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FINANCIAL REPORTING AND THE PUBLIC IMAGE.

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Those of us who are engaged in the preparation of the financial statements of large industrial enterprises today find ourselves in a curious–and uncomfortable–posture. On the one hand, we have a larger and more critical readership than we have ever had. On the other hand, those who read our end product, the financial statements, are too often suspicious of their fairness and their accuracy. A security analyst in the United States once, only half humorously, described the operating statement of a large multinational conglomerate as being much like the miniskirt worn by his secretary: "What it reveals is interesting; what it conceals is essential!" He likened the balance sheet to the costume worn by the aging cabaret performer–the generous use of a corset to conceal the fat (the creation of secret reserves) and a little padding here and there to conceal the thin spots (reversals of reserves).

Unfortunately, in America the suspicion with which financial statements are viewed by the financial community has not been confined to semihumorous comments. We have seen a substantial and frightening increase in the number and the severity of legal actions in which the management, the directors and the auditors have had to defend their financial judgments in the courts. Prior to 1940 there was little litigation that related to the accuracy of the financial statements. During the past thirty years there has been a substantial increase in this type of litigation in the United States. In some cases the defendants have had to pay substantial sums to disgruntled stockholders who claimed to have been misled by the financial statements; in some cases the defendants have been forced to resign their official positions; and in some cases they have been found guilty of criminal offenses. That this wave of litigation against corporate officers has to date been largely limited to the United States should give only scant comfort to businessmen in other countries. Lawsuits against corporations and their officers by shareholders (described by Americans as class actions or derivative suits) have proved to be extremely profitable to the attorneys who specialize in this type of litigation. I am sure their counterparts in Germany are carefully examining the possibilities.

THE CREDIBILITY GAP

There has been a substantial increase in the amount of material appearing in the public press that is critical of the financial data available to a stockholder or potential stockholder. While some of what has been written is unfair, inaccurate and unrealistic, much of the published material is thoughtful and constructive, and the criticisms voiced are justified.

While my experience is largely in the United States, my colleagues in Amsterdam, Frankfurt and London tell me that the skepticism with which financial statements are being read in America is beginning to be felt in every financial community in the free world. I think there can be little question but that we accountants are facing a credibility gap of serious consequence.

As a matter of fact, even corporate officials recognize that their published financial statements now tell the reader only so much of the story as the company feels inclined to tell. Just recently the managing director of a large firm in South Africa sent me a copy of his annual report. In his letter he said, "We have shown a profit of five rand a share this year and have assigned the balance of our income to a special reserve since we are not too optimistic about next year."

What are the basic causes of this credibility gap? To my mind there are several factors that have contributed to our present problems.

In the first place, we have a far larger readership than heretofore—the shareholders who receive corporate annual reports. The president of the New York Stock Exchange recently estimated that in the United States more than 32.5 million persons own shares in publicly traded corporations. As our readers increased, so did their questions on the data included in those financial statements. Too often, I am afraid, corporate management and their auditors were unwilling to answer adequately the questions that were raised or were unable to justify the positions taken.

As an inevitable result of the increase in the number of persons reading financial statements, there was a steady and dramatic decrease in the level of sophistication of the readers. Whereas in the early 1950s the financial statements were normally read by a trained, experienced banker or security analyst who was aware of the inherent limitations involved in the preparation of statements and the conventions on which they were constructed, today the average reader has little or no awareness of these limitations and conventions, and expects the financial statements to serve a more useful purpose than the original designers ever expected.

PURPOSE OF FINANCIAL STATEMENTS

This set of circumstances has caused the accounting fraternity in the United States to reexamine the whole question of the basic nature of financial statements and the objectives of financial reporting. The American Institute of Certified Public Accountants, in response to the growing demand for a clear definition of the objectives of financial statements, created a special committee to study the problems. The committee, consisting of accountants, educators and financial analysts, labored for more than thirty months, had thirty-five public hearings and asked for the opinions of over five thousand users of financial data. After all this effort, it produced a report that made the profound observation that "The basic objective of financial statements is to provide information useful for making economic decisions." It further stated that this conclusion was based upon the following assumptions:

(a) Users of financial statements seek to predict, compare, and evaluate the cash consequences of their economic decisions.

(b) Information about the cash consequences of decisions made by the enterprise is useful for predicting, comparing, and evaluating cash flows to users.

(c) Financial statements are more useful if they include, but distinguish, information that is primarily factual, and therefore can be measured objectively, from information that is primarily interpretive.

In further expanding on that theme, the report went on to list ten objectives that are collateral to the basic objective:

1. To serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise's economic activities.
2. To provide information useful to investors and creditors for predicting, comparing, and evaluating potential cash flows to them in terms of amount, timing, and related uncertainty.
3. To provide users with information for predicting, comparing, and evaluating enterprise earning power.
4. To supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal.
5. To provide factual and interpretive information about transactions and other events which is useful for predicting, comparing, and evaluating earning power.
6. To provide a statement of financial position useful for predicting, comparing, and evaluating enterprise earning power. This statement should provide information

concerning enterprise transactions and other events that are part of incomplete earnings cycles. Current values should also be reported when they differ significantly from historical cost. Assets and liabilities should be grouped or segregated by the relative uncertainty of the amount and timing of prospective realization or liquidation.

7. To provide a statement of periodic earnings useful for predicting, comparing, and evaluating enterprise earning power. The net result of completed earnings cycles and enterprise activities resulting in recognizable progress toward completion of incomplete cycles should be reported. Changes in the values reflected in successive statements of financial position should also be reported, but separately, since they differ in terms of their certainty of realization.

8. To provide a statement of financial activities useful for predicting, comparing, and evaluating enterprise earning power. This statement should report mainly on factual aspects of enterprise transactions having or expected to have significant cash consequences. This statement should report data that requires minimal judgment and interpretation by the preparer.

9. To provide information useful for the predictive process. Financial forecasts should be provided when they will enhance the reliability of users' predictions.

10. To report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment.

I submit that now that we have begun to define in America what we are trying to accomplish when we prepare financial statements, we are on the road to doing a more effective piece of work. Not having a clear understanding of the objectives of our financial report is as absurd as asking an architect to design a building without telling him the purpose for which it will be used, or asking a scientist to develop a drug to cure a disease that has not yet been discovered. In the broadest terms, if financial statements are to be merely a report of management's stewardship—a report on what has occurred—the reporting principles and conventions will be quite different from those that must be adopted if the report is intended to give some indication of the future.

MULTINATIONAL OPERATIONS

As the number of our readers was increasing, the size and complexity of our corporate structure were also increasing. Corporate activities have exploded beyond their historical national boundaries. More and more turnover results from sales in foreign countries, and a greater share of assets is invested overseas.

A recent survey of the largest American corporations indicated that there had been a substantial increase in the volume of overseas sales as a

consequence of a greater investment overseas. Securities of American corporations are now being listed in increasing numbers on the London and Tokyo Stock Exchanges as American corporations seek to attract foreign capital to support the cost of their overseas investments. I think that we are beginning to see the reverse flow as European and Japanese multinational companies begin to investigate the possibilities of attracting foreign investors to their companies by listing their securities on the New York and London Stock Exchanges.

This growth of multinational corporations has created an entirely new series of problems for the designer of the financial statements. Accounting and reporting standards vary widely from country to country. The German Stock Corporation Law, for example, sets forth in very specific terms the information that must be furnished in the annual report of the corporation. Nowhere in that law does the concept of materiality or significance appear. The U.S. laws, on the other hand, provide that certain data should be included in the report if they are significant and further require that any information of any nature, whether specified by regulation or not, that is important for a fair understanding of the financial statements must be included.

In a recent court decision in which management of a large corporation and its auditors were convicted of criminal fraud, the judge in his opinion stated in part that the reader of a financial statement is entitled to be informed of every significant fact relating to the financial affairs of the corporation, and no set of rules devised by accountants could circumvent that obligation.

NEW FINANCING TECHNIQUES

Further compounding our problems in the construction of financial statements has been the development of highly sophisticated, complex financing devices which have been introduced by banking institutions since the middle of the 1950s. In the old days a corporation would lease an existing plant or a warehouse from an independent landlord and pay a fixed rental for a specified period, and at the expiration of the lease the property would revert to the landlord. Life is no longer that simple! Today we have a wide variety of alternatives to the standard lease. In some cases the landlord is a creature of the leasing corporation, such as a pension fund or an affiliated company, so the arm's-length feature of the normal lease disappears. In some cases the landlord constructs the building in accordance with the specific plans of the tenant, in exchange for which the tenant guarantees the obligations of the landlord. In many cases the tenant acquires the right to

purchase the building at the expiration of the term of the lease at an amount that is not related to the then fair value of the property. These complications have added to our reporting and disclosure burdens.

CLOSING THE GAP

I mentioned earlier that we who are engaged in the preparation of financial statements face a credibility gap, that our readers at best do not understand what we are trying to say to them and at worst do not believe us. How, then, can we reestablish rapport with our shareholders and investors and regain their trust?

■ **Reexamination of Accounting Principles.** First, we must examine the accounting policies we have adopted in the past and satisfy ourselves that they fairly present the economic and financial facts—that they report what has actually occurred. For example, let us look at the principles of consolidation.

In Germany it is customary to present, in addition to the parent-company statements, the consolidated statements of the parent company and its German subsidiaries. All of the investments in companies located outside of Germany are shown as one figure, described casually as "carrying value"—an amount that might represent the initial cost of the investment or an amount substantially less than cost as a result of the creation of reserves. The income generated by these overseas investments, if shown at all, consists of the dividends that the parent has caused the subsidiary to declare. Thus, neither the book value of the investment nor the income reported necessarily has any relationship to the true value of the assets of the affiliate or to the income it has produced. Furthermore, the income of the German parent can be affected profoundly by the pricing policies adopted for sales to its foreign subsidiaries.

If the operations of these foreign subsidiaries represent a significant proportion of the total operations of the enterprise, I submit that it would be much fairer to the reader to include these companies in the group statements so that the sales and income of the foreign operations are included in the operating results after appropriate elimination of intercompany transactions.

I recognize that some may argue that the inclusion of the operations of foreign subsidiaries in the group statements involves too much work, or is too complicated or presents overwhelming mechanical problems. Not so! In the case of one German multinational company with which I am familiar, complete financial statements of its worldwide organization, prepared on a

completely consistent basis and including all intercorporate eliminations, have been compiled, and those statements have been ready for management within three months after the close of the year. Furthermore, those statements have been reviewed by the outside auditors who have expressed their opinion on them in accordance with the legal requirements in Germany and in each of the countries in which the affiliates are located. Admittedly, this task was not easy the first year and involved considerable advance planning. Now, after three years of experience, it has become almost routine. The benefits are obvious. For the first time the investor, the prospective investor *and management* have available a clear view of the nature and scope of the organization's worldwide activities, including sales and profits by location and by product line.

Another area of our present accounting principles that could stand critical scrutiny is the basis that we use in the valuation of inventories and the measurement of the cost of product sold. Let me use a simple illustration of the problem.

Assume that a company purchases items for inventory at DM 10 and sells them to its customers at DM 15. Under the conventional methods now in use, that company would report a gross profit of DM 5. Suppose, however, that prices are constantly rising, and that by the time the sale is made at DM 15 the cost of items needed to replace the original inventory has risen to DM 12. One might well argue that economically the realized gain was only DM 3, the difference between the actual sales price and the current replacement cost, and that the remaining DM 2 was simply the result of inflation, which had nothing to do with the current efficiency of the company's operations.

Germany has tried to solve the problem through a recent change in tax laws which permits the creation of a reserve for price-level changes, and thus permits a corporation to exclude from current taxable income a portion of the increased cost of the inventories. In America, we have not gone as far as this, but we are requiring disclosure, in a footnote to the financial statements, of the extent to which income has been affected by price-level changes in inventory.

Some companies have attempted to solve the reporting problem by adopting the LIFO inventory technique which in its simplest terms applies against sales the cost of the most recent purchases. Other companies have adopted a modified form of LIFO, called the base-stock method. This latter technique is based on the notion that in order to maintain a normal flow of operations certain inventory quantities are required to be on hand and in the manufacturing stream. These inventories are called the "base stock" and are

valued at the historical cost at the date the base-stock method is adopted. Inventory quantities in excess of the base stock are considered to be within the normal trading cycle and are valued at current cost and related to the sales within that cycle.

The entire problem of present values and inflation permeates all of our accounting problems. Depreciation based on historical cost of the plant may be satisfactory as a method of ultimately removing the cost of the plant from the balance sheet, but it obviously completely ignores the fact that the new plant will cost far more than the original plant.

The Financial Accounting Standards Board in America has recently prepared a research study on the entire question of price-level accounting and is at present conducting a series of public hearings on the subject. While it is too early to predict the final outcome of these hearings, they have generated considerable thought and discussion in the financial community, and have served to focus attention on the entire problem.

And so, I suggest that our first step in reestablishing the credibility of our financial statements must be in the direction of developing reasonable and logical principles of accounting and valuation, principles that fit within the objectives we are attempting to attain.

An observation as to who should have the responsibility of establishing the accounting principles may be appropriate at this point. In 1932, following the collapse of the stock market and the great depression that followed, we in America decided that corporations had to be subject to some more stringent requirements than in the past. From the study emerged the Securities and Exchange Commission which was assigned the task of supervising those corporations that had sold, or were planning to sell, their securities to the public. In the hearing that preceded the enactment of that legislation, the then senior partner of my Firm testified before the congressional committee that was studying the question. He argued that the establishment of accounting principles and reporting requirements ought to be left to the professional accountant, and that no legislative body, no matter how well-intentioned, could enact legislation dealing with such technical matters. Now, forty years later, the wisdom of his views is unchallenged. In America the professional accountants have been entrusted, through the Financial Accounting Standards Board, with the responsibility of developing accepted accounting principles and reporting requirements. Obviously, this requires close cooperation between the professional accountants and the government agency, and imposes a heavy sense of public responsibility on the accountant.

It has worked well, however, and will continue to work, in my judgment, so long as we meet our responsibilities to the public.

We must develop a set of principles that are logical and that are designed to report fairly the economic realities. No longer can we as trained accountants defend our reporting of results by arguing that they are based on "established conventions" or are in accordance with "generally accepted principles," or report that the statements "conform to tax regulations" or "corporate law."

Recently the leading professional accounting organizations in ten countries met to discuss the questions of accounting principles. That group, known as the International Accounting Standards Committee, issued the first of its reports early in 1974. In that report they indicated that their objective was "to formulate and publish in the public interest, basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance and observance." They further listed three important considerations that should govern the selection and application of accounting policies:

(a) Prudence
Uncertainties inevitably surround many transactions and this should be recognized by exercising prudence in preparing financial statements. Prudence does not, however, justify the creation of secret or hidden reserves.

(b) Substance Over Form
Transactions and events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

(c) Materiality
Financial statements should disclose all items which are material enough to affect evaluations or decisions.

■ **Informing the Public.** Once we have established sound principles of accounting which accurately reflect the economic facts of life, we must then, in my judgment, describe them to the reader of the statements. I am not speaking here of a long, detailed, technical description of all the principles adopted or practices applied in the statements, but I am suggesting that those principles and practices that significantly affect the statements should be described clearly, especially if several methods are available. For example, if a significant portion of a company's activities is conducted overseas, I believe the reader has a right to know the extent to which the corporate assets are subject to the risk of foreign-exchange fluctuations and foreign government

regulations. When does the corporation recognize the income on the foreign sales—when the product is sold to the foreign customer, when the receivable from the customer is collected in foreign currency or only when the proceeds of the sale are converted into the currency of the parent company?

If the applicable tax laws existing in the countries in which the company operates provide for certain benefits that are unrelated to economic reality, to what extent have they affected net income? For example, under the German law, a corporation may defer the gain on certain types of assets if the proceeds of the sale are reinvested within a specified period of time. Clearly, the gain on the sale of a major investment gives rise to income, and the fact that the gain escapes taxation if reinvested in a new factory building does not change that economic fact. I submit that the reader is entitled to know the amount of the gain realized and the method adopted by the company in reporting that gain.

In today's environment companies are forced to spend substantial sums on research and development projects. Should not the reader of the financial statement be informed as to the amounts expended on research in the current year, how much has been charged to income and how much has been deferred, and what basis has been used to decide the nature and amounts of research expenses deferred?

And so, I submit that in addition to establishing sound principles of accounting, we must explain them to the reader of the statements, clearly, succinctly and, if I may say so, honestly.

As a part of our educational process, we must also develop the view that all financial statements, no matter how well prepared, have some inherent limitations. They are based on some conventions that are fundamental. The balance sheet can show the financial condition at a moment in time and should not be used by the reader for anything more than that. The income statement can show the results of the company's operations for a year or a period of years, and obviously possible trends can be developed on the basis of past experience. The income statement by itself, however, cannot be and is not intended to be a guarantee of future results.

■ **Consistency and Change.** Two more tasks remain. Once we have adopted principles of accounting, we have an obligation to follow them consistently. No longer can we indulge in the luxury of picking and choosing the principle that best serves the corporate purpose. If a company has elected to write off the cost of its research program as the expenses are incurred, it should not change the method and commence a program of capitalizing those expenses

in a year in which earnings are lower than management would like. If corporate profits are somewhat higher than management might like, there is little ethical justification for concealing a portion of those profits by creating unnecessary reserves.

. I am not suggesting that an accounting policy once adopted is then carved in stone and can never be changed. Quite the reverse. I submit that the corporate accountant has the obligation to review constantly the accounting principles and policies that he uses in constructing his financial statements. He must be alert to the changing conditions and circumstances, and responsive to them. I do submit, however, that an accounting principle or practice once adopted should not be altered unless:

1. The proposed change more clearly reports the economic facts of the situation—is in fact a better principle than the one in use.
2. The effects of the change, if significant, are clearly revealed to the reader of the statement.

Perhaps a simple illustration will suffice. Assume that you have constructed a new chemical plant, and you commence depreciating the equipment in that plant over the same period as your other equipment—let us say fifteen years. After a year or two of operating the new plant, you discover that, because of the unusual corrosive nature of the manufacturing process, the equipment probably will not last more than ten years. Clearly, your annual charge for depreciation at that plant should be increased, and you should not be bound by the depreciation rates being used elsewhere. By the same token, however, the reader of the income statement is entitled to know that the amount of depreciation charged to operations has been increased by 50 percent, and he should be told why.

We are living in a dynamic era, and we are in the process of constant change. We must recognize the forces that produce those changes in our everyday lives. We must be prepared to recognize those same forces as they affect the economics of our corporate life, and adopt those principles of accounting that most clearly reflect those changing circumstances. No laws or regulations can be written as irrevocable. They must be constantly examined, critically tested in the light of experience and, of necessity, changed.

I would add one last rule of fair disclosure. If the income of the company has been affected by an unusual circumstance or extraordinary event, it should be described to the reader. Suppose you sell an investment in an affiliate at a rather substantial profit. Clearly, the amount of that profit should be disclosed in the financial statements, and the reader should be able

to identify the gain as an unusual, nonrecurring item. In brief, he should be able to measure the amount of income that has resulted from the normal operations of the company and how much of the income resulted from events that were neither usual nor recurring.

CONCLUSION

And so, I return to my starting place. As corporations grow in size they will need to attract capital, whether in the form of long-term debt or of capital stock. As multinational corporations expand their operations throughout the world, they will be competing in world markets for new capital and not confining themselves to their own countries as the source of funds. Prospective investors are going to demand financial data that are reliable and accurate, and that are comparable to financial data submitted by companies located in other countries. The prospective investor in New York, given his choice of investing in a United States company or a German company, must and will exercise his option on the basis of the financial statements of both companies. Unless those statements are prepared on the basis of a logical and consistent set of well-founded and adequately described principles, he cannot make an intelligent choice.

I am not advocating the notion that our rules in America are proper and all other rules are wrong. Nothing could be further from my position. What I am suggesting is a study by all of us throughout the world who are engaged in the preparation of financial statements–a study designed to furnish the prospective investor with financial data that are meaningful and that he can understand and evaluate whether he be in Frankfurt, London, Tokyo or New York. ●