced me that it was right on its own, on economic terms as well, and I still feel that way.

MR. GELLEIN: I wonder if we could turn to another question. Frank?

MR. WESTON: In connection with the development of managerial accounting and, as you indicate, the use of discounted cash-flow techniques, opportunity costs, and so on, could you tell us whether your MBA group and your younger managerial accounting types do use any indication of rate of return on value and opportunity costs in connection with the operation of the company?

MR. BORST: Yes. We use these extensively.

MR. WESTON: We have been told generally in our interviews that management does not use opportunity cost and dis-

counted cash-flow and current values in determining the rate of return on investment, but that they always use historical cost. My question is: Do the new techniques pay more attention to alternative investments, opportunity costs, and annual return on what you might call closer relative values?

MR. BORST: Let me distinguish that. At this point in time we are heavily using these techniques for new decisions, both short run and long run. When we are looking at a strategy for the next six months, we look at the opportunity costs.

MR. WESTON: But do you use that to evaluate existing non-decisions? In other words, a decision not to...

MR. BORST: No, we have not got to the point yet.

MR. WESTON: Why not? Why has that happened? I don't understand why that would be true.

MR. BORST: We have not got to the point yet in measuring internal rate of return as a measure of profitability within the Corporation.

MR. WESTON: You use this for new decisions, but not for hold and don't-sell decisions?

MR. BORST: We just haven't evolved that far yet. If we were smart enough to know how to do that in the total group, we would do it; but we are moving strongly in that direction.

MR. GELLEIN: We could take one more question.

MR. REINHART: I was curious about your proposal on the use of direct costing. Would that indicate that your concern is more toward the income statement than it is to the balance sheet, since direct costing tends to undervalue inventories on

the balance sheet?

MR. BORST: I'm not sure if I understood your question, but let me restate the point I was making.

MR. REINHART: Well, what I was saying was: If you follow the direct costing principle, I understand the advantages of that with regard to present earnings, I guess, because earnings react much more...

MR. BORST: Dynamically.

MR. REINHART: They are much more reactive to it. But would that indicate that you would state your inventories on the balance sheet on a direct cost basis, and therefore generally understate them, as to their value--which would indicate to me that you think the income statement is more important than the balance sheet?

MR. BORST: Yes. That's why I referred to George Sorter's monograph here, because that problem distresses me too. When you turn to the balance sheet side, for other users--lenders, and so forth--who are interested in the value of your assets, then I think we have got a problem.

Now, I might also say that no matter what method we use in industry to value inventory, it does not reflect its insurable value. It doesn't reflect liquidation value. So I think it's an irrelevant question anyway. That's why it doesn't really disturb me as much.

MR. REINHART: Although there are some relationships between the valuation of cost of sales, if you still have that

in the income statement and inventory terms--I mean, on a direct cost, understated inventory basis--it would appear, looking at a statement like that, that your inventory turnover was very rapid, and I think it can also be misleading to the investor as to how much inventory you actually are sitting with, if it isn't related to the cost of sales number.

MR. BORST: True, I don't have answers to all those problems, but let me ask you in turn: How does the investor handle the same question with companies like ours that are on the LIFO method, where the balance sheet figure is substantially below current costs, even on an absorption basis, much less any concept of current value? I'm not trying to use another negative to upset your point.

MR. REINHART: I'm supposed to have an open mind on this committee, but I would rule out all inventory valuation except FIFO.

MR. GELLEIN: Mr. Borst, thank you very much for your contribution to our efforts.

The National Society of Public Accountants.

CHAIRMAN TRUEBLOOD: Would you introduce yourself, Mr. Passero?

MR. RUDOLPH J. PASSERO: Yes. My name is Rudolph Passero, and I'm presently serving as the President of the National Society of Public Accountants. Accompanying me today is Miss Phyllis Borghese. She's Director of Education for our National Society.

I believe you all received our statement, possibly a little late. We tried to arrange it so that it would be here in time for your hearings, this past Monday morning.

By way of introduction, I'd like to make mention that the National Society is an organization of over 13,000 practicing accountants located throughout the country. There is a public accountants' association in each state affiliated with the National Society.

The members of the Society of course are, for the most part, either sole practitioners or partners in moderately-sized public accounting firms. NSPA members provide--as do members of the Institute--accounting, auditing, tax preparation, tax planning and management advisory services to individuals and to small to medium-sized business concerns.

Members of the Society are pledged to a strict code of professional ethics and rules of professional conduct, and we believe that they are no less stringent than those applicable to CPAs under the rules of the American Institute of CPAs.

In the important area of technical competence, the Society--in order to promote a uniform application of professional standards--has adopted with the Institute's permission the AICPA's auditing standards and procedures for its members. All NSPA members are duty-bound to adhere to these generally accepted procedures for financial reporting. Also, various American Institute literature is made available to our members through our Society as new material is issued by the Institute.

It is our belief that these comments being presented today reflect the views of an overwhelming number of accountants, including many thousands of other public accountants and local CPAs not affiliated with national firms, who provide virtually the same services through the work that they do and the audits that they perform, although the purposes for their development of reports may vary slightly.

For purposes of this group of small and medium-sized practitioners, then, management and enterprise owners and lending institutions constitute the primary users of financial statements which form the basis for financial business decisions. It should be noted that often the owners, who may include sole proprietors, members of family held partnerships or of closely held corporations, may also be the management.

For a long time, reference to financial reporting has been limited for the most part to reporting for large, complex firms. It must be recognized, however, that there are problems peculiar to reporting for small firms.

In the average business situation where we render services, the business enterprise is too small to require or justify the number of persons needed to be involved to achieve good internal controls in the accounting function. It simply would not be economical for the client. Or, if the system has been ideally designed, in the closely held businesses there may be deviations such as shortcuts from authorized procedures. Contrary being an ideal situation, it does not necessarily mean, however,

that such occurrences are unsatisfactory either. In the case of the small enterprise, when actions are initiated by the top echelon of management, such persons are also the controlling or sole members of the small business. Therefore, the reasons for such conduct is merely for expediting matters. Besides, in the smaller concern management is in a position to more closely supervise operations, though perhaps lacking conventional internal control. In the small firm, internal control is basically a tool for exercising managerial control, whereby in the larger entity it is used to test the effectiveness of management. It should be stressed that there is a fundamental difference as to the purpose of financial statements of the smaller client.

Characteristically, in the small-scale unit, the accountant is reporting to management, which often is the controlling stockholder, and to creditors--more often bankers. This is distinguished from the usual purpose of the large audit of major companies, when the accountant is reporting not to management, but about management and management's achievements, to shareholders and creditors.

While large or publicly held corporations maintain a staff of accountants, the smaller firms with which local accounting practitioners deal often lack this ability internally. Thus, the accountant who fills this gap in his client's organization provides an additional valuable service.

As an outsider, the relatively small accountant in public practice has, we believe, greater objectivity and also

is more tuned in to the specific needs of his client.

With his broad background resulting from a combination of education and experience with clients in varied businesses, he can offer alternative recommendations from which the client can select a course of action.

The main third-party user also includes the credit grantor. Increasingly, the lending institutions play a part in commercial ventures.

During the past years of inflation and increasing income taxes on small business enterprises, it has become more and more difficult for an owner of a small business to retain profits which might increase his net worth or capital. Each year it takes more capital to support a growing sales volume, to purchase inventory, to give pay raises and benefits to employees, and to keep up with other operating expenses. Inflation, as we all know, has added greatly to the cost of doing business; so, when a suitable profit is realized at the end of the year, the income and other taxes siphon off a chunk of that profit which otherwise might have been kept in the business to increase capital. Consequently, the small businessman has become more and more reliant on bank loans to supplement his own capital.

In order to respond to the needs of these three prime groups of users of financial statements, financial reporting should reflect information expressed in monetary terms. Generally speaking, financial reporting should be based on historical cost and completed transactions.

Besides the prevailing view of the accounting profession and various government agencies such as the SEC, there is an important factor supporting this basis. Attempting to measure values on the basis of forecasts of earnings and of capital appreciation most decidedly introduces an element of uncertainty. Therefore, such estimates are better expressed in supplemental disclosures. The inclusion of budgets and forecasts should not be part of the basic financial statements, but rather, they should be presented separately in order to distinguish these items from the historical financial statements which provide a better basis, financially speaking.

Indeed, it may be appropriate to furnish this information not only to management but also to credit grantors, as such forecasts or projections are beneficial to those who need such information for decision making. Management, owners, and bankers are as interested in such supplementary disclosures focusing on what is expected to be accomplished as in what did happen.

Financial statements are more effective when comparative information covering several dates and accounting periods is given. Analyzing monthly statements can disclose the effects of seasonal fluctuations, and so forth. Inclusion of statements for several years can reveal whether the entity is expanding or declining or has reached a plateau, or if perhaps the business is subject to erratic changes from time to time.

To be useful, financial statements should be ana-

lyzed and interpreted, for the results can be indeed revealing for the necessary decisions to be made.

Comparative figures and key business ratios provide vital data for the banker who is naturally concerned with recovering the funds loaned or to be loaned with minimal risk. Besides indicating the ability of the borrower to repay in the case of the lender, such information is invaluable to the entrepreneur.

After all, in most circumstances, the basic purpose or objective of organizing and operating a business is to achieve satisfactory profits. While the income statement shows how successful management has been in attaining this goal, the analysis becomes more meaningful when net income is related to sales, net worth, prior years' earnings, and so on. From the balance sheet can be determined if the business is solvent, and how solvent, in addition to the likelihood it will remain in that state for a given period. The significant test consists of the ability of the enterprise to pay its liabilities as they become due rather than merely having more assets than liabilities. To measure the adequacy of working capital it is necessary to indicate fair market values of assets, maturity dates or payment terms of obligations, and similar information as part of the statements.

Since being able to assess the customer's liquidity is an important objective of those who grant credit, making available to them cash flow information along with sources and uses of working capital as part of the basic financial statements will certainly be of assistance in providing the primary

basis for such determination. Such additional information is useful to management and others too, of course. The various funds statements complement the conventional statements by reporting changes not otherwise readily discernible relating to financial activities of the business.

Whereas the long form audit report is rendered predominately to large clients, it is appropriate, if not more appropriate, for the smaller client to have this service. Various analyses, comments, ratios and additional statements would provide the smaller entity with a better understanding of the financial data. However, ironically, the client who could perhaps benefit greater from the long form report often is the smaller client who cannot always afford this type of service.

Much that has been said about big business is presumed to apply to smaller enterprises as well. On the contrary, the small and medium sized businesses which are so fundamental to our economy have their own problems and peculiarities which must be handled in ways distinctively applicable to them.

For example, just recently, it was announced that small business firms--by definition, they were taken to mean those which have fewer than 60 employees--with certain limitations, are now exempt from the wage-and-price regulations. Significantly, this exemption affects five million small businesses which account for approximately \$500 billion in total annual sales, or 28% of all sales.

Accordingly, we must not lose sight of the fact that

we serve the small businessman, and therefore consideration should be given to the role or function of the accountant in public practice who has a different audience and which may perhaps result in a major difference in the purpose of financial statements.

The National Society shares a great many interests with the American Institute, and we feel this is an important first step today. It demonstrates the great common area of interest between our two organizations.

This kind invitation to participate in these hearings is a big step forward and this presentation of our views today shows one area where working together has made a significant contribution, particularly from the viewpoint of those professionals who provide financial statements and reports for small and medium-size clients. Of course, there are other areas--the ethical standards, professional development, accounting principles, auditing procedures and standards, community services, aid to small businesses, and assistance to minority groups. These and yet other important areas are indicative of our many common goals.

Miss Borghese and I sincerely appreciate the opportunity today to express our views to this important Study Group and to promote a closer liaison between our two organizations. We hope that you will feel free to call on us at any time if we may be of some assistance.

CHAIRMAN TRUEBLOOD: Thank you very much, Mr. Passero, for a very nice presentation.

I gather that in many respects, apart from our commonality of interest on the broader objectives, you are making some considerable plea for an expansion of information to smaller business community, which may even be in the subjective area, but should be supplemental as distinguished from required, and an integral part of statements as such. Do I understand correctly?

MR. PASSERO: That's a fair statement, yes.

CHAIRMAN TRUEBLOOD: Anybody on the panel who wishes to...?

MR. GELLEIN: Just a general question.

You referred on page 3 to the fact that there is a fundamental difference as to the purpose of financial statements of the smaller client. Now, granted, you might say the fundamental difference runs to the number of users and the classes

MR. PASSERO: Yes, sir.

MR. GELLEIN: And do you think that difference in the users and the classes of users calls for different objectives, and therefore different basic considerations in the preparation of the financial statements themselves? I'm thinking of the determination of income, for example. Does it run to that, or does it simply run to the way in which the other information is disclosed? That's what I'm trying to get at.

MR. PASSERO: I think more along the lines of the methods that are used to bring supplemental or additional information to the attention of the management of small business

users.

CHAIRMAN TRUEBLOOD: Just to make me perfectly clear on that--inventory valuation, for example, in the sense of principles, objectives, disclosures, and so on, would be commonly treated, as between...

MR. PASSERO: We would not advocate a change in that procedure.

MR. PARKER: I noticed your reference that in some of these reports there ought to be preparation by the accountant of some relevant ratios. Would you have any feeling that that ought to be included as a part of some kind of subset of general objectives for financial statements?

MR. PASSERO: Well, I believe it's probably desirable, to the extent that it can be brought into the basic financial statements, to represent them along with the basic financial statements. If it is not appropriate to work them in as part of the basic statements, then of course it ought to be laid out in the form of supplemental information.

CHAIRMAN TRUEBLOOD: In addition to ratios and that sort of thing, I believe you put some emphasis on cash analyses and flows, and so forth. Picking up Reed's question about ratios and my observation about the cash status, would you feel that your members should generally attest to those supplemental data or merely supply them?

MR. PASSERO: Well, we would be treading on thin ground here, indeed, when we talk about attestation of some of

the supplemental information. I can envision some instances where attestation would be appropriate; in others, frankly, it would not.

CHAIRMAN TRUEBLOOD: But the attestation form, I suppose, might take a somewhat different form than the standard ones we use?

MR. PASSERO: Depending upon the information, yes.

CHAIRMAN TRUEBLOOD: Any other questions from the panel?

MR. WESTON: I have a brief one.

We have had a bit of discussion over the last three days about the use of fair values in financial statements, and I wonder whether the type of statement that you describe in your paper would fit their usages, whether fair values have entered into any of those determinations.

MR. PASSERO: Well, certainly fair values ought to be brought into play in the financial presentation. I think we're all probably pretty well convinced of the need for presentation of fair value. It has its place in the presentation of financial data. Again, I don't mean to infer that it necessarily ought to be carried as part of the balance sheet, but rather to be supplied in some form of supplemental data. It has its place. I think it's important.

Mr. Block, from the floor, points out that on page 5 you take the position that financial reporting should be based on historical cost. On page 7 you say that in order to measure

the adequacy of working capital it's necessary to indicate the fair market value of the assets.

Now, may I rightly assume, or would the correct answer be, that this fair-market-value indication is also supplemental data, so it can be worked in but not become a part of the statements?

MR. PASSERO: Yes, it needs to be worked in, in some form. It's too important to leave out.

CHAIRMAN TRUEBLOOD: But as a principle, you stand by your page 5 statement?

MR. PASSERO: Yes, to stay with historical cost.

CHAIRMAN TRUEBLOOD: Any other questions?

(There were none.) All right, if there is nothing else coming from the floor, thank you very much.

MR. PASSERO: Thank you, gentlemen, again.

CHAIRMAN TRUEBLOOD: We appreciate your coming, and we agree completely with you on the desirability of our cooperation and our commonality of interests.

Mr. Jewett of Technical Audit Associates will be next.

MR. FRANK B. JEWETT, JR.: Is this the hot seat?

CHAIRMAN TRUEBLOOD: That's the hot seat, Mr. Jewett. I'm sorry to inconvenience you with respect to our rescheduling, but we appreciate very much your making yourself available.

I think it might be helpful, particularly in this case if you would explain just very briefly the nature and purpose of your organization. Some of that is included in the paper, but maybe just a little prelude on that, before your summary of the

paper, would be helpful.

MR. JEWETT: Yes, sir.

I have spent my whole life at the interface between technology and its applications, including several years as President of Vitro Corporation, which had major systems-engineering responsibilities for programs like the Polaris, the Poseidon program, and so forth.

After a merger, where they didn't need two presidents, I had a sabbatical year to contemplate the forest instead of the trees, and during this period I began to see what I thought was an answer to some of the problems that were emerging in the management and control, and assessment of major development programs-- the kinds of things that have led to all of Senator Proxmire's very great furor.

It became increasingly apparent to me that one of the problems lay in the management structure under which these programs were run, which was something that worked pretty well twenty years ago, but where a number of changes in the technical environment had changed the ground rules of the ball game, and essentially reduced the effectiveness of the decision maker by limiting his knowledge of what was really going on in his program.

This resulted from a number of identifiable changes-- increase in size, increase in the pace of technological development, increasing complexity of programs. Just to give you an order of magnitude, on the Polaris program there were somewhere between 10,000 and 20,000 suppliers. There were 67,000 people

in many thousands of different organizations involved in the development team. This all had to be integrated, information had to pass, and just very simply--actually one morning while shaving--I thought: Well, by God, the decision maker has only one channel of information coming to him, and the things have gotten so complicated that he is no longer like the old director of a laboratory where he knew everything that was going on, and knew as much or more about all of the technical decisions as all of his people. Now you have people reading reports with recommendations that are made by some other organization, people they don't even know, and about subjects in which they are not necessarily completely competent.

The problem of the decision maker is that he is no longer in a position where he is a good judge of the validity of the information that he is getting or he may not be getting. And if he is not qualified to judge the reliability of this information, he is neither in a position to ask the right questions nor to interpret the answers properly when he's asked them.

Again I go back to the fact that he tends to be dependent on a single line of communication.

So it seemed to me that technology had come to need a function which was somewhat analogue to the function of public accounting--a competent, redundant line of communication that would either validate the information that the decision maker was receiving, by saying: Go ahead. Make whatever decision you want; what you are getting is complete, it's objective, it's

good. Or it would say to him: Watch out, because there are areas here that have not been included in the information that's getting to you, or the test data has not been properly evaluated. In other words, it would give him a warning that would enable him to focus his attention on potential troubles early in the game.

I have had a lot of good ideas in my life--ideas that I felt were good--and usually I found they weren't much good, for a couple of basic reasons. Either somebody else had already undertaken them, and it was too late, or they were no good for some reasons that weren't very obvious to me.

So I started a procedure of trying to get shot down early with these smart ideas that I would have, and I started talking with a large number of people who were eminent and expert in the various areas of technical management--not just technology, but also the other things--financial management and the other aspects that go with it. And instead of getting shot down, I found that more and more people agreed with me that this sounded like a sensible approach to improve the management processes in technology.

But if you stop and think of this process, it becomes clear that it extends to a lot of areas. It extends to the kind or the quality of information that goes into prospectuses, and to whether you can escape trying to evaluate technical matters by just declaring with a caveat that there's lots of risk in everything, and so forth, and duck the issue. This is an area that I think demands attention, because I think there is a better way of doing it.

Now, that's a long preamble to answer your question as to what I'm doing. What I have done is to organize a small firm, and you're looking essentially at it--although I do have quite a few associates in the thing in a rather informal kind of way--called Technical Audit Associates--to try and practice what I was preaching. And in my view, if I am right, I am going to try and be a pioneer and forerunner of what I believe may develop in some form, somewhat related to what I see as the first of a new profession of independent technical auditors.

That is the background.

CHAIRMAN TRUEBLOOD: Thank you very much.

MR. JEWETT: Now, would you like...?

CHAIRMAN TRUEBLOOD: Yes, if you would proceed to summarize your paper; it has been made available to the members of the Study Group.

MR. JEWETT: Mr. Trueblood and members of the Accounting Objectives Study Group: I appreciate the privilege of appearing before you. My prepared statement is brief, and copies of it are available. I will be glad to respond to any questions you may have at the end of my presentation.

It is recognized that you are addressing a broad spectrum of subjects having to do with the objectives of financial statements and the relation of the public accountant's opinion to them. My focus is on one restricted but important area within your total context; namely, the impact of technology on the assessment and reporting of business activities.

The process of applying technology to the production

of new products has undergone dramatic change during the past twenty years. The rate of technological development has accelerated. Increasing size and complexity have intensified the problems of integrating more diverse sciences. The time interval of development processes has lengthened. These circumstances are at the root of much which is going wrong with the management, control, and assessment of technology today. The problems are fundamental. They cannot be ignored nor can they be cured by tinkering with procurement policies or other modifications of surface phenomena. The difficulties lie in the very structure and system of technical management. The end result is that in many companies, the decision makers have been overwhelmed by the existing processes for assessment and management of changing technology. No cure will be effective unless it recognizes the nature and addresses the fundamentals of the changes that have occurred.

From the public accountant's standpoint, the nub of the problem is that technology can make financial statements grossly misleading. Technology has placed the public accountant on the horns of a dilemma. Long-term, technically based endeavor has become so important in many business situations that technical considerations may dominate all others; yet the public accountant has no basis for expressing an independent opinion on these matters. He must rely on management's judgment, and management's self-assessment of technical matters can be faulty.

For example, when a company is building a major processing plant or a C-5A airplane--projects that may take several

years to complete--the capitalized values appearing in its financial statements during the intervening years can become crucial. In its 1968 Annual Report, Lockheed reported inventories of \$775 million applicable to the development, production, and testing of the C-5A. Total shareholders' equity amounted to \$371 million, so the C-5A work-in-process inventory alone represented more than twice the shareholders' equity. These inventories presumably were valued at the lower of cost or market. By hindsight, we now know that they were greatly in excess of market. This fact was far more important than any other consideration used by the auditors in examining the Lockheed statement. The inventory in question was not, however, a normal manufacturing inventory, because the C-5A project involved substantial development, and the verification of the development values in the work-in-process inventory dollars was a matter of vital importance.

As I see it, the problem for the public accountant is that, except for management opinions, he has no way of judging the value of the assets such companies are creating. In these instances, his opinion on financial statements may cover everything but the most important factor in that particular business situation. This fact makes his opinion relatively meaningless. The public accountant may be able to avoid legal responsibility by properly claiming no expertise in technology, and passing the buck to management. When management is wrong, however, the public accountant cannot avoid the stigma of the ensuing dis-

aster.

If you think I am stirring up a tempest in a teapot, consider for a moment some of the recent catastrophies that have involved applications of technology. Military programs galore have resulted in vast cost overruns, some measured in billions of dollars, late deliveries, sometimes years behind schedule or faulty equipment, sometimes so bad that projects have been abandoned after millions have been spent. Other examples, in addition to the C-5A, are the F-111, the Cheyenne Helicopter, the Mark-48 Torpedo, the Main Battle Tank, numerous shipbuilding programs, and so on. Also consider the bankruptcies of Rolls-Royce and Viatron, the insolvency of Cogar Corporation and the near insolvency of Lockheed, the demise of RCA's computer business, the problems of the Bay Area Rapid Transit System, and so forth.

The various managements did not intentionally create these situations, but the calamities did occur. The message for the public accountant seems clear. First, technical matters have achieved an order of importance in business that the public accountant cannot ignore. Second, continued reliance primarily on management's judgment in lieu of independent technical verification is no longer a tenable policy.

I do not mean to imply that management has suddenly lost either its intelligence or its integrity. Rather, what I see is the evolution of a new set of conditions that have made the existing systems and procedures for the management of technology

unreliable. These are the changes in the environment of technology which were referred to earlier.

It is necessary to recognize and understand the changes that have taken place in the application of technology in order to cope intelligently with the results. Technical information flows along organizational lines, and the decision maker, increasingly remote from the action as programs have grown in size and complexity, finds himself on the receiving end of a single channel of information. Remoteness and the broadening span of technology have eroded the decision maker's competence to evaluate or question intelligently the information he receives. As a result, the self-assessments of the doers have assumed increasing dominance in the ultimate appraisals and decisions. The proliferation of documentation abets the process by submerging all along the line with more than they can digest, and the accelerating pace of technical development exposes the whole procedure to a kaleidoscope of ever-changing options that frequently introduce serious financial consequences. To top it all, the information that flows up the lines of a technical development organization to the decision maker tends to become biased by parochial interests that are difficult for a technically unsophisticated manager to detect.

This system tends to bury its faults as long as possible. It tends to make top management the last party to know the truth about the program for which it is responsible, and most likely to live the longest with euphoric beliefs about them.

Finally, it tends to deny management timely information about problem areas, which would enable it to focus its attention on potential troubles while time and money still remain for corrective action to be taken, and be effective.

For a vivid account of this phenomenon at work, I refer you to "The Aircraft Brake Scandal", Harper's, April 1972. The importance of this article is not the specifics of the breakdown at B.F. Goodrich, but its exposure of a management system that can fail for similar reasons anywhere.

Having spent my career at the interface between technology and its applications, and having contended with the problems that technical management creates for the chief executive, I feel more than minimally qualified to propose an answer which in structure and philosophy goes to the heart of the difficulty. I propose that a new professional responsibility is needed that will independently and competently evaluate the technical aspects of a program. Its function with respect to management would be either to validate the line generated information and assessments or to give management substantive reasons for questioning the information it receives. For the public accountant, the existence of such a body of responsible independent technical opinion would represent a source for independent appraisals of technical matters, a condition which I believe would markedly improve the meaning and reliability of audited financial statements.

It is my opinion that it will be necessary to create a new professional function--independent technical auditing--to

accomplish what I have in mind, and I believe such a function is practical. In fact, to my engineering-management-oriented mind, financial and technical auditing must eventually come together, if financial statements are to have dependable validity. It is, however, premature to decide whether technical auditing should forever remain a separate function or coalesce into the overall scope of the public accountant's function. Independent technical auditing will of course have to be carefully controlled in its ethics, policies, and standards, and those will have to be thoughtfully evolved. Disaster will occur if technical auditing becomes the happy hunting ground for any firm seeking business for a few spare engineers.

Many of my friends in public accounting have taken me to task in the mistaken impression that I am proposing a super-human function for the prediction of the outcome of technical endeavor. This would of course be just as improper and impossible for a technical auditor as it is for his financial counterpart.

There are in technical management, however, a myriad of matters that are subject to qualified independent appraisal, and that are indicative of the condition of a development program. By validation or exposing deficiencies in what has been done, the technical auditor restricts his opinion to past actions, the only things which can be subject to audit. His assessments would be against what might be defined as "acceptable standards of good technical-management practice." It would be up to the management or the investor to project the meaning of a technical

auditor's opinion into the future.

It is my assertion that factors exist in technology that are just as measurable and meaningful to persons skilled in technology as are the different factors that a public accountant inspects in reaching his opinion. What I refer to are such things as the thoroughness with which technical risk has been assessed; whether all alternative solutions have been considered and objectively evaluated; whether the development plan recognizes the risks and available alternatives; whether "milestones" and tests to prove their accomplishment are significant; whether the specifications on either side of an interface are compatible; whether change-order procedures and the justifications and approvals necessary to initiate a change are clear and being followed; whether progress to date has met its schedule when measured in terms of technical tests; and so forth.

It is possible for qualified people to assess a technical program in terms as I have outlined above, and the findings independently arrived at would provide a good measure of the healthiness or sickness of a program long before the condition would be disclosed by the income statement.

This is not the time to go into the details of how an independent technical audit should be accomplished, but two cardinal aspects are worth mentioning.

First, three types of expertise are required:

(a) Mature persons with experience in the area of technology in question, to provide reliable, subjective judg-

ments and the recognized expertise to make them credible. They would be equivalent to the senior partners in a law or public accounting firm.

(b) Persons who are fully conversant with what is happening at the forefront of science, again in the particular technologies critical to the project at hand. These technical specialists would have a knowledge of the state of the art that must be available to ensure that the technical audit opinion is based on current technology.

(c) A supporting staff that would look much like a miniature systems-engineering organization, to do the data gathering, analysis work, preparation of position summaries, and so forth, so as to minimize the time required of the more senior people. Just as systems-coordination engineers develop the special skills, attitudes, and procedures to execute their unique responsibility effectively, it can be presumed that a technical audit staff will develop a special expertise of its own.

Second, it is imperative to match critical technical areas with expertise in those specific aspects of technology. If this is not done, the technical auditor will not be able to probe intelligently for and detect flaws in the underlying technical detail. If he cannot do this with razor-sharp acuteness, his opinion will either be in danger of grass roots error, or it will become too general to be very useful.

Because the spectrum of scientific and engineering specialties is so much broader than the variations in accounting

specialization from industry to industry, it is in this latter area that the structuring of technical auditing differs most from public accounting.

The objective of a balance sheet, as I see it, is to present a fair picture of the condition of a business. The condition of technical aspects which may dominate all other considerations is, I believe, not dependably disclosed by the existing procedures for reporting and auditing.

What I believe is necessary, and what I believe public accountants should insist upon, is a competent, independent verification of technical assessments and progress wherever and whenever this subject has significance for the condition of a business enterprise. Thank you.

CHAIRMAN TRUEBLOOD: Thank you, Mr. Jewett.

As I read your paper this morning, and as I hear you talk now, it appears what you are really saying is that this increasing technological complexity of business is producing another degree of uncertainty, or a problem of imprecision, which becomes increasingly difficult to measure. I presume that would be a fair summary.

Now, is there anything in your proposal that requires a separation of the functions between technical audits and the financial audits, considering that there are indeed, internally to the public accounting firms and internally to business, available technical resources for analyses of this kind, which I believe are used by us presently--consultants or otherwise?

MR. JEWETT: If I understand your question, I think you are asking if I feel that this has to be a separate function.

CHAIRMAN TRUEBLOOD: That's right.

MR. JEWETT: The answer to that is: No, it does not have to be a separate function; and I realize that there is a large gray area, but I am proposing a function that goes much farther than, let's say, the somewhat similar function that is accomplished by research institutes like the Stanford Research Institute, or Arthur D. Little, by some management consulting firms, by feasibility studies of architect-engineers and engineering firms, by ad hoc committees of the National Academy of Sciences, and so forth.

There are a lot of bits and pieces that lead in this direction, but I think there are faults with these things.

For instance, in the sense that I see the need for it, I don't believe that a technical audit can really be undertaken effectively by an organization that does it as a sideline, which is essentially what a research institute does. And let me talk for a minute about that.

A research institute is in business primarily to do development work, and they find themselves with all kinds of internal conflicts when they start, as Standard Research did when starting to audit a part of the Cheyenne Helicopter program. Then they find that they have placed off limits a whole area of work for the major part of their organization.

This type of organization also tends to do the job with the people they have on their staff, and that does not necessar-

ily mean they get the right people on the job. In this particular area, matching of expertise is critical. It's like making a key that will turn a lock; you have whatever you call the nubs on a key, which are like the expertise. They have to push the tumblers very exactly, and if those nubs are displaced just a little bit, the key either sticks or it won't turn the lock at all.

MR. WESTON: Reading through your paper, I note in the beginning you cite a number of financial disasters, and there is an inference through there that if a technical audit had been made back in those years, somehow these disasters would have been avoided, or at least would have been brought forward. But on page 7, when you describe the technical auditor's report, you say he restricts his opinion to past actions, and will only assess them against acceptable standards of technical management practice.

I find a conflict, really, in the paper in that area, and I wonder if you could tell us, first, how you would visualize the technical auditor would face up to the early stages of a very complicated contract, when the future change orders and cost overruns and other problems are unknown to everyone. And second, what language would your audit report use? Would you be responsible for saying that these inventories are at cost or market?

MR. JEWETT: Well, you have asked several questions. Let me try to address your first one, and I'll try to do it with

an example.

Let me take the case of the Rolls-Royce RB-211 engine, which led to the bankruptcy of Rolls-Royce. Now obviously, I'm on the outside, and I can only know what I read in the paper about the thing, but in citing this example, I bring to your attention that in this particular case, inadvertently, a little bit of a technical audit was made, which was quite informal and unexpected, and it confirms what I'm saying.

I think that the problem in the Rolls-Royce case was that in the attempt to develop successful crescent filament blades for the compressor, while the very high risk was recognized, it wasn't recognized as thoroughly as it should have been; or perhaps it wasn't properly recognized by the top management.

So what I'm saying is that the past action that a tech-auditor would have looked at would be the fact that this program involved a very high risk, and he could flag this for proper action. He wouldn't have said it can't be done, but if the high risk had been properly recognized--and I think this is a definable thing--a number of other actions different from what took place would have ensured.

MR. WESTON: But how would the accounting or the financial statements differ, based on an evaluation of more or less risk? In other words, how would the inventory have been carried, if the risk were twice what someone thought it would be?

That's our problem today, the objectives of accounting. In stating these inventories in an area in which you say there

is great risk, how would the inventories be changed?

It seems to me there might be more disclosure, that would say: These are the costs to date, and the risks are overwhelming. But as you say, no one can say what the outcome will be, and I'm wondering what your opinion would say on that kind of an inventory.

MR. JEWETT: Well, now I've got to hypothesize here, but I can imagine a situation where in the case of Rolls-Royce's statement, the technical auditor would have said, to whomever he says this, that he finds the development plan for the RB-211 engine deficient.

MR. WESTON: And what does he expect they will do with that information?

MR. JEWETT: Well, I expect that the sequence of events might have been that this would have caused considerable commotion in Lockheed, or with the banks that were financing the airplanes, and that that would have resulted in the development of a plan for the RB-211 engine and its subsequent financing on an alternative course, which they would eventually have followed, with a quicker cutover to it.

MR. WESTON: But you're implying that this risk wasn't known by these people, and I think that may be an unfair inference.

MR. JEWETT: I'm not saying that it wasn't known. I'm saying that I'm sure it was known, but I don't think it was recognized with the degree of force that was necessary to cause the

proper actions to be taken.

CHAIRMAN TRUEBLOOD: Does that complete your questioning, Frank? Anybody else around the table? (No one responded.)

Thank you very, very much, Mr. Jewett. This is a problem that is of increasing concern--you're extremely correct--and we're each trying to cope with it in our own way. Thank you.

Next, and our final presenter, Price Waterhouse & Co. Good morning, Henry. I again apologize for rescheduling your day of meetings, but it's delightful that you can be with us at this time.

MR. HENRY P. HILL: I suppose I should start off by saying I'm Henry P. Hill, a partner in Price Waterhouse, occupying the position of National Director of Accounting and Auditing Services. With me is Bob Liptak of our staff, who has accumulated a number of papers while helping me, and he has very strict instructions to rustle those papers like mad if the questions get too hot.

May I start off by expressing our appreciation for the opportunity to be heard by the Study Group. At least, at this stage I'm appreciative. I know more than half of you from other contacts, and I know how penetrating your questions can be, and perhaps 45 minutes from now I will not be quite so appreciative.

I have noted from the experience of observing other panels conducting hearings like this that a tendency develops for the later arrivals to address themselves to the particular questions of interest that came up in earlier discussions. Well, I haven't attended the hearings prior to this morning, and although

I have read all the papers submitted in advance that I could get my hands on, I'm not aware of the issues that have come up in the discussion. So perhaps what we lose in repetition we might gain in freshness. If it results in repetition, I apologize.

You have all received a paper from my firm. I understand it was the first one submitted. I hope it's not an indication of fair value that the first paper submitted results in the last appearance before the Board.

In any case, it may be helpful if I draw attention to the two principal points made in our paper.

The first point had to do with the purpose of the Study Group. This is the kind of issue that could have emotional overtones, but our objective in raising it was at the other end of the scale. This Group was originally called upon to examine the objectives of corporate financial statements. My source for this statement is the ARA Newsletter of August 16, 1971, which I may say corresponds to my recollection of the proceedings at the Sterling Institute that gave rise to the Group. Somehow or other, by October it had become the Accounting Objectives Study Group.

This change in wording could, I believe, signal a major change in direction which would expand the work of the Study Group enormously and could at the same time lead it off in the wrong direction. Expansion per se is no cause of dismay to me. The fact that the Study Group is willing to take on a larger role is a cause for congratulations as to its energy and sense of obligations, assuming of course--as I am--that no unnecessary delay results, and provided it does not result in the fulfillment of

that direful prediction by your Chairman, who was reported in the New York Times to have said that the task of the Study Group is a terrifying one that may come to zero.

But the point is, the need now is for a statement of purpose of financial statements. I cannot say it any better than Bill Werntz did in the very quotation you used in your own October 1971 progress report. You said he--and I quote you--emphasized the overriding need for an explicit statement of frame of reference within which to argue the acceptability of a particular practice, and a set of criteria by which to test proposed solutions.

The words "frame of reference" are the key words. The end product of financial reporting is financial statements, and it is these statements that need a frame of reference. If they ever had a clear one, it's been lost in the effort to deal with the complexities and pressures, both internal and external, to which financial accounting has been subjected in the past 15 years.

In my opinion, this has resulted from a situation whereby each accountant has a slightly different perception of the financial reporting process, and perceives the solutions to particular problems differently in the light of his previously formed mental image. Let me give you an example Mr. Reinhart has heard before.

There are two major classes of institutions in this country that marshal the savings of individuals and put them to productive use. They are banks and insurance companies. Ten

years ago, neither was influenced much by accounting theory, their primary reporting concern being the requirements of the states. The accounting profession became interested in this situation, and perceiving that it could not last indefinitely, set about to deal with some of the problems of applying GAAP to these industries. Special committees of the AICPA were organized.

Because they have related functions, the two types of institutions had a related accounting problem: what to do with marketable securities. The Banks Committee concluded that banks had an amount invested in securities that had lower limits, and to a large degree funds from securities sold were reinvested in similar securities. To the Banks Committee, this was just trading paper, and they proposed a deferred recognition of profit and loss on sales.

The Insurance Committee noted that the necessity for a sale to establish a profit on a good investment had elements of artificiality about it, and by a majority vote proposed that some method be devised to record profit on securities on an annual yield basis that would take into account quoted values.

So there you have it. The insurance companies would show a profit without any sale, but the banks would not show a profit even after a sale.

The important thing is, despite their superficial conflicting conclusions, both proposals make sense. They make sense only because their proponents start off at different places. But what is also important to recognize is that the APB bought nei-

ther view.

Accounting is a conventional practice. It has been devised by human beings to deal with a specific objective--the choice of deployment of financial resources in our economy. Change the economy, or eliminate the choice, and you change the thrust of accounting.

But accounting is a discipline that covers a lot of territory, much of which is not being severely criticized at the present time. Though there are always those who would make changes in the management aspects of accounting, the primary criticism at the moment is in the public summaries we call financial statements. And so I urge the Committee to give us a frame of reference for the preparation of those statements so that those who compile them, those who read them, and those who analyze them have the same understanding.

The second point made in our paper is an exhibition of what in our judgment the frame of reference should be. It's hard to miss that conclusion. We followed the instructions of the country preacher in preparing a sermon, and we put it in three times in these words: General purpose financial statements are designed to report to investors on the use of funds they have invested in their enterprise, in such a way as to facilitate their investment decisions of the future.

Some of the key words emphasized in this simple statement are: "general purpose," meaning--as they used to say on railroad bills of lading--NOIBN, not otherwise indicated by name;

"investors" --which eliminates employees, creditors, estates, and others as the primary viewpoint. It tells us that if you use general purpose statements for rate making, taxation, economic forecasting, or most of the other purposes for which they have not been devised--you are, in the words of G.L. May, eating peas with your knife; "funds," which emphasizes money as against value; "investment decisions of the future," emphasizing the continuity and the potential for short term action.

I could go on, but you have read our paper, and I should like to wind up with a quotation. It's from a letter to the Editor of Business Week that appeared in the January 8, 1972 issue. I have no idea who the writer is. He may not be one of the quotable accounting greats, but he's got something for us to think about.

"As a major stockholder, director, and employee of a small manufacturing business, I have more recently come to a deeper understanding of the term 'profit' and its vagaries. Among even our handful of more or less equal principles, not all of whom are number-minded, the term incites argument, suspicion, and misunderstanding. Everyone still likes to peek into a cash drawer."

Arch R. Newton

CHAIRMAN TRUEBLOOD: Thank you, Henry. Your superbly done paper was indeed received first--not to suggest that we now have a new terminology called first in, last out--FILO.

I would respond to the Accounting Study Group termi-

nology. Frankly, we found ourselves, in our early meetings, using the words "financial statements." "financial accounting," and "accounting" almost interchangeably. It was not nearly the deliberate decision that you may think it to be, and we do not intend it to change our charter or objective or our role in any way.

You start out your paper by being very startling, and continue in a very lucid, clear fashion, page by page and sentence by sentence, contending that this is a conservative paper. Is it really that conservative?

For example, you move over somewhere along the line into a rather strong emphasis on cash presentations which are not typical, which are new, and which are one of the subjects some of our members are significantly interested in. And you also talk in some places about prospective results and analyses, as well as retrospective results and analyses.

Would you care to comment about your initial sentence, in relation to what you believe the general tone of your paper to be?

MR. HILL: Well, I thought it characterized the tone of the paper. "Conservative" means you save what you have, or preserve what you have. I don't visualize if the recommendations in our paper were followed that accounting would instantaneously change substantially, and that's really what I meant by the use of the word "conservative."

Beyond that, I guess it's in your own mind what is conservative and what is not. I view this as a paper of the

right rather than a paper of the left. I would view the left as being a fair value paper, or something like that.

CHAIRMAN TRUEBLOOD: One more question, and then I'll ask Oscar to proceed.

In this very simple and well written sentence on the first page which you quoted "General purpose financial statements are designed to report to the investor"--I presume you mean the actual investor as well as the potential investor; that is, the public in the large sense.

MR. HILL: Yes, I do. I intended to cover the investing function.

MR. GELLEIN: Henry, my first question really relates to what is at the bottom of page 13 and at the top of page 14, and I'm really asking for a little elaboration, if you don't mind. I was kind of fascinated by this. It's the emphasis on the short term decisions that underly the investor's action.

Then you refer to some things not based on the accounting for money. I don't know--maybe that's my term--but you conclude by saying that if accounting is to depart from the cash basis, the burden of proof is on those who justify the departure from the cash basis--and I think I see what you mean.

Then you talk about pension costs, accounting for deferred taxes, and the like. I know, for instance, as to accounting for pension costs, some actuaries said at the time Opinion 8 was written that if you went to the maximum, and you funded that amount, you'd be putting cash into a fund that you would

never have to pay out, and that sort of thing.

On the other hand, you see, to me that may mean that maybe we measured it wrong. I'm going to ask you a question in a minute, when I get through here.

When you come to deferred taxes, you again say, or you imply, it will never be paid. Well, again, maybe we measured it wrong. Maybe we should have been on the liability approach, and maybe we should have had a present value number on it, or whatever it may be.

But my real question, then, is this. If all of this derives from the emphasis on the short range decision, which I read into this as a key part of what you deem to be objectives relating to investors, then why do we record depreciation on a 50-year asset? How do you conclude that you don't account for deferred taxes, based on this objective in relation to a tax-book difference on a 50-year asset, in accounting for the depreciation itself?

I don't mean to argue the technical matter.

MR. HILL: Well, if I may, Oscar--we don't mean to say that you should not record any deferred tax. If that comes through, that's the problem.

MR. GELLEIN: No, I was trying to get away from a technical point to a philosophical point.

MR. HILL: But I think I can address it in philosophical terms.

I believe the real necessity for accounting for de-

ferred taxes is a short term one. I think it's significant that you account for deferred taxes in a case where the expense may be in next year's profit-and-loss statement, and the deduction may be in this year's tax return. In that case, it's quite simple to flip from one year to another the profit that results from the tax saving.

On the other hand, when you get this enormous pool of deferred taxes, as you get down to the bottom of the pool the probabilities of their being paid get lower and lower. And what's really indicated, it seems to me, is some kind of a probability analysis at the bottom of that pool.

MR. GELLEIN: But aren't you really saying, then, Henry, that in that regard we came up with the wrong answer? That we had the right objective--purpose--but we came up with the wrong answer?

MR. HILL: To some degree I think we did, yes. Not completely.

MR. GELLEIN: So I was really trying to explore whether there was some other objective in here that cuts across more broadly.

MR. HILL: No, I think we came up with the wrong answer, and you can say the same thing about pensions. The bottom of this pool will never be paid, because if the company stays alive it won't need to be, et cetera, et cetera, as we say in the paper.

MR. WESTON: Henry, at the bottom of page 7 there's a comment which other speakers have quoted here at our session. This is the statement that the manner in which the most success-

ful real estate investments regularly report a loss is an accounting scandal.

I wonder if you could enlarge on that, and tell us how we could phrase an objective of accounting which would overcome that. And particularly with respect to real estate, my impression is that, in addition to the timing of depreciation, which may be the reason for this loss which you say is a scandal, possibly the value increment in real estate is where the problem and the scandalous accounting is, in terms of nonrecognition.

Would you care to comment on that particular sentence? Because it is a rather strong sentence in an otherwise conservative paper.

MR. HILL: Well, it has been noted by several people. I saw it in the press somewhere. It's a bit of hyperbole that perhaps we shouldn't have indulged in.

We have a situation now where, if you try to find financial statements of real estate syndicates--I'm speaking now of the small groups who combine to engage in real estate transactions--you find that they almost never prepare a statement, even under GAAP. They prepare a tax statement and a cash flow statement, and stop there. I can give you numerous quotes. I sent you some, which I assume you circulated to the Group, from annual reports which say, in effect: Here are our financial statements, but don't look at them. They don't mean very much.

I believe it's pretty well acknowledged that financial statements of real estate transactions under GAAP are not used

by real estate people.

MR. WESTON: How could we improve them? What would be the objective that would improve them?

MR. HILL: Well, I didn't intend to solve all the real estate problems, which are pretty tough problems, and I don't think that this Group can come up with the answers to all problems. It seems to me that if we can set the frame of reference, we can then devote ourselves to the problems individually within that frame. I believe there'd be a heavy emphasis on cash flow. I believe there'd be a reexamination of depreciation under real estate accounting. As you know full well, at least two of the National Institutes--the Canadian and the Australian--have been reexamining whether they should take depreciation on real property under conventional methods. We have proposals that depreciation be taken on an inclining basis in real estate in order to counteract the declining interest, and come up with a kind of level cash, or level profit reporting.

MR. WESTON: But isn't the thrust of many of these syndications the fact that the value of the land is increasing considerably at the same time depreciation is being accelerated, so we have a compounding of reality, in a sense?

I'm really trying to find out whether an objective in real estate might not be phrased in an investment environment; say, real estate syndication--where value is really the economic reality of the situation, and an objective of accounting should be to reflect that, rather than historical cost and depreciation

accounting.

MR. HILL: Well, if I could focus on the word "value", except for that one word I think you would be right. It may be that it's the implied diminution of value in depreciation that's wrong, and the diminution of value as measured by original cost.

We have in downtown New York several buildings that were built in the '20s that are practically prime buildings, and I don't know how many times they have been depreciated, but they stand alongside new buildings as prime rental properties.

MR. GELLEIN: Henry, could I turn to the thing you said three times--and put it in italics three times?

I'm looking at the last page, or you can look at the first page. It's both places.

MR. REINHART: Page 14 too.

MR. GELLEIN: Taking the illustration that you used, Henry, of the banks and the insurance companies and marketable securities, do you see this frame of reference, as stated here--that its application by people expert in its application within that frame would result in a unique answer in the treatment of marketable securities in the financial statements of banks and insurance companies?

In other words, will this once and for all lead us to a unique answer?

MR. HILL: Well, what do you mean by unique? I'm not sure I know what you mean by unique.

MR. GELLEIN: I mean a common answer.

MR. HILL: You mean unique to banks or...?

MR. GELLEIN: No, unique to the circumstances, whatever they are.

MR. HILL: Yes, I do. I feel, for example, that you would take into account the fact that banks invest in debt securities. At one time they had a very high tax advantage, which encouraged them to trade artificially. There were cases, and I know of them in fact, where three banks sat around the table, and A sold to B and B sold to C and C sold to A, just to establish profits and losses.

I believe within this you would say: Well, having invested the bank's funds in securities, we are locked into this kind of security until we decide to get rid of the total portfolio, and therefore you would then structure a kind of yield approach, and a deferred approach, which the Committee came up with.

MR. GELLEIN: Do you think it would lead to a yield approach?

MR. HILL: Yes, I do.

MR. GELLEIN: The direct application of this stated objective?

MR. HILL: Yes, I do.

DEAN CYERT: I was interested in the fact that you seemed to restrict the actual users of financial statements in this definition that we are talking about. We have been concerned on the Committee with looking at the number of users. I would be interested in your rationale for restricting other users than

the investor. And I assume from what you have said, you would think of creditors as being also included in the investor group-- or not?

MR. HILL: Well, that's a two part question.

DEAN CYERT: Yes.

MR. HILL: When we speak of establishing a frame of reference, we're asking for the rules of the game we're playing. We could play golf with a croquet ball. I've never tried it. I have a pretty good understanding that it wouldn't work very well, because a golf course wasn't designed for playing golf with a croquet ball.

All I'm saying is that it doesn't restrict their use by establishing a frame of reference that says these statements were prepared with the investor in mind. It means that you, other than investors, who use them know that we prepared them with the investor in mind, and if you use them for some other purpose, you should make the appropriate adjustments.

If you are a bank, for example, and you're lending, you're not interested in the depreciated value of, let's say, vessels of a shipping company. You're interested in what the vessels are, what models they are. You ask certain kinds of questions. You start off knowing that the number on the balance sheet isn't put there for your purpose.

Now, this doesn't restrict you. It simply establishes the rules under which we prepare these statements.

DEAN CYERT: So you are sort of saying, then, that historically, that really has been the purpose of financial state-

ments, and we should make it more explicit and clear?

MR. HILL: That's why I used the word "conservative," to get back to the first question.

DEAN CYERT: The second part of your definition says that we should report in such a way as to facilitate investment decisions of the future. To me this implies to some extent that we should know more about that investment decision process; that we should in fact, know the kinds of information that investors do try to use; that we should really have some sort of a model of that process, and then try to develop as much as possible of the information consistent with that broad model.

Would this be consistent with what you are thinking of there, or are you thinking more in the line of--well, let's do a little introspection about how we would make a decision, and try to provide the information needed? Would you talk about that aspect?

MR. HILL: Well, I think you are leading into a discussion of whether investments are made on a rational basis.

DEAN CYERT: I think that's one element of it. Another is: Shall we facilitate the way they should make decisions, or the way they do make decisions, if there is a difference?

MR. HILL: All right. I think it has to be "do". I don't think it has to be "should". I don't think we can ride herd on the intellectual processes, or selling process, or whatever we are talking about in the investment decision making.

DEAN CYERT: Do you think we know enough about how

those decisions are made now to be able to go from there to detailing the information we should have on financial statements?

MR. HILL: Well, I think we have at our disposal material which is prepared and intended to influence investment decisions. For example, we see prospectuses, and then we see how the salesmen don't even pass out the prospectuses, and instead emphasize something else in discussing a sale with a prospective investor. I think we know quite a bit about how the investing process works today. I would agree that I could not construct a model of one, or...

DEAN CYERT: I'm sorry. I didn't hear the last thing you said. After you said we know quite a bit about the way decisions are made, then...

MR. HILL: I would agree that we can't construct a mathematical model, a scientific linear equation that shows the factors that go in and how the investment comes out.

DEAN CYERT: Well, I guess one of the things is that there is quite a bit of information which, let's say, some sophisticated investors use, and others don't. I'm trying to find out how far you would go in facilitating the investment decisions of the future, in terms of this broader range of material.

Do you have in mind any broad criterion?

MR. HILL: I can be concrete about a few things. For example, I believe that a summary of earnings as now prepared in a prospectus, which is a historical recitation of income statements that have been previously circulated, is not necessarily

the right document for an investment decision. In a prospectus, we have a five-year-old income statement; we got that five-year-old income statement together within six weeks or two months after the end of that fifth year back. We know a lot more about that year at this point.

We might very well say the accounting principles that apply to a summary of earnings are not necessarily the ones we had to apply the day we prepared the annual financial report. That's one of the kinds of things I'm thinking about.

DEAN CYERT: Good.

MR. HILL: A second one is, I believe that--as collateral information, and not the frame of reference--we owe the investor other information. We owe him the information that we're going to tear this plant down, and we're going to leave New England and go to South Carolina, which doesn't necessarily mean we need to show him next year's profit-and-loss statement, but it means we need to show him something about what's going to happen, in order that he may make some kind of an intelligent decision.

DEAN CYERT: What about things like, say, concentration ratios of the firm, and its various product lines? In other words, is the firm one of two or three firms in a number of product lines, and is it in a highly competitive industry in another one. Would this information be some of the kind that you would want to show?

MR. HILL: I would certainly believe that product line information is basic information, yes.

DEAN CYERT: But along the lines of something like the economic characteristics of the industry that the firm is in, would you extend it that way, or would you argue that that's not really financial information?

MR. HILL: To me, that's not accounting information. I would like to say this company is in the business of the pill, but I wouldn't like to forecast whether the pill is a good product or not. Somebody else has to do that.

DEAN EDWARDS: Henry, do you visualize your statement on page 17 as serving--as some people have indicated--as the Constitution for the new Financial Accounting Standards Board, in solving some of the complex problems that it's going to be facing?

MR. HILL: Yes. That's really the thrust of our recommendation, that coming behind this Committee is probably the Financial Accounting Standards Board, and they are going to have to solve the details of accounting applications.

DEAN EDWARDS: Well, do you think the objectives, as you have stated them, realizing your report was in before the Standards Board was approved, or even its recommendations were known, are pervasive enough to serve as a constitution for such an organization?

MR. HILL: Yes, I think so. They are pretty general.

DEAN EDWARDS: I have one other question related to this. Is one of the purposes of your statement to establish some parameters for accounting? There is certain material, for example within the material that has been submitted, that in-

dicates that anything you can count is accounting.

Was that one of your premises to establish some parameters on accounting?

MR. HILL: Absolutely. I believe it's said in here somewhere that our reach should not exceed our grasp; there's a limit to what accounting can encompass, and just because a thing is expressed in numbers doesn't make it accounting.

MR. GELLEIN: Henry, if you would like to comment on this, do do; if not, you can simply say so.

You indicate that in a five year summary, for example in a registration statement, maybe the accounting applied to the five years might be different from what actually had been applied to each year of the report. Would you care to comment on whether that same information on that same basis ought to be a part of the shareholders' report?

MR. HILL: Yes. I can see it would be suitable to just put a summary in the shareholders' report which reflects the decisions that we now see were inadequately made years before. When you get to things like reserves for bad debts, and you discover that we had a big investment in Penn Central that's now all gone down the tube, and here we took a nice, big, fat interest on these loans all those years, and then in the fourth year of the five years we suffered a big, fat loss, it seems to me we might reconsider carefully whether we don't want to readjust all years for that interest, and show that we were really just building up a loss, not building up a profit.

MR. GELLEIN: I guess an easy way to make a transition to this, if this should be a desirable goal, would be to work on this basis on the historical summaries that are there right now.

MR. HILL: Yes.

MR. WESTON: Under those conditions, though, Henry, what kind of reporting would the CPA make? He'd say: "This is the statement today, but two years from now I'll give you the right figures"?

MR. HILL: Well, he does that many times now.

MR. WESTON: A few times, but very rarely. Those are the rare exceptions.

MR. HILL: Well, they're growing, and they're growing defensively, as we all will admit.

MR. WESTON: But would statements of that type be useful to investors?

MR. HILL: I believe they would, yes.

MR. WESTON: Particularly to short term investors that you indicate are in and out?

MR. HILL: Well, you know, you can never get a Price Waterhouse partner out without having him quote G. O. May, and G. O. said that short term accounting would be indefensible if it were not indispensable; and it's a perfectly valid position even today. But that doesn't mean we have to live with it forever. We have to make our decisions now.

MR. WESTON: But would you, in effect, go back and apply subsequent information to an earlier period?

MR. HILL: I can visualize coming up with a brand new

summary of earnings which shows what we know now.

MR. PARKER: I think you might be aware that a good number of financial analytical tools make rations out of things that are in the income statement and the balance sheet, and relate them to other things going on in the economy, either economic factors or down to and including market prices. You can adjust the figures later on for the income statement and the balance sheet. I don't suppose you would go back and adjust market prices, and things like that.

What happens to that process if you are going to be revising the figures all the time? If you don't leave the old figures available as well, then you leave, I suggest, a very substantial tool in the hands of the sophisticated analyst who keeps all the old figures and can use them, as opposed to the investors you have now provided.

MR. HILL: Obviously, we can't lose the historical numbers. We have to have some kind of firm foundation for our readers. Otherwise they are driving an automobile with a speedometer on which both the needle and the numbers move, and then they have nothing.

MR. GELLEIN: Henry, I just wanted to clarify one thing. I think you have, but just to be sure it's understood as we interpret on page 7, the middle paragraph, where you end the first sentence: We should show the plans that have been made for the future. I think a moment ago you referred to some illustrations of that sort of thing, but could you elaborate just a little bit

more, so we understand it?

MR. HILL: Well, Oscar, I think if you will accept a degree of accountability as implicit in them, think of the kinds of things the presidents of corporations stand up and tell the analysts at the lunches they go to. They tell them what's going to happen to our product. Sure, they make a forecast of earnings per share, and, sure, their correlation is pretty low. But the important thing is, they stand up there and say what this company is going to do--what its plans are. And without that, the historical financial statements have got to be of low utility.

MR. GELLEIN: Again, if we embrace this--or the extension of it--as an objective, would you think we'd have to do it more often than once a year? At least quarterly? Maybe when the plans change?

MR. HILL: As appropriate, yes. That's what I would think.

DEAN CYERT: Do you think that one of the important aspects of developing this frame of reference that we have talked about is a more precise definition of what we mean by income?

MR. HILL: I'd like to think about that. It seems implicit, but I'm not sure what's behind the question. It just seems to come out that income is the number one thing the investor wants to know, and I'm not quite sure what you have in mind.

DEAN CYERT: Well, I'm really just getting a little guidance on methodology for our procedure, and I wanted to know

whether you felt that there is a need for a better definition of income than we are using, or let's say a different definition. I then would be interested in asking you what areas we should be concerned about in defining income.

I guess maybe I see where the confusion in the question is. What I'm thinking of is whether we should, for instance, try to get a little broader definition than accounting has traditionally used. Should we be moving more toward concepts like opportunity cost, or should we be considering trying to separate out in the profit those things that may come about because of historical accident a low-rent lease things of this kind?

Is this a direction toward the definition of income, let's say, as an economist defines it, if you are familiar with that.

MR. HILL: Well, I'm still a little confused, and not able to deal with your question.

If your question is directed toward the definition of income do we need to expand the income details? Should we pull out things--unusual things, or remarkable things? I would say yes. I believe, where the tendency is today toward a rigid format of profit-and-loss statement, it really should be the other way. We should have a kind of free-flowing profit-and-loss statement whereby you put the things down in a way that most clearly discloses what happens, rather than try to force them into the extraordinary and the non-extraordinary, for example, which leads to artificial rules. What's extraordinary to you may be ordinary to me.

DEAN CYERT: Let me just give you a simple example to help me get a better feeling of what you are thinking about. Let's suppose that this company made a lease twenty years ago, and it pays a very low rent. And we could compute what the rent would be if the lease were made today, so what happens is that in the profits there really is rent.

Now, would you see it desirable to essentially impute the actual rent and get that out of the profit, so that the investor is not misled in terms of saying: "Well, the firm is really making this money in its business operation--this kind of definition?"

MR. HILL: No, I don't think you can set up this kind of bogey, and I would not impute under that circumstance.

DEAN CYERT: You'd try to keep it still as objective as one can.

MR. GELLEIN: I think we have delayed your lunch long enough, really. Henry and Bob, we thank you very, very much for your time and efforts, and your explanations and observations.

CHAIRMAN TRUEBLOOD: I think it's impossible to summarize a proceedings such as this in any adequate way, at least so soon after the heat of the debate, but I would like just to make a few closing remarks and some general comments.

I was quite impressed by the consistently well done presentations and their temperateness. I was very impressed, as I'm sure my peers are, by the welcome and encouraging willingness on the part of the witnesses to join in the efforts to

improve financial reporting. I think there is evidence presented by each of the participants of their very broad concern about all of the matters which have been under discussion.

It's in some respects really overwhelming that it is possible to channel such a substantial commitment of time and manpower our way, in order to assist us in our forward deliberations. I can assure you that all members of the Study Group are most appreciative, and everything that has been said and submitted will be considered very carefully and with deep sincerity.

I think we can pull out just a very few broad areas of wide agreement. I think we can say that we agree that objectives are needed to guide improvements in financial reporting, that they should be stated explicitly, rather than left unsaid or poorly formed or ill defined. It seems to me that, even though not implicit in some of the statements, there is a tendency to regard a kind of trichotomy here in our practice, with objectives at the highest level, principles or standards at a second level, practice and procedure at a third level. We tend to get them mixed up, because we use them as examples, as it were. Clearly, our purpose is to think mostly at the highest level. The situation then leaves to the Standards Board, probably, even some of the more difficult things.

Another area of significance, I think, is that there is recognition that several categories of interested parties must be served, that their legitimate interests can be stated, and solutions should be directed to varied points of view. I can think

of at least three that have been stated by many: first those direct users of financial statements, which are, in a sense, the primary parties at interest; then there are the preparers of financial statements, the managements of enterprises who act as representatives of owners and potential owners.

Perhaps most importantly, I read out of many of the presentations a recognition that society at large, as distinguished from the individual investor, has a continuing direct and indirect interest in all of the professional work of the accountant. And, finally, in that area I think there is some agreement that broad concepts, principles, and reporting formats for financial accounting are not sacred. They need to be reexamined to see if they have continuing utility and validity, and determine appropriate modifications and substitutions in some cases. Clearly, all of us feel, on the witness stand and around the table, that nothing should be retained merely because we have always done it, or because many people have believed in it for a very long time.

But there is also coming out of these meetings, I think, a wide range of viewpoints that do not have agreement, and on which there has been a variety of response, a diversity of conclusion, about how those issues should be approached, and for that matter, how those issues may relate to the broad objectives.

Very generally, these views range from a total endorsement of present practice, with no change whatsoever, to a suggestion here and there for substantial changes across the board, not only in concepts but in principles and formats. Clearly, at this

level, no endorsement of any one viewpoint was unanimous, so the Study Group will have to examine each of these in detail, giving attention to all of the arguments on either side which have been presented, and for that matter which will become available to us through our other courses of research.

I think we should agree that our ultimate conclusions--and I now talk about "our" in the professional sense, as distinguished from the Study Group sense--really should not be formulated on a head count basis, if we are going to come up with that larger frame of reference that Bill Werntz and Henry Hill have talked about.

I'll just take one minute to talk about some of the principal issues that I see emerging. Clearly, the first two days took current and fair value up and down and back and forth, and forecasting in the same way. Large questions were raised about the completed transaction concept and our historical notions of realization. In the forecasting area there is a diversity of points of view about availability and the right to know. And there's the whole problem of the changing environment of the attest function as it might be extended to such issues as forecasting.

I think one of the happier things that I observed as an individual was that the strict debate about uniformity versus flexibility of some years ago has at least diminished in its intensity. It is not solved, but I don't detect quite the same strength of position on that subject. We've talked a good bit

about price level distorting effects, as tied in in some ways to the fair value and the realization concept.

One thing not explicitly on our agenda--I don't know how it might be worked into our ultimate product--is a concern expressed also by the New York Stock Exchange on the enforcement of professional standards and the formalization of institutional groups for purposes of that enforcement.

Again, perhaps somewhat outside our area of direct responsibility, comments were made very interestingly, about training, education, objectivity, and professional stature of accountants, as these issues relate to the accountant's role in serving the legitimate interests of society.

Finally, let me thank you again. Let me urge you to continue to monitor our program. Let me remind you that transcripts of these entire proceedings will be available shortly, on request, for what we trust will be a modest fee.

The Study Group continues to look forward to making a meaningful contribution to the profession, to the financial community, and to me, what should be our most important interest--the general public.

Thank you for your patience, your consideration, and your excellent attention and considerable help. Goodbye.