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Section A - Transcript

P R O C E E D I N G S

PUBLIC HEARING OF THE STUDY ON ESTABLISHMENT
OF ACCOUNTING PRINCIPLES

November 3 and 4, 1971
1700 Broadway
New York, New York

SECTION A

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WEDNESDAY MORNING SESSION

November 3, 1971

The Study on Establishment of Accounting Principles, sponsored by the American Institute of Certified Public Accountants, convened on Wednesday morning, November 3, 1971, in the meeting room of the Institute at 1700 Broadway, New York, New York, at ten-ten o'clock, Francis M. Wheat, Esq., Chairman.

Committee members present were:

Mr. John C. Biegler, CPA, senior partner of Price Waterhouse & Co.;

Mr. Arnold I. Levine, CPA, national executive partner, management of J. K. Lasser & Co.;

Mr. Wallace E. Olson, CPA, executive partner of Alexander Grant & Company;

Mr. Thomas C. Pryor, CFA, partner and chairman of the investment committee of White Weld & Co.;

Mr. Roger B. Smith, vice president-finance, General Motors Corporation;

Dr. David Solomons, FCA, professor and chairman of the accounting department, Wharton School of Finance and Commerce, University of Pennsylvania;

Francis M. Wheat, Esq., Attorney-at-law, Chairman

CHAIRMAN WHEAT: The only thing I have to say at the outset this morning is a word of appreciation from myself and my colleagues, for the time and trouble you have all taken to

come and meet with us. I hope we can keep these proceedings relatively informal; I think we will gain more from them that way. We're most grateful to every one of you, in case we don't have a chance to repeat that comment each time you come to the microphone to talk with us.

So thank you on behalf of all of us; I hope that you will feel ultimately that your participation and the time and effort you have put in will have been worthwhile.

You all know why we're here. I don't think that any further remarks on my part are necessary, unless any of my colleagues have anything to say at the outset.

They stand mute, for the moment, but look out later.

Our first witness in the box this morning is our eminent colleague, Mr. Robert Trueblood, who is chairman of the parallel study which some people think, quite correctly, is a seminal study and we're the technical one.

He is, as you all know, the chairman of the study on the objectives of financial reporting, and in addition to that he's the managing partner, I believe, of Touche Ross, and I think he brings us a message from Touche Ross. Perhaps he'll say something, too, about the progress of his own study, which I'm sure will be of interest to all of you. Bob!

MR. ROBERT TRUEBLOOD: I will be glad, Chairman Wheat, to answer any questions about the progress of our own group, of the objectives study group, but I think it should be abundantly clear that I do state this morning only for Touche Ross of which I am chairman of the board.

The first official statement Touche Ross made on the matter of the contribution of the APB was a speech over my name made two years ago, "Ten Years with the APB." This has been supplied to the Commission, but is not today a matter of our formal submission.

Touche Ross representatives met with the Wheat Commission in Chicago on June 25, and issued a formal statement which is available in printed form today. We do not intend to enlarge upon that rather brief statement, but I would summarize it for you so that you, if you wish, may let me stand questioning.

Very briefly, Touche Ross believes that the best solution to the problem of establishing accounting principles holds with the creation of a small, full-time accounting principles board. Such a group would be chartered to deal with new developments involving accounting and accountability as they emerge; to conduct a significant level of research, and development of an underlying conceptual framework of the accounting discipline; and to anticipate future accounting needs that will be imposed upon the profession by the public.

First in terms of the board itself, we contemplate a small group of five to seven fully-paid members, members that would be without regard to firm affiliation or membership in the Institute, but with considerable appreciation of practice considerations.

Each member would be required to dissociate himself from his prior affiliation; a business firm, a practicing

firm, or a university.

Most importantly, we think that a small, top-level board should be supported heavily by competent staff, and would require significant involvement with its peers in the financial, business and academic communities.

The scope of its activities would be broad, ranging from the formulation of objectives to the enunciation of principles, to consideration of practice pronouncements.

As sort of a peripheral idea we feel that the historic separation of accounting and auditing within the framework of the American Institute is not supportable logically and should not be maintained. So that the forward work of the board would also have some influence on direct auditing matters.

We concur with the current practice and procedure of involving the business community in early discussions and projected opinions.

As to levels of performance, we might describe our position this way: we presently conceive the board as a kind of inverse pyramid, with a lot of effort at the top; with a very small underpinning of research either in the purchase sense or in the activity sense.

We like to think that ideally the structure of the board would really be pyramidal, in the sense that there would be a small group of top people, heavily supported by competent staff, and heavily supported by formal research.

We have made rough estimates that this procedure could cost as much as eight or ten million dollars, but I

will have a few comments on that later. Most importantly, on the cost side, we feel that at least 50 per cent of the total effort should be devoted to research.

This statement we make constructively, in the spirit and vigor of youth and growth, without any institutional or proprietary bias. We put it forth as a suggestion for the consideration of the Commission; we do not take the position that any single one of our proposals should be inviolate.

I would like to talk very briefly about two aspects of this. There has been some criticism already that we do not put enough score on the requirements of practice involvement on the part of members of the board. I feel very strongly that given a reasonable term, a reasonable cycling of terms, that day-to-day involvement with client matters is not necessary, and even could be a positive aspect of our proposal.

And just one word about relative cost as between the present situation and our proposal. I think if one really does cost out what we're presently doing, including the contribution of time, imputed implied costs, that there is really not that much difference between our present proposal and our present experience. But enough for that.

One comment relating to the profession which is not covered in our official submission is the matter of discipline and enforcement. We regard this whole subject as somewhat outside the direct concern of the Wheat Commission; we do feel very strongly, however, that particularly in its professional interplay with the SEC the matter

of discipline and enforcement is a very critical forward problem. It's a past problem as well, but it must be handled in the future.

Our firm, Touche Ross, has large disappointment in the outcome of the so-called "Seidman Resolution" which has not yet been worked into canons. We think it should. But most importantly, we simply feel that it is imperative that the profession undertake a higher level of interest, a higher level of concern, a more timely effectiveness in the enforcement of its technical conclusions in the entire discipline of accounting.

Mr. Chairman, that's all I have to say at the moment.

CHAIRMAN WHEAT: Let me propose a procedure, which will involve all of us, to the extent that we have time. The panel will have some questions for Mr. Trueblood, and then if we have time before we move on, I would like to invite any of you who are present to pose a question or two which Mr. Trueblood, I'm sure, would be glad to try to answer. If none of you have any specific objections we will try to follow that procedure throughout the hearing.

On the other hand, if any of you do have any specific objections, I would ask you to let me know and we will, of course, accommodate your wishes.

Let me ask a question of you. As you know if you have looked at any of the papers we have received in advance of this hearing, there are a number of eminent commentators who have drawn a sharp distinction between

so-called accounting principles, basic, fundamental matters of a higher nature, and what you refer to as practice pronouncements.

They recommend that there be two entirely separate bodies; body number one (perhaps even under separate auspices), which would deal with matters of accounting principles; and a separate body--of a somewhat lesser stature, I take it--which would be charged with dealing with practice pronouncements and, if you will, what some people call detailed standards.

In view of your comment that you envisage your board dealing with both of these, and particularly in view of the fact that you have had the benefit of the experience of chairing the committee which is trying to search for basic principles, I wonder if you would give us your comments on that proposition and your reactions to those proposals?

MR. TRUEBLOOD: I regard, and the Touche proposal regards, the subject matter at three levels--broad objectives, principles and procedures. How each of them is dealt with is a difficult question. I think the Touche position is that we must have a compatible and consistent set of broad objectives which, I believe, our paper presumes to ultimately come from the board, as a sort of companion piece to the work of our present objective committee.

The principles are the broad statements of applicability to accounting as it is done; the practice statements are the more or less procedural aspects of the situation.

First I would point out that the Board in its present method of operation tends to make some distinction between what they call the principle level and the practice level, in that frequently, if not always, an opinion is followed by a series of interpretations at the detail level. So the present Board has already made some such distinctions.

In our own proposal, we suggest that the board confine itself to objectives and principles, and that these procedural implementations and interpretation kind of things come either or both from practicing firms or from the staff itself.

I think the distinction which was made in one paper I read is quite appropriate. I have only recently read that paper; I do not care to comment on the structure or the organization, which it explicitly proposes, but the distinction between the two matters is completely appropriate and completely consistent with the Touche position.

CHAIRMAN WHEAT: Let me follow that up just a little bit. You address yourself primarily to the distinction, possibly semantical and otherwise, between these different kinds of pronouncements. What concerns me more than that is the question as to whether or not in your judgment it would be a desirable form of organization to have a separate body dealing with the one under different auspices, as in one proposal, and another body attempting to deal with the other; whether or not a distinction can be made so sharp that there will be no problem in having two separate bodies trying to coordinate between each other.

That concerns me and I wonder if you could give us your reaction?

MR. TRUEBLOOD: That is my explicitly withheld judgment as a result of my brief exposure to that proposal on the organizational structure. I think there is a distinction; I think they should, however, be blended together; they have to work hand-in-hand, and I would be somewhat disturbed if one didn't have to report to the other or they didn't have to coordinate together, and so on.

But the distinction is completely appropriate; I can't conceive that the organizational framework could not be worked out.

CHAIRMAN WHEAT: Let me just ask one more question. You draw this explicit distinction between the principles and the procedures or practice pronouncements. I have been puzzled by that distinction from the beginning, but that's understandable since I am not a professional accountant.

On the other hand, I would like to give you one example and ask your opinion. You indicated that the present Board does draw a distinction between what you refer to as principle and what is referred to as procedure in relation to its process for interpretation.

Let me give you an example of an opinion; I believe it's 18, which deals with the equity method. Would you regard that opinion as dealing with a matter of principle, or a matter of practice pronouncement?

MR. TRUEBLOOD: I would say that that portion of the opinion which deals with the conceptual correctness of picking up equity in an associated company is a principle. All the detailed rules and procedures about percentages and circumstances and caveats, ought to come out as a practice bulletin.

CHAIRMAN WHEAT: Do you really think it's feasible to have one organization announce the principle and then a totally separate organization attempt, without having had the benefit of the debate, concern and philosophical discussion that goes into the formulation of a principle, to take that as a given affair and fill out these details. Do you visualize that some lack of coordination might creep into that?

MR. TRUEBLOOD: You're pressing me on this.

CHAIRMAN WHEAT: I am. I don't have an answer which is quite satisfactory.

MR. TRUEBLOOD: I have taken the position that there must be, by one arrangement or another, a high degree of coordination, cooperation and collaboration. After all, it's the profession that has responsibility for all three levels of pronouncement, and one way or the other, the profession must find a way for them to hang together.

CHAIRMAN WHEAT: Let me just follow that for a moment. You would prefer to see Opinion No. 18, instead of being contained in one single integrated pronouncement, separated out into various and sundry parts which would be issued separately at separate times?

MR. TRUEBLOOD: I think the substance of 18 could be stated in at most a paragraph or two. The interpretations and detailed rules sort of follow on naturally in most cases. I submit that in Opinion 11 there is a very long series of interpretations and questions and analytical decisions about details, many of which were not even on the table for discussion; they came up later.

CHAIRMAN WHEAT: Mr. Trueblood, is it really possible for a group of men to sit on high and pronounce on matters of principle without considering and being enmeshed in the problem of how they would be applied--whether or not the principle really works in practice? In other words, can you really separate these things and say, "We're going to announce this principle, but it's up to somebody else to worry about all the details?"

MR. TRUEBLOOD: You cannot sit in this room and talk about principles without thinking about impact. You cannot sit in this room and draw up 125 detailed applications without considering what went on in relation to principles.

But my point is really that one follows from the other. And I want to go back one step further and say that it is the Touche position that objectives are fundamental; principles follow from objectives, and practice implementation details follow from principles.

CHAIRMAN WHEAT: My questions, as you understand, are not designed to press you too much. But as a layman and

a practical lawyer trying to figure out whether or not it's feasible for somebody to pronounce on matters of principle without having to have his nose rubbed in the problem of practice and whether or not these principles will work, I am concerned about separating the two.

MR. TRUEBLOOD: There is no question that a high degree of coordination is required. In the Touche proposal we do not make that separation as between bodies, but we contemplate a separation as between responsibilities for these two issues. The principle, as between the Touche proposal and the one you're talking about is not inconsistent. The organizational framework is different from what we contemplate.

PROFESSOR SOLOMONS: There's one point, Mr. Trueblood, that doesn't come out quite clearly in your statement. You say that your reconstituted board would consist of the best professional accountants in the country; you say that the practicing profession can neither share nor delegate the main responsibility for this matter. It isn't quite clear from your statement whether you envisage your new board as continuing to be an arm of the AICPA or whether members of the board will have to be members of the AICPA. Also, how do you respond to the view that because accounting is so important to the whole economy, the board should not be composed exclusively of professional accountants?

MR. TRUEBLOOD: I think the intention of that statement, and I believe I submitted a clarification of

that statement, is that we regard the board as properly consisting of accountants, but not necessarily CPAs. And in my own personal view, not necessarily members of the American Institute, because that's an interlocking problem. As distinguished from a proposal which might include men from other disciplines such as the behavioral sciences, I think the Touche proposal contemplates that that kind of input would best be secured from two sources: either purchased consulting or membership of other disciplinary people on active project advisory committees, support committees, etc.

The second part of your question had to do with public sector versus the private.

PROFESSOR SOLOMONS: I think I was concerned about bringing onto the board disciplines other than accounting.

MR. TRUEBLOOD: Yes. Did I answer that satisfactorily?

PROFESSOR SOLOMONS: Yes, thank you.

MR. PRYOR: I have two questions. First, would the accounting profession support the opinions rendered by a small board of the size you described? Secondly, could you describe a little more specifically what you visualize in terms of these broad objectives?

MR. TRUEBLOOD: In response to your first question, I think I would say categorically that the practicing profession, as I know it, would support the opinions of the smaller board, even though it means that certain firms would not always have representation on that board, or might never have representation on the board.

I think this goes back to one of the reasons we're here. The profession wants a strong, viable, accepted group which will establish opinions for use of the profession. I have no concern on that score.

Your second question, about the distinction between objectives and principles is a little bit more complex and one which the objectives study group is reviewing every day and finding difficult. One can say simply, that the objective of financial accounting or financial statements shall be that they shall give all necessary and useful information to all users. That's a broad statement of philosophy about which we could have no problem.

Then one runs into a series of what we might call institutional constraints, one of which is independence, for example. Then you go to a third level or characteristics, such as causality, comparability, consistency. Next, I think one goes down one step further to prescriptive characteristics, such as fair-value accounting versus historical cost.

This is the philosophical, conceptual underlay for methods of accounting, as distinguished from rules and regulations.

MR. OLSON: Do you regard the appearance of independence to be an important factor in suggesting a smaller, full-time board?

MR. TRUEBLOOD: It's not critical to my thinking about a full-time board. As far as I'm concerned, and Touche is concerned, we know enough about the workings of

the Board and have been so heavily involved that dependency in fact is not a valid criticism. I do feel that the automatic seats, the automatic representation of certain firms does create a problem which relates to the appearance of independence from the public point of view. That is not a significant or major reason underlying the Touche proposal.

MR. LEVINE: Mr. Trueblood, carrying that a step further, how do you anticipate that this board will be appointed? Have you given this any consideration?

MR. TRUEBLOOD: Not in the detailed organizational sense. Presently, Board appointments are made, I believe, on recommendation of the Board of Directors with approval of Council--am I correct, Mr. Savoie? Is that how it is?

MR. SAVOIE: The President appoints with the approval of the Board of Directors.

MR. LEVINE: Are you suggesting that the selection would be under the auspices of the Institute?

MR. TRUEBLOOD: Yes, I presume that the selection would be under the auspices of the Institute. I presume that recommendation would come from other professional groups, such as Financial Executives Institute.

MR. BIEGLER: Mr. Trueblood, one point is not absolutely clear to me. What fundamental feature is involved in your proposal that would suggest that the end product of the effort of this board will be any better or any more acceptable than the end product of the present Board, which is strictly a

voluntary operation. This Board has out of its eighteen members the equivalent, certainly, of more than seven full-time persons.

MR. TRUEBLOOD: My concerns on that point are threefold: First, given a part-time, volunteer board, in most cases, if not in all, the individual members of the board are devoting a great deal of time and attention to the affairs of the board in a very dedicated, thorough and admirable way. But, at the same time they do have clients to take care of; they do have telephone calls, and the like. This is a distractive process, and it tends to take away from their total involvement with the board.

Also, I really think that as an organizational matter, as a psychological principle, total involvement with any procedure, is significantly different than casual or part-time involvement with that same project, no matter how sincere the effort.

I can further attest that in our own experiences on our objectives group, where we are presently working with total full-time staff as distinguished from a part-time staff, the difference in the production and attitude is very apparent and the result is very ~~appare~~ apparent already.

May I make one more point: Although you ~~may~~ may regard the main thrust of the Touche proposal to be the smaller board, an equivalent thrust is enlarging the face of this parameter in terms of staff, competent, expensive, and full-time, and research, purchased from or contracted with the best people in the world who can do that piece of

research. And that, in terms of the ultimate output of the board, is equally important to Touche as the reconstitution of the physical body.

PROFESSOR SOLOMONS: That part of your proposal is not inconsistent with the present Board, which could have a broader staff base.

MR. TRUEBLOOD: But they do not.

PROFESSOR SOLOMONS: But they could have.

MR. TRUEBLOOD: Yes, they could have. This is how our conversation got started. It is our view that many opinions go out without any empirical research, any fundamental research, sometimes with relatively little conversational research. This is one of the things we are urging you to consider seriously and to make whatever suggestions you wish regarding it.

CHAIRMAN WHEAT: Mr. Trueblood, almost all of the discussion we have had has had to do with the mechanics of the process of arriving at principles and pronouncements on practice. In 1964 the Institute adopted a Council resolution indicating, generally, that the objective was to narrow the range of alternatives in generally accepted practices, and thus to narrow all the choices that were then present in preparing financial statements.

Do you still regard that objective as a primary one, and is it your general observation, and the basis upon which you make your proposal, that this work should proceed more rapidly and effectively in the future than it has in the past?

MR. TRUEBLOOD: When you tied in 1964, were you speaking explicitly of the Seidman resolution and the discipline part of it, or were you speaking of the broader question?

CHAIRMAN WHEAT: The broader part.

MR. TRUEBLOOD: There is no question in my mind that we must proceed further and faster in making like things look alike and making unlike things look different; narrowing the differences, or however you want to put it. We have made some progress, but not enough. We must proceed.

Along with that we should have enforcement procedures, too. It's not your business, but an important part of the issue.

CHAIRMAN WHEAT: Let me comment on that. It is our business, in a sense, because we have had eminent and experienced people advise us that in their judgment the task of establishing these principles and practice pronouncements ought to reside in the Government. It is not the business of the accounting profession to do this; it is a public matter which should be handled by an interdisciplinary group such as the Securities Exchange Commission. The SEC has this responsibility under statute and ought to pick up the ball and do the job. They say we ought to put an end to this business of trying to do the job in the private sector. A part of that proposal, of course, is that this would bring together the organization which is doing the enforcing and the organization which is doing the pronouncing.

It would, therefore, ensure better enforcement than we have today.

I wonder if you would comment on that?

MR. TRUEBLOOD: The constrast suggestion--the Government suggestion--is certainly logical and viable. In our 1969 paper we took the position that the profession had two alternatives. One was to withdraw completely and let the Government do it. The other was to get with it and do it creditably ourselves and work along in the historic manner with Government agencies.

I have two comments. The first is somewhat trivial, I suppose, but it has certainly been our experience in accounting areas that where certain agencies have taken over the rule-making process completely, the experience has tended to be bad in the sense that there is a lag, an inflexibility about detail governmental rules and regulations.

More importantly, I think the transfer of the function from the private sector to the government sector raises some very broad philosophical questions which you must consider. The best source material on this I have ever found is the late Flexner, who did the study on the medical profession and education in 1912, '14 and '16. He has an explicit article, which I think runs from about 1920, in which he attempts to define a profession. And one of the five or six cardinal characteristics he sets forth is that if the subject matter be professional, and if the discipline is properly handled in the private sector, one of the principal characteristics is self-discipline.

So if accounting is truly a profession, then self-discipline must come from us. It seems to me that that is going to be the test. We get with the self-discipline or we lose a lot of other things.

CHAIRMAN WHEAT: I wonder if anybody in the audience has a question for Mr. Trueblood? You are welcome to ask him. Mr. Gibbs has a question.

MR. GIBBS: How long a term would your men serve?

MR. TRUEBLOOD: We did not go to that level of mechanical implementation. There have been several suggestions of three-year or five-year terms, with no more than one repetition; and seven-year terms with no repetition. There are quite reasonable parameters which would be acceptable to us.

CHAIRMAN WHEAT: Any other questions?

We thank you very much.

MR. TRUEBLOOD: Thank you very much for hearing us again.

CHAIRMAN WHEAT: Next on the program was Mr. Bernard Maas of the American Stock Exchange, but unfortunately he found it impossible to be here. So if Mr. Etra is here, we would proceed with him. I hope he's here.

Mr. Donald Etra of the Corporate Accountability Research Group, Washington, D. C.

MR. DONALD ETRA: Thank you, Mr. Wheat.

It certainly is a privilege to be here this morning because the accounting profession holds a high responsibility to the public. Both the courts and the

profession itself have come to recognize that the accountant's primary responsibility is to the public as opposed to the management group which hires him and pays his fee.

I myself am a public interest lawyer from a firm of four public interest lawyers. This last year we organized what is known as The Company to Solicit Questions on Professional Responsibility. As a result we've received letters from the professions--law, medicine and accounting--from individuals who have expressed criticism of their own profession.

I would like to bring you, this morning, in touch with some of the ideas that individual accountants have brought forth to us. I would also like to present four challenges to the accounting profession:

Firstly, the challenge to strive for greater uniformity in accounting procedures;

Secondly, to reassert the independence of the accounting profession;

Thirdly, to accept liability--a better word might be responsibility-- for the work of each individual accountant;

And fourthly, perhaps the most exciting challenge, to accept a leadership role in innovating for the public good.

Firstly, on this question of uniformity. What the accounting profession has strived for over the past couple of years is a conceptual framework. Why do accountants do the work that they do? What use is made of financial statements to which accountants certify? Investors make use of these statements, creditors, labor groups look at the statements to

see if they're getting a fair share of the profits; consumers look at the results of the corporation to see if the prices which are charged are just prices, and government regulators make use of these financial statements to compile aggregate data to evaluate performance of the economy.

Are financial statements comparable? At the moment, unfortunately, no! And this is where the problem lies, because if financial statements are to be useful to the above-mentioned groups, an investor must be able to compare the performance of one company against another.

The availability of alternate procedures makes it a hard task to compare the financial statement of Company A to the financial statement of Company B.

In short, perhaps what is needed is an "esperanto," a common language for the accounting profession. If uniformity is not possible on an across-the-board basis, then I suggest that the AICPA take a leadership role in suggesting uniform accounting standards within industry groupings. Industry groupings can be based on the Standard Industrial Classifications. If that doesn't work, refine these classifications.

The Small Business Administration finds it very difficult to analyze the performance of companies when they can't compare financial statements of one company or another.

As you know, the Government last year conducted a feasibility study on the establishment of uniform cost accounting standards, and Congress felt that cost accounting

standards and uniformity in that area were feasible. In fact, it was estimated that out of the \$70 billion of business the Government does in contracting with defense contractors, perhaps \$2 billion could be saved if the Government were able to compare the statements and compare the cost estimates of those companies with whom it contracted.

Should not similar savings be available to the private sector? Comparability and usefulness would be one way of ensuring that financial statements would again become relevant to those who rely on them.

My second challenge is one to reassert independence. This challenge is related to the question of uniformity. If an accountant can choose among alternate accounting procedures, then management can say, "Paint me a picture which will show that I have done a good job," and management will tell the accountants, "You can do it because you've got the alternate procedures available."

We've got to create uniformity, restrict the alternative procedures available, and that will be one way for the profession to reassert its independence.

I'd like now to present to you a hypothetical situation. For instance, I propose a suggestion, you follow my suggestion and then you come to me and say, "How did I do by following your suggestion?" I've got a proprietary interest in my answer, because I made the suggestion which you subsequently followed.

This, Gentlemen, is the situation which exists in the accounting profession when accounting firms also do management consulting work.

Professional Ethics Opinion No. 12 is entitled, Independence--Auditors' responsibility to avoid relationships which to a reasonable observer might suggest a conflict of interest. The opinion concludes that an accountant can give management advice as long as in doing so he does not impair his objectivity.

The crucial question is, does the giving of management advice impair an accountant's objectivity? I know that the AICPA has taken the position that playing a dual role does not impair a CPA firm's objectivity. But how does the public view an accountant who plays a dual role?

Professor Abraham Briloff conducted a study on this issue. The conclusions of his study, after polling investment analysts and other men in the financial field, was that 58 per cent of those polled felt that objectivity was incompatible with accountants' giving both accounting advice and management consulting advice.

A potential conflict of interest exists with any group that's on two sides of an issue.

I make no charges that a real conflict of interest exists. I do assert, however, that we should at least have the opportunity to see what are the results of an accounting firm playing a dual role.

Therefore, I suggest to this body today that you

require disclosure of those clients of accounting firms, to whom the accounting firms give management advice. At least let the public see that the accounting firm is playing a dual role; let the public judge whether the accounting firm can be as objective and independent as it asserts that it is.

I also suggest to this body that it examine the financial statements of those companies who use the same accounting firm that certifies the statement as the accounting firm which gives management consulting advice.

The Corporate Accountability Research Group is disturbed by the trend over the past few years--and this brings me to my third point--that the AICPA has sought to restrict the liability of accountants. The AICPA, in its amicus curiae brief in the Continental Vending suit, stated that as long as an accountant adheres to generally accepted accounting principles, he should be free from liability.

On one hand, one can see from the accountant's point of view it is perhaps wise for him to cover himself and say, "As long as I'm within the purvue of GAAP I'm okay; no one can assert that I'm breaching any fiduciary rules."

However, I'd like to suggest to the AICPA at this hearing today that a policy of strict liability be imposed. It is not enough to say that you simply follow generally accepted accounting principles, if those principles themselves do not provide a reasonably prudent investor with that which he wants to know.

In short, there is a credibility gap in generally

accepted accounting principles, and this credibility gap does not reflect honor on a profession which has been known throughout history as an honorable profession; as a profession with a high degree of integrity; a profession that accepts responsibility for its work.

My fourth challenge to this body today is the most exciting one. I ask the American Institute of Certified Public Accountants, and I ask each individual accounting firm here today, to take a leadership role in innovating for the public good; to try to expand the interpretive indices available to accountants; to analyze the social consequences of some of the corporate actions that we see in the world today.

Gentlemen, I ask you to analyze the costs of producing an unsafe car. What is the cost in terms of life? What is the cost to society and communities in terms of failing to put pollution-restricting devices on chimneys and after-burners? The true costs of these if reflected in accounting statements would heighten the public interest. Investors and stockholders would then say to corporations, "All right, men, we see that there's more to profit than money. We also want a better environment; we also want better cars; we also want safer streets for our children."

Yes, General Motors can make more money by putting a fancy hood ornament on a car. But consider the brain damage to little children when their brains are penetrated by these dashboards and the hood ornaments which run into them.

There is more to analyzing costs than mere profit and money; pollution, safety, environmental factors.

This profession can innovate and develop these new interpretive indices.

I ask the AICPA to take a stand on the disclosure hearings, on the issue of product-line reporting. The Small Business Administration, small businesses, the Government, would like to know the specific areas where large conglomerates are doing business and making profits.

This is important to the financial data the Government assembles; this is important to the small businessman; and this is important to the consumer and the public, because corporations today do not exist within a vacuum; they have a tremendous impact on the public and on the communities in which they exist.

I ask the profession to assume an attitude of preventive medicine. It does not reflect credit on the accounting profession when so many brokerage firms went under during the past two years. Accountants are privy to the goings on in corporations. They are aware of many of the financial decisions. Why shouldn't the accountant step in and say, "Stop!" Eight months from now the public is going to find out what's going on, we can halt the situation now before innocent consumers are hurt.

Therefore, Gentlemen, I present to you four challenges: One, to strive for greater uniformity; two, to reassert your independence; three, to accept responsibility for the work of individual accountants, and four, to take an exciting leadership role in developing new interpretive indices in working for the

public good. Thank you.

CHAIRMAN WHEAT: I might comment on two points. One of them has to do with this business of accounting for social costs and things of that kind. I'm sure you are aware of the fact that Mr. Trueblood's committee is in the very process of considering that aspect of the objectives of accounting. I am sure, therefore, that you will want to deliver your views to that committee, which is just starting its interviewing process.

That really is probably more in the area of their effort than it is of our task.

The second comment is on the subject of line of business reporting--breaking out the separate segments of the business conglomerate. I believe that it's appropriate for me to comment on the fact that the Accounting Principles Board has that subject on its very active agenda, and is in the process of studying the question.

I think the question boils down to this: The Securities and Exchange Commission today has certain rules requiring the breaking down of the financial statements of a conglomerate into its various segments. However, the disclosure requirements of the SEC do not require that the product-line information be certified by independent accountants. And the basic question, I think, is whether or not that process can be regularized to the extent that it can be covered by the auditor's opinion and standards developed to a greater extent than they are today.

MR. ETRA: I would hope so. I would hope that even before the Trueblood Committee does come to its conclusion that we in this room today would exert an influence on management in terms of asking them to analyze more carefully the true cost of what they're doing on the product-line issue. Unfortunately, as the situation exists today management can decide what product-lines it feels it has, and perhaps this vitiates somewhat the progress made along these lines. I think the AICPA could at least take an unofficial or an official stand for greater disclosure as a whole, this being merely one aspect of the disclosure issue.

CHAIRMAN WHEAT: I would like to ask you one question as a matter of clarification. I'm sure that you're aware of the fact that the word "uniformity" is kind of a pejorative word in accounting circles. One of the reasons is that uniformity is associated historically with so-called uniform systems of accounts.

I'm sure you're familiar with the recent report of the staff of the House Committee on Interstate and Foreign Commerce relative to the Penn Central situation, and the Interstate Commerce Commission and its jurisdiction over the accounting of railroads and railroad subsidiaries. If not, you will want to look at it.

The Interstate Commerce Commission busies itself with uniform systems of accounts, which don't always produce, in terms of financial reporting, the kind of results one might wish.

There have been other examples in Government of pinning everything down to a certain rigid formulation and then putting numbers into slots. Too often, that is the vision that is conjured up by the term "uniformity" in accounting. Whereas, I believe that you had in mind as you explained the matter--and I just want to be sure-- a reduction in the number of alternatives that can be used in the same situation covering the same circumstances. This would reduce the number of choices that can be utilized to flavor the accounts in a different direction--is that what you had in mind?

MR. ETRA: Exactly--the reduction in the number of alternatives. What I was getting at was that the former mentor of the SEC, Mr. Carey, explained that there were many areas where there were alternative procedures to produce materially different results.

He listed some of them back in 1964 and some of these alternate methods still exist--depreciation, income tax allocation and inventories. This lack of uniformity seems to be a frustration that the SEC and many of the observers of the accounting profession have. There is no comparability, and, therefore, the usefulness of the accounting statement to the layman is somewhat vitiated.

CHAIRMAN WHEAT: My only suggestion is that the word "uniformity" is unfortunately not a very specific word and doesn't really mean, I don't think, what you have in mind. I think clarification here is important, because we want to be sure we're all talking about the same thing.

Gentlemen of the panel?

MR. LEVINE: I'd like to ask one question about independence in management services. Could it not be equally said that the fee itself influences the independence? To what extent do you go in trying to evaluate independence? Isn't independence in essence a state of mind and a condition that exists in a profession; something that has to be upheld regardless of the other influences upon it?

MR. ETRA: The idea of receiving a fee is inevitable. It's hardly likely that people will work for nothing, but the idea of--

MR. LEVINE: But could it not influence the independence?

MR. ETRA: I think that question would have to be thrown open to the floor, to those people who receive fees. Do the accountants here today feel that the mere receiving of a fee influences their decision; influences their professional judgment?

PROFESSOR SOLOMONS: It seems to me that everything you've said, or very much of it, is slightly tangential to the main thrust of this group. You have addressed yourself to certain questions of professional ethics which fall into the area of the Institute's Ethics Division; you are dissatisfied with what we presently regard as generally accepted accounting principles, and that is very much the concern of the Trueblood group.

We're principally concerned here with the method by which those principles are formulated. I didn't see anything in the paper which you distributed at the beginning of the meeting, that could be described as suggestions for improving those methods.

Do you have anything to say in response to that specific point? What kind of machinery would you like to see replace the present machinery for the formulation of accounting principles?

MR. ETRA: I would concur with those proposals that have to do with a full-time board. I would add to those proposals that representation on that board not be restricted to accountants and a few academicians, and that investors, creditors, labor, consumers and Government regulators be on that board itself.

The gist of my comments is not necessarily the composition of that board, but what the board comes up with. Is the board capitulating to management by encouraging a great deal of alternative accounting procedures?

Mr. Solomons, you talk about the tangentiality of my remarks. I think what's wrong is that accounting standards lack a conceptual framework. What I'm trying to do this morning is to point out certain philosophical underpinnings which are vital to the accounting profession--independence; restricting available alternatives; accepting liability and accepting a role in developing new social cost accounting.

CHAIRMAN WHEAT: I was going to comment that you heard my last question to Mr. Trueblood regarding his reaction

to the basic task of whatever body we have--the body which he recommends or the Accounting Principles Board--to continue to narrow these differences and eliminate alternatives.

I take it you don't have any exception to his comments? They would be similar to yours.

MR. ETRA: My comment would be similar regarding the SEC's acceptance of its jurisdiction as given by the Securities Act. The history of it seems to be that each SEC chairman speaks at an accounting meeting and says, "You fellows do it, and we'll go along." That's all very well, but accept the challenge and do the job of serving the public.

CHAIRMAN WHEAT: What you're saying, in effect, is that you do regard the accounting profession as a profession, and that you would ask that the accounting profession and its institutions get with it and do the job.

MR. ETRA: Exactly, with respect to expertise. And I would hope independence could be added to the expertise.

CHAIRMAN WHEAT: Let me comment on one very interesting point that you raised. I happen to have with me a summary of Mr. Carey's testimony before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce in 1964 to which you referred. You will recall that Mr. Staggers, chairman of the committee, instructed Mr. Carey to submit a report on what were the alternatives and which ones the SEC considered to be significant. You correctly referred to some of them.

But there is another point that it will be interesting to touch on; there were eight areas that were specifically referred to by the SEC in its submission.

The first area was the valuation of inventories, which I think you mentioned, an area which I don't believe has been fully dealt with yet.

The second area was depreciation and depletion, which is another area that remains on the agenda of the Accounting Principles Board.

The third area, income tax allocation, was essentially dealt with in APB Opinion No. 11, as I recall. This rather full and detailed analysis and opinion has been followed by the profession, I understand, almost without exception.

The fourth area was pensions, where business had much leeway in deciding what amount they wished to put into their pension fund. This area was studied extensively and dealt with by the Board in Opinion No. 8 which narrowed significantly, I believe, the areas of alternatives in pension plan accounting.

The fifth was research and development costs. This remains on the agenda of the Board, with a research study under way.

The sixth was goodwill, which was, as you know, dealt with in Opinion No. 17, which requires amortization over a maximum period of forty years, I believe.

The seventh was a broad question: When is income realized? This subject has been dealt with in a number of

areas by the Board. I refer particularly to a recent Opinion, especially applicable to real estate matters, on accounting for receivables and payables. Some people refer to this as the imputed interest Opinion. It's a technical Opinion, yet very controversial and deals explicitly with the subject.

The eighth is the all-inclusive versus the current operating performance income statement. I believe that was dealt with in an Opinion several years ago. Mr. Barr perhaps can refer to the name of it--

MR. BARR: Number 9.

CHAIRMAN WHEAT: Opinion No. 9. This was a basic objective which was largely realized in Opinion No. 9.

That is the list of principal matters which was referred to by the SEC and the Congress in 1964. I leave it to you and the audience to judge whether or not there has been some marked progress, but in addition some important areas not yet dealt with.

MR. ETRA: If fifty per cent of the task remains to be done, and you can accomplish it in the next few years, I would hope that the purpose of our meeting here today would be served.

CHAIRMAN WHEAT: Now let me ask the audience if they have any questions for Mr. Etra. Would anybody like to comment on what he said or ask him a question.

(There was no response.)

I guess we have a relatively silent audience today. Mr. Etra, thank you very, very much.

MR. ETRA: Thank you, sir.

CHAIRMAN WHEAT: I'm glad to see that we're running ahead of schedule. We will try to stay that way, but we want to allow maximum time for those who are on our program and for anyone here to ask his fill of questions. Our next speaker is Mr. John Rapp of Louis Sternbach & Company. I hope he is here because he was scheduled at eleven forty-five.

MR. JOHN RAPP: In dealing with the questions that have been suggested for this meeting, we construed our brief, rather narrowly. We have attempted to follow rather closely the group of questions arranged under five main subdivisions as a primary responsibility, rather than to go into the more abstract and philosophical fields.

I do want to remark, in reply to the question concerning use of principles of financial accounting or reporting standards, that we side rather strongly with the use of financial accounting and reporting standards.

To us, principles while absolutely essential conjure up something rather abstract and we are concerned with the workability of what comes out of the deliberations of the Accounting Principles Board.

Principles and procedures must be researched and explored. But if we deal with principles from the purely academic point of view, we may possibly not be as much help to the users of financial statements as we would like to be. To the extent that we are practicing accountants, we might be a little out of our depth as compared with the academicians.

I don't want to downgrade the fact that there are broad fundamental principles underlying any kind of procedures. I think, however, that we must strive for the development of workable standards within the overall philosophical thinking that is probably common to most of us in the profession--the basic fundamental of what financial statements should be. Procedures should point to the most desirable way of implementation, but not prescribe them. I am rather taken back when at times we verge on the rule-making process.

It may sometimes be inevitable to veer a little bit that way, but I think we have to be very careful that we do not prescribe operating procedures in such detail that we tend to put out cookbooks. We must leave plenty of scope within well defined parameters for the profession to exert its fullest professional judgment.

I draw attention to the uniformity that was described, for instance, by certain regulatory agencies or the uniformity that prevails in countries other than ours. I believe the public is ill-served when there is such a situation. In certain countries in Europe there is in force at present a system of forcing things into prescribed bases.

I believe in at least one of the countries the so-called opinions read in accordance with the law, or in accordance with such-and-such regulations. We have something to protect.

Now, I may sound like a one-man cheering section when I come to who should have the primary responsibility of performing

the task. I think the task should remain in the Accounting Principles Board, possibly with slight revisions and additions. I think the responsibility should be that of a professional body rather than that of a governmental agency or governmentally appointed body.

I do not want in any way to downgrade or belittle the mission given to the Securities and Exchange Commission. I am concerned that when responsibility for accounting principles is taken out of the private sector, it becomes colored by political considerations, consciously or unconsciously.

It might swing this way or that, according to the prevalent views of the philosophy of the government of the day. I'd like to see standards formulated to stand for a long time by people who know what they are about and who will do so without fear or favor and not be swayed by political or semi-political considerations; by people who, besides their expertise in accounting techniques, should bring additionally the expertise of the surrounding disciplines, such as economics and finance and various others that contribute to making this meaningful.

I certainly would want to continue a very close and harmonious working relationship between the Accounting Principles Board and the SEC, because I think there has been a wonderful amount of professional understanding and give and take. I believe this is something not likely to be superseded. I would like to see that relationship extended. Those people that have problems with the SEC should more readily ask for consultations, rather than inviting a letter of deficiency at some later date.

As to the composition of the nongovernmental standards board, we would like to see representation from accountants other than CPAs, maybe one or two of those who have demonstrated leadership and imagination in working towards more adequate reporting.

As to the CPA composition, I think there should be a good cross-section in the sense of public practice, nongovernmental practice, and industrial practice. And within the public practice sector, I would like to see some representation from the local or regional firms in addition to people from the very large firms. While the affairs of large corporations are influenced by large firms, ninety or ninety-five per cent of the businesses that are not that large are guided by the smaller professional firms. I think they should have a voice in the deliberations.

In some of these smaller regional or local firms the spirit or alertness and inquisitiveness is just as great as some of the larger firms.

As to whether this should be a paid or unpaid board, we would like to see the present volunteer board continue, because we think the very distinction of serving on such a volunteer board would be sufficient compensation to the person serving.

One way in which this could be made practical would be that partners of firms could be sent to the board for a certain term, so that they could be free from distractions.

I would like to see a lot more support from people just below full board stature. They could come in and help the Accounting Principles Board on research, maybe on a share basis--where their firm pays half and the AICPA pays half.

In that way you could, over a period of time, find material for succession to the Board.

I would like to see the entire profession finance the Board. If it means a large increase in dues, I think that's the way it should be, because the profession has a stake in the financial support of the Board and its activity.

While we would not discourage contributions from a research foundation, we would like to see the financial support as broadly based as possible. In this way the smaller man has a very great awareness of his stake in what is going on.

The procedure of the hearings, I think, is desirable and adequate. One thing occurred to me when I saw an opinion passing by a vote of 12 out of 18; would it be possible to review such opinions after a lapse of two or three years, to see whether they would have achieved something like a 75 or 80 per cent majority. Or, to see whether the application of these rather touchy, controversial opinions have sort of proved or disproved themselves in the first year of practice.

It was asked in the questions, I recall, if there should be provision for an appeal procedure from opinions. I do not think that anything smacking of an accounting court would be advisable because it would introduce too much rigidity.

I think the appeal should come from good communications from and to the board.

To me accounting has a dual character: it is in part a science; but also an art and thus nearer to the essence of reality.

CHAIRMAN WHEAT: Thank you, Mr. Rapp.

At the very outset you touched on a matter which is of great interest to us. It is the matter of elusive analysis, and it came up very briefly when we were talking with Mr. Trueblood. It is this business of drawing fine distinctions between principles, standards and practices. This causes me some concern, and I was particularly interested in the comment that in your judgment the primary job of the Board is to develop workable accounting standards. And that by and large, these high principles are matters which accountants pretty well know and recognize.

There seems to be a bit of disagreement over these matters, and I am not sure that they are all matters of semantics. But I know that some part of this confusion may have been engendered by the name which this organization has always had--the Accounting Principles Board. In fact much of what it has dealt with has not been one-sentence or one-paragraph principles, but more detailed matters such as the illustration I gave Mr. Trueblood, Opinion No. 18.

I just read--and I hope I'm not anticipating-- the comments of the National Association of Accountants. On page 6 of those comments this Association makes the following comment:

"We recommend that a new name be created for this body to make clear that there is a complete change in, and departure from its current procedures." Suggested designations included, The Council on Financial Reporting Standards, and The Financial Reporting Standards Authority. The name "Financial Accounting and Standards Board" has also been suggested by at least one other person.

What is your reaction to the question of confusion which I raise? Would there be any merit in making a change of name, here, under these circumstances?

MR. RAPP: My reaction to the change of name would be favorable, because it would more clearly indicate what in our view this board sets out to do: narrow the areas of differences in accounting and reporting treatments, and, therefore, arrive at something more workable, more informative, and more in the public interest.

To me it would correspond much better to what I perceive the role of the board to be.

CHAIRMAN WHEAT: We had some questions earlier in our discussion about whether or not it is feasible or desirable to allocate to this same body the task of setting forth a conceptual framework, i.e. a set of basic principles, if that can be done. Or should that task be wholly separated from the body which has the basic task to do. I would appreciate it if you would let us know your reaction to that.

There is a rather sizable number of people who are concerned and who believe that the job of setting forth the conceptual framework is important. As you know, it is a task

the existing Board has been struggling with since it was formed. It has not yet successfully produced a set of basic principles to which everybody on the Board could adhere.

What is your comment on whether this should be a continuing responsibility of this board, or should be wholly separate?

MR. RAPP: It would depend on whether we see this board as purely a reporting or accounting standards board. The question of the underlying framework is something that goes deeper than that. It might possibly be the province of some other bodies, or drawn from the representative membership-- a parallel study similar to the one put out by Mr. Grady a good many years back. This study was very informative and illuminating, but not really an APB pronouncement. It was done by another part of the Institute.

CHAIRMAN WHEAT: Let me ask you just one more question, for the moment. You indicated that you wanted a professional body and that you felt a volunteer board would continue to be desirable. There has been, as you know, serious question raised with us about the appearance of independence.

Some say that when you have a volunteer board, it appears that members of the board may be subservient to strong client pressures. They say this appearance is unsatisfactory and the whole process may break down as a result.

I take it from your conclusion that you would not regard that as necessarily true, and that in any event you would regard the volunteer board as the better solution. Is that correct?

What is your comment on this independence problem we have to face?

MR. RAPP: I would regard independence as a state of mind which is very difficult for the outsider to evaluate. I would consider that people of sufficient leadership caliber to serve on this board, would have enough independence not to be subservient; not to be pressured. To the extent that continued firm affiliation during tenure on the board might cause an appearance of lack of independence, perhaps some mechanism could be found for these people, during their tenure on the board, to take a leave of absence from their firm. They could return once their term is over. This would make it clear to the public that they are dissociated from the operating decisions of their firms.

CHAIRMAN WHEAT: That suggestion might conflict, might it not, with your desire to be sure that important and experienced accountants from local and small firms are adequately represented on the board. It would be extremely difficult for such gentlemen to sever their relationship from their firm.

MR. RAPP: It might be difficult but not impossible. It would all depend upon the degree of public spirit that the particular person had and the extent to which he would be willing to work for the improvement of principles and standards. I can see where certain persons might be glad of a chance to spend time away from operating decisions in the interest of improving the profession.

MR. BIEGLER: Mr. Rapp, in response to one of the questions, you agreed with the thought that perhaps some clarification would result from renaming the body to something like, the Financial Accounting Standards Board.

Proceeding from there, would it be your thought that a similar clarification would follow if the reference in the accountant's opinion was changed from generally accepted accounting principles, which tracks the Accounting Principles Board, to some other reference?

MR. RAPP: I think that would be quite necessary. That would lead me to some other areas of unhappiness I have with the present wording, namely accepted by whom.

We may possibly think now of revising the short form opinion; some clarification might be in order.

MR. BIEGLER: I'll ask one other question in quite a different area: In your paper you refer to the possibility of the board having approximately twenty-five people. The present board is eighteen; we heard earlier from Mr. Trueblood a suggestion for a board of seven. Do you think it is practical for twenty-five board members to reach a decision or decisions on a timely basis, or don't you consider that a problem?

MR. RAPP: I would like to see within that somewhat larger board, constant work on the part of smaller subcommittees with frequent meetings of the full board to evaluate, praise, criticize, and reject.

If it calls for more frequent meetings, then so be it.

Maybe it would be good public relations to know that this board is now meeting every month, so that the people that complain about nothing being done know that something is being done and somebody is regarding this as a matter of urgency.

For this to be workable they would have to have very good staff.

CHAIRMAN WHEAT: As a point of clarification, I think it might be worth noting that the Study Group has examined into the history of the Board, including the time consumed on projects and the frequency of its meetings. As you point out, Mr. Rapp, there has been an evolution here.

In the first year of its existence the Board met three or four full days in the year. This current year meetings which have been held or scheduled will consume about thirty full days of work.

PROFESSOR SOLOMONS: It's not quite clear, Mr. Rapp, why you think a board of twenty-five men would be more effective than one of the present size or even smaller.

MR. RAPP: I suggest the possible enlargement of the board to accommodate representation from non-CPA accountants in industry who have shown leadership in financial reporting, and representation from the smaller regional firms.

I do not want the board to be too heavily weighted by these additional elements. Otherwise, there may be a possible injustice in the composition of the board.

PROFESSOR SOLOMONS: In your written statement you spoke of having an increase in the membership so that the public interest is served. Mr. Etra also wanted to see the public interest served, but for him those words meant something very different than I think they mean to you. In your statement, the public will be served by having only accountants on the board; not necessarily CPAs. You're somewhat contradictory, because you say in one place it should be composed of CPAs, and you say elsewhere that there should be one or two executives who are not CPAs.

MR. RAPP: Non-CPAs who have shown leadership should be invited. What I really meant was that the balance should be CPAs.

PROFESSOR SOLOMONS: What do you have to say about the public interest being served by a board of this kind?

MR. RAPP: To me the matter of financial reporting is a matter for accountants, provided that they are sufficiently broad in outlook and training, and have support from related disciplines. I think they are the ones who would be able to police and regulate, instead of having people with other interests come in from the outside, whether they be attorneys or financial executives. I think it is a case of accountants putting their house in order to lead the profession strongly. It should be a continuing self-policing, self-disciplining effort.

PROFESSOR SOLOMONS: About members of the board being on leave of absence from their firms, in universities we make important distinctions between paid leave and unpaid leave. (Laughter)

MR. RAPP: I was hoping that it might be a paid leave of absence from the firms. I did not fully investigate this, but I would hope that firms willing to have members work in the general interest of the profession would not cut off the money.

PROFESSOR SOLOMONS: That also raises the point that the Chairman mentioned before--if a man is on paid leave, is he, in the eyes of the world, really any more independent of his firm that he was before?

MR. RAPP: Maybe each situation would have to be judged on a case-by-case basis. If the person concerned would be in a position to render the service without being paid by the firm, maybe that might be done. The firm would support him only as necessary.

But again, I am mainly concerned with the actual presence of independence. While I don't believe in concealing things, it does not have to be publicly announced that a member of the board is on a paid leave of absence from his firm.

MR. PRYOR: I'd like to understand one thing a little more clearly. As I understand what you were saying, in order to improve the quality of the decisions by enlarging the group and broadening its base, you would be willing to accept such greater inefficiencies as might develop from the

expanded size. Or don't you think that would be the result?

MR. RAPP: I don't think the additional number of people would necessarily cause more inefficiency. But, it might be desirable to study what's going on within the Board as it has been performing, in order that it become as efficient as possible.

We think of a twenty-five-member board, for instance, as one that could have five or six working subcommittees at the same time.

MR. PRYOR: Of course, they use subcommittees now.

MR. RAPP: I know, but with a larger board they could have more subcommittees, and could go into details of structure and timetables. And even though it would have greater and more comprehensive representation, that in itself would not necessarily cause added inefficiencies; it could work the other way.

MR. OLSON: Mr. Rapp, while you've made a number of suggestions in your paper, I get the impression that you don't characterize yourself as a severe critic of the present APB operations.

If that impression is wrong, I wonder if you might focus on the prime area that causes you concern with the present setup.

MR. RAPP: I am indeed not a severe critic; I think the APB has made great strides towards narrowing differences in accounting practices. I know there's a lot to be done in many areas, and I think rather than trying to

toss out what the past has brought us, we should capitalize on what we have. Possibly by fairly mild and not so mild reforms, we could go on with what we have.

I am afraid of a lot of complications and unwieldiness in the case of restructuring, and also afraid of a lot of confusion on the part of the public. I think the public has gotten used to the fact that there is something called the APB. If that existing body can be made into a sharper more precise instrument than it is, I would prefer that.

CHAIRMAN WHEAT: Mr. Rapp, you may recall Mr. Trueblood's comment that he does not think it is any longer feasible to separate the formulation of accounting standards from auditing standards. He would like to see the auditing standards and financial accounting standards, under one roof, so to speak.

There is an intermediate position which has been suggested to us, and I think it might be particularly important to get your views on this, in view of your comment about the auditor's short form opinion. Some say that although auditing standards should remain under the jurisdiction of the Committee on Auditing Procedure, the language used by the certified public accountant in rendering his opinion upon the financial statements ought to be a matter of concern to the standards board; it should be placed under its jurisdiction, for such reform or revision as might be indicated.

What is your view on this?

MR. RAPP: My view of this is a strictly personal one. I would like to see the responsibility for the auditor's opinion remain where it is. However, I would want to see the Committee on Auditing Procedure have its thinking affected by whatever goes on at the APB, or however we name it.

In other words, there should be continued cross-fertilization of ideas and probably exchange of views from one to the other. I don't think much will be gained by putting things under different hats. Maybe I'm too much of a gradualist, but I believe in judiciously pushing evolution.

CHAIRMAN WHEAT: Your comment about the opinion of the auditor was of great interest to me. There have been a number of suggestions, and I would particularly comment on the paper submitted to this Study Group by Mr. Carl Tietjen.

The general thrust of his comments, and others of similar character, is that the certifying accountant should state, in his opinion, that he has approved, in essence, the presentation as being a fair presentation, rather than stating that the financial statements are fairly presented in accordance with generally accepted accounting principles. This is not quite the same as saying fairly presented, but a somewhat ambiguous mixture of the two. Mr. Tietjen and others have suggested that what we need in the accountant's opinion is a statement that the principles and practices used are the appropriate ones for this situation. This places the responsibility on the certifying accountant; what is your reaction to that?

MR. RAPP: My reaction is quite positive. To the

extent that it makes the certified public accountant live up to the standards of his profession, so be it. When rendering his opinion, he should be expressing it on fairness.

The opinion could be cross-referenced to the work of the APB or the standards board, by stating that there has been no significant departure from the reporting standards prescribed by the profession. Maybe two things are necessary: approval as a certified practitioner, and a statement that there has been no material departure from reporting standards.

CHAIRMAN WHEAT: I take it that your comment recognizes that there may be cases in which a departure from a particular opinion or standard might be justified because of peculiar circumstances, with the departure giving a better presentation and avoiding some misleading point.

MR. RAPP: That is really why I phrased it the way I did.

CHAIRMAN WHEAT: So that the departure would be disclosed?

MR. RAPP: Yes.

CHAIRMAN WHEAT: I want to see if I understand perfectly what you're saying. What you are saying is that the accountant's opinion might state two things: one, that standards announced by the standards board have been followed, unless a departure is justified; and that he approves, as being a fair presentation, the standards which have been applied in areas not yet covered by standards.

MR. RAPP: The language must be polished up considerably, but basically I think these two ideas should be included.

CHAIRMAN WHEAT: Now, are there any questions from the audience? We have two; would you identify yourself for our reporter, please?

QUESTION: My name is Don Zima from Daytona Beach, Florida.

Would you explain why you feel that a separation of the principles board from the practice and procedure section wouldn't be feasible and of ultimate benefit? Might it not be a limit on interpretations or representations of these procedures?

CHAIRMAN WHEAT: I regret that I have given the impression that I feel very strongly about that, because I don't. I am seeking information and sometimes lawyers seek information, as you well know, by propounding a view and asking what the reaction is to it.

I did not intend to indicate that I felt strongly about that.

Do you? (Laughter)

MR. ZIMA: I believe as you do.

CHAIRMAN WHEAT: I haven't indicated how I feel. (Laughter) I'm not doing very well.

MR. ZIMA: I think there should be a separation.

CHAIRMAN WHEAT: It's not my job to indicate to you gentlemen how I believe. I'm hopefully going to conceal that for the time being, because I have not made up my mind, nor have

any of us. We are here to gain enlightenment rather than to project our individual viewpoints as they might be. I would hope that our minds are open; we are here to learn the views of those who are appearing at this hearing. So I would repeat again, this is a matter in which I am interested in viewpoints.

QUESTION: I am Luke Patrick, President of Continental Gas Pipeline Corporation, Houston, Texas.

Mr. Rapp, I understood you to say that you felt generally that independent accountants should continue to establish accounting principles, and that they should put their house in order. I'm interested in knowing why you conclude that the business of establishing accounting principles is their province exclusively.

MR. RAPP: Accounting standards should be established by those primarily concerned with the task of accounting reporting. They gain an insight into what is fairest in accounting practices among widely different industries, occupations and circumstances.

I believe that independent accountants might be better placed to formulate such standards than highly skilled accountants in a particular industry or group of industries. They might possibly take on the color of their particular industry or industries.

I think the range of the professional accountant permits him to make and formulate standards that can be generally applied.

MR. PATRICK: Speaking of the responsibilities of the business accountant, however, for properly reporting and recording the results of his business, wouldn't you grant him some equal expertise and knowledge in the area of accounting principles?

MR. RAPP: I am in favor of having on the standards board representation from non-CPA accountants in industry who have shown leadership in that particular area. And by that to make the weight of their leadership, their insight, and their acumen felt.

MR. PATRICK: Then I understand. I misunderstood your answer to the previous question. You didn't intend it to be entirely the province of independent accountants; it's the house of all accountants.

Thank you.

CHAIRMAN WHEAT: Yes?

QUESTION: George Sorter from Chicago.

Mr. Rapp, I'm interested in your proposal of a full-time, twenty-five-man board.

MR. RAPP: I didn't advocate a full-time board. I was advocating a volunteer board, heavily part-time; not a full-time board.

MR. SORTER: One of the criticisms of a part-time board is that it does not permit the interaction, the total involvement, this sort of symbiotic relationship toward a joint product. This is the position that Mr. Trueblood took earlier today.

You tend to get fragmented and sort of non-cohesive positions. Don't you feel that would be accentuated, if you enlarged the board to twenty-five?

MR. RAPP: I can see the dangers you outline, but as I said before, it doesn't have to be that way. It all depends on how much imagination and effort you put into it. If people living in different parts of the country want to get together, what is to prevent them from catching a plane and having a meeting face to face?

MR. PRYOR: With your volunteer board would you want a full-time paid chairman? You didn't mention that.

MR. RAPP: I did not address myself to that question and have an open mind on it. It might possibly be necessary under the circumstances. I have not specifically suggested an answer because my thinking has not yet crystallized.

MR. PRYOR: But you don't rule it out?

MR. RAPP: I do not by any means rule out a full-time, paid chairman.

CHAIRMAN WHEAT: Ladies and Gentlemen, let's break for lunch and plan to reconvene promptly at one-thirty, or a little earlier if possible.

(The morning session ended at twelve-ten o'clock.)

WEDNESDAY AFTERNOON SESSION

November 3, 1971

The afternoon session of the meeting of the Study on Establishment of Accounting Principles convened on Wednesday, November 3, 1971, at one-thirty o'clock, Chairman Wheat presiding.

CHAIRMAN WHEAT: Next we will hear from Arthur Andersen & Co., represented by Harvey Kapnick and George Catlett, who is an experienced member of the Accounting Principles Board. We're delighted to have you both.

MR. HARVEY KAPNICK: Thank you, Mr. Chairman. I would like to identify the fact that our brief, which has been presented to you, represents the firm's viewpoint on the matters before your Study Group, as well as my personal viewpoint, as chief executive, and George Catlett's as Chairman of our Policy Committee.

I would like, if I could, to take just a little different tack from some of the presentations this morning. In opening I'd like to identify why we are here and why we have taken the position that we have in our brief.

First of all, I think we should all recognize that we're here for one basic purpose: In most respects we are the ones that are responsible to the public for proper financial reporting. There is a public interest involved in this subject; one of the most sincere public interests that I think exists anywhere in the world today.

The second reason we're here is because we have elected to have self-regulation. In any type of self-regulation

problems can become more severe, and accountability for responsiveness to this public interest can become much greater.

There are four points I would like to cover with you this afternoon.

The first is that in any type of self-regulation, in any type of public interest, the need for criteria for decision-making is almost overwhelming. They should be identified and published so that everyone can understand what the decision-making criteria are. I strongly want this to be part of the record. Obviously this is not part of your study, but is part of the entire problem. Unless the criteria can be determined, I feel strongly that the issue of self-regulation may well be academic. If we were to go to the public sector--in other words to the SEC--these criteria, would not, I believe, be as important because a regulatory body, under laws of the country, can do what they decide without relating to the logic of a decision.

In self-regulation, however, every decision we make must be logical, and must be tied to the type of criteria that was previously developed.

I go from there to the next point: in self-regulation we must have three additional points other than the criteria. First, we are not self-appointed arbitrators; we are responsible for the determination of sound accounting. But all interested parties should have a right to be heard and have their views considered by whatever body is determining what principles should be.

I can relate that to the SEC if we were to go into the public sector. Obviously they do have a procedure whereby all interested parties can be heard, and differing viewpoints reconciled.

A second point that I would like to make in this area is that a record of the views and the pertinent background and reasoning for the decision are absolutely necessary in any type of self-regulation. It is an understanding of the reasoning and background, and the reconciliation of viewpoints which gain their acceptance or non-acceptance.

There is a third point, about which we talked a little bit today, that is the need for the appearance of complete independence. I would say that the further we go into self-regulation, the greater the need for appearance of independence. The key issue in the entire deliberations may well rise or fall on the issue of independence.

There are many areas of this question of independence. Many years ago--and I think you can talk about many of these ramifications for some of you may have questions--when the profession was discussing ownership of securities by independent auditors, the same questions and considerations were discussed. We elected as a profession to self-regulate our independence. I think this is the same issue we have today.

I want to make sure that the record is clear. I am not in any way saying that members of the APB today or in the past have not been independent per se. I think that anyone who has read the newspapers and participated in discussions, however, must recognize that there have been questions raised with regard

to the appearance of independence. That is the context in which I would like to leave it.

The question of whether or not the present APB or the past APBs have been independent will only be answered by history. It is not necessarily a subject that we should explore further unless, of course, you want to.

With those remarks, Mr. Chairman, I would be happy to answer any questions you might have with regard to our proposal, and my comments.

CHAIRMAN WHEAT: Thank you very much, Mr. Kapnick. Mr. Catlett, do you have any comments you want to add?

MR. CATLETT: I think I'll wait for the question period.

CHAIRMAN WHEAT: Mr. Kapnick, you referred at the outset of your comments to the fact that the accounting profession is responsible to the public for proper financial reporting. Your emphasis was on two things: one, that the independent accountant has the basic responsibility to assure that the public receives the very best financial reporting; and two, this responsibility lies very heavily upon the independent accountant in the function that he has to perform.

At a later time you made a comment that I'm not certain is entirely consistent with that. You said, "We are not the self-appointed arbiters." I would certainly second that comment, and add that it appears to me that the Securities Acts of 1933 and 1934, particularly the latter, indicate a

a conscious choice by Congress to interpose the independent public accountant into the process of disclosure to investors, rather than having Government send out auditors as was originally proposed. The choice was made in the Congress, after the eloquent intervention of some leading members of the accounting profession, to delegate to the profession the task of protecting the public and making certain that the financial statements meet the highest standards of disclosure and fairness.

I would take it, therefore, that the accounting profession--and I would ask you if you agree with this--is not a self-appointed arbiter at all. Rather, it has been designated by a special Congressional philosophy and by the intent of Congress to play a very significant role in making sure that financial statements are in accordance with the highest standards of disclosure.

It was determined at the very outset that this essential function did not have to reside in a group of governmental accountants.

Would you comment on whether or not that is a fair analysis of your statement?

MR. KAPNICK: There are three observations I would like to make on that. First of all, we've got to separate the attestation function from the development of accounting principles.

In that regard, the attest function under the law clearly belongs to the public accountant. It is my recollection that the law does not identify the accounting profession as the one responsible for the determination of the principles that are

followed. I think that we have to clearly establish that as a point of fact.

If we are going to determine accounting principles, which, as indicated in our brief, we think we should, then we have to assume and execute that delegated responsibility with the very highest degree of professionalism available to us.

Therefore, when I indicated we weren't the self-appointed arbiters, it was in the context of needing as much input from everybody as possible.

Any new organization must have that as a criterion and as a part of the program, or we are going to fail in this role. It was in that context that I wanted to make that remark.

CHAIRMAN WHEAT: I think I understand your position more clearly, but, let me see if I can clarify it a little more in my mind.

On page 21 of your brief, you say that during the past forty years "...the accounting profession has borne a significant responsibility in the development of accounting principles. We believe that the basic responsibility for developing accounting principles should continue to rest within the accounting profession as represented by the AICPA." You go on to point out the need for a restructuring which emphasizes independence.

I take it that your view is a twofold one; first, that the basic responsibility, although you recognize that it is heavily upon the profession, should remain with the

profession. However, you would want to make sure that better and more constructive arrangements be developed for input between the business community and those who are particularly affected by these matters. In this way, there would be no question about complete due process and the coverage of all viewpoints.

In addition to that, you emphasized the need for a relatively public record of steps that are taken and whatever influences there are.

MR. KAPNICK: Absolutely.

CHAIRMAN WHEAT: I have a question that relates to pages 23 and 24 of your brief, where you discuss the suggestion that there be a full-time group of top quality people who would be members of this restructured APB. I wonder if you have given some thought to the question of how these people would be obtained; from what segments of the profession; what compensation ought to be paid to them in order to get the type of people you want.

MR. KAPNICK: I think in one section of our brief we do explain how we would go about obtaining or nominating in the selection process. The selection process that we visualize would have the American Institute, the Board of Directors through its President, appoint a fifteen-man commission.

The commission would be made up of leading authorities, partially from the AICPA and partially from industry, Government and others. This commission would select the men that would be on the fully-paid board. After they were nominated by the commission, they would be ratified by Council. If there has

been great dissension over a person, it can be expressed by this means. Council does represent a broad spectrum of the profession and the academic world and business accountants.

CHAIRMAN WHEAT: What I am particularly concerned about is the question of what level of salary would or should be paid in order to meet your criteria.

MR. KAPNICK: I think the real question is what level of salary is required to obtain the top guy? I think you're talking in terms of a minimum of \$75,000 to \$100,000 a year for this man.

CHAIRMAN WHEAT: In other words, this would be a level substantially below the level of compensation of important partners of major firms, isn't that correct?

MR. KAPNICK: I can't speak for the other firms--
(Laughter).

CHAIRMAN WHEAT: Wouldn't it be a fair statement to say that \$75,000 to \$100,000 would be substantially below?

MR. KAPNICK: If you're going to get into this line of reasoning, you have to put it in context with a time frame; with the reputation that the position carries with it; with a man's motivation and career. I'm not so sure that those who have discussed behavioral sciences relate everything to dollars and cents. I think an income of \$100,000 in the most prestigious part of the profession could well be compatible with many people within the profession, if you put it within a time frame.

The time frame I'd put it in would probably be past the age of fifty. First of all, I would like to see a wealth

of experience in this person. I would like to see his maturity of judgment and other personal attributes at a mature level. I would also like to see a time frame of five to ten years, which would almost be the final position a man would carry.

So I personally see this being completely consistent with a professional career, and I think that many judges do the same thing.

CHAIRMAN WHEAT: Take, for example, the gentleman in the accounting profession who has reached the age of fifty. At that point he is very close to the top of his firm, let's say, or he has reached the point where during the next ten years he is going to be at the peak of his profession, and presumably at the highest earning point of his lifetime.

Do you think you can get this man to leave his profession at that point in his career, at a substantially reduced compensation and essentially no opportunity to return to his firm?

MR. KAPNICK: Why do you say he can't go back?

CHAIRMAN WHEAT: You're talking about a relatively long period of time. Wouldn't it be difficult for him?

MR. KAPNICK: I'm concerned about the practicality, also. I think, however, that we have to ask ourselves the same question as it relates to Government. People who go to the SEC resign from very substantial positions and take even a bigger decline in income than probably I am suggesting.

So that we have the experience in other sectors of our life where people, because of various motivating reasons,

have given up positions for less income. I think this is obviously a key question in any full-time, paid board. But I don't know that it is necessarily a controlling factor, because we can look at Government and see what is happening in the selection of SEC Commissioners, and so forth.

CHAIRMAN WHEAT: That raises two questions: SEC Commissioners, as you know, are paid at about the level of \$36,000 or \$37,000 a year and they do have massive public responsibilities cutting across the area of accounting.

Suppose you established a five-man commission in the private sector, with each of the five men being paid \$100,000 and give them responsibility for establishment of accounting principles. Do you visualize any problem at all in that men in Government who have basic responsibility will note that they are being paid \$36,000 or \$37,000 a year, whereas these gentlemen in the private sector are being paid \$100,000 a year for a small slice of that responsibility? Does that give you any concern or pause at all, about the likelihood that such a structure might rather swiftly move the whole task into Government?

MR. KAPNICK: Mr. Chairman, I think there are several ramifications to your questions. I think first of all, we've got to recognize that the SEC has the responsibility and the authority for what we have been discussing.

Therefore, it is to their best interests to make sure that the accounting profession does this as well as it can be done, or else they will have to take it over themselves. If salary is the issue, then I think, as I said earlier, it's

probably there already. We are going to need some type of a salary, and there's no way that I can see of going to \$36,000 on this. It becomes completely incompatible with the type of situation we're looking at. If we don't move in the direction of as much independence as the people in the public sector have for this, then we are going to move it into that sector anyway, and it's only a matter of when.

CHAIRMAN WHEAT: Of course, when we're talking about self-regulation, to which you key this task of the accounting profession, we have certain analogies; the New York Stock Exchange and other stock exchanges, for example; the integrated Bar Association in some of the states; the National Association of Securities Dealers.

In none of those instances are the responsible boards and groups paid at salaries which would command the top leaders of their respective industries or professions. You would have to pay roughly the same or more than you have suggested--in the neighborhood of \$100,000 to get somebody full-time.

What we have had to date in the field of self-regulation has been essentially volunteers of higher education and experience who have been willing to take substantial time off from their professions or occupations but who might or might not have been willing to divest themselves and serve full-time.

I wonder if past experience doesn't suggest that the volunteer arrangement comports a little better with the question of self-regulation. I'd like your reaction to this.

MR. CATLETT: I might comment on this briefly. There are advantages and disadvantages to all the different ways of going about this. I think we all recognize that. The question we're really addressing ourselves to is what on balance will give us the best approach.

I think in the long run it is likely to rise or fall on how good a job has been done. I recognize very well the point you are making; I suppose there is a little danger there, but I feel there is a greater danger in not doing the job well enough. In my thinking the number one consideration is the organizational structure that will do the very best job. To me, as between the two, a full-time group has a much better chance of doing a much better job.

As you know I've been on the Board for about six years and will shortly be going off. Therefore, I may have certain biases. It would be my observation that the present organizational structure is not efficient enough. This group--as others have said--works harder than anybody has a right to expect them to. A great effort is going into this work--but the very organizational structure and the way in which it operates are terribly inefficient.

A great deal of time is wasted; the time lag between starting something and finishing it can be shown by the record to be too long. I think more and more

Government agencies and many professional and public organizations wait this long. The reaction period is a very present problem; it's a year before the Board can even get something on the agenda.

CHAIRMAN WHEAT: We've made a study which would tend to indicate that after the completion of a research study the reaction time of the Board has not been terribly long. The great delay has been caused by the enormous time it takes to get research studies completed.

Would it be your view that at least a substantial part of the problem of efficiency has been that of getting research done effectively and quickly so that the Board could then have the benefit of it?

MR. CATLETT: That is certainly part of the problem. But even beyond that are the subjects the Board should have taken up and never did.

Right now there are a number of subjects the Board should react to; people need guidance from the Board and we can't give it to them. It's not because people don't want to, but it's the cumbersomeness of the entire mechanism. There are things that possibly could be handled in three or four days if they were handled properly.

CHAIRMAN WHEAT: Mr. Catlett, you've been stressing the question of efficiency and the ability to get things done, which was also stressed by Mr. Trueblood this morning. However, Mr. Trueblood said that he did not consider this question of

independence--the appearance of independence--as critical in his judgment. He did not think that lack of independence was a valid criticism of the present Board.

I take it that you are in total disagreement with Mr. Trueblood on that point.

MR. CATLETT: I wasn't comparing the efficiency--

CHAIRMAN WHEAT: I didn't mean to put it quite that way. You had indicated that you had no question about individuals on the present Board. But I take it that there's a fundamental disagreement between you and Mr. Trueblood on this question of independence.

MR. CATLETT: I think we put a slightly different emphasis on it. We're not saying that Board members aren't independent. I think what we're saying is that the public interest in this area is very high, probably higher than most areas of the American Institute, and that everything should be done to achieve maximum independence, both in effect and in appearance. That ought to be one of the major considerations.

MR. BIEGLER: Mr. Kapnick, in your comments you made a statement, if I heard it correctly, that said we-- and I assume that is the accounting profession--are responsible for the determination of sound accounting principles.

On page 36 of your brief you say almost the same thing: that an accounting profession which retains, on a merit basis, the right to develop accounting principles in

a professional manner is desirable. This suggests that the right could be taken away and put in somebody else's hands.

I'd like to speculate with you for just a moment, and ask what you think might happen if, for example, this Study Group were to conclude that everything should go on as it is now. What do you see down the road?

MR. KAPNICK: I think that the accounting profession will not solve its problems by merely continuing with what it is now doing; I have to start with that premise.

Secondly, I think that the press and users of financial information have become aware, in the last decade, of the public interest in accounting. I can go back not so many years ago when there was very, very little interest in accounting or the differences between the various alternatives. People accepted a balance sheet or an income statement because it was footed properly. That day is over.

I think the user groups are now questioning the need for more and more disclosure and better and more information for their own purposes. Therefore, I think that you're going to see more public interest.

Where is that public interest coming from? I think we have seen in recent months what ten years ago would have been debated as hotly as anything we had in the profession-- Congress stepping in and saying that uniform cost accounting standards should be developed not only for Government contracts but essentially for all of industry to follow.

You have that in the record. You have further in the

record, I think, the fact that Commissioners of the SEC have been questioned on this; and even Congressmen are becoming interested in knowing why the FPC is doing this and the SEC is doing that. They all relate to Penn Central, and say, "Hey, there must be something in accounting that we don't understand."

I think you're going to see a greater assertion on the part of the Congress as to what has happened in the profession. Unfortunately, I think if the economy does continue to have its problems and more and more bankruptcies occur, there has to be an acceleration of this type of questioning.

There was something in The New York Times this morning and as I read it I thought, "I hope that doesn't happen to us." I think the headline went something like this:

"Congress Questions SEC About Why It Took Two Years to Do Certain Things in the Securities Industry."

At what point is Congress going to question the SEC as to why it took so long for the accounting profession to do its job. There is no question in my mind that even though the SEC has always maintained that they wanted this job in the profession, and I think they're sincere in this, there is a point in time when they must look to their own authority and responsibility as outlined in the Securities Acts. I think at that time you're going to see the SEC start moving in on an issue-by-issue basis and setting good accounting.

This is nothing startling; they can do it this afternoon and they have done it, on occasion, when the profession hasn't acted. So that would be where I would say it would go.

MR. BIEGLER: Thank you.

PROFESSOR SOLOMONS: That New York Times headline is another straw in the wind to what you're saying, Mr. Kapnick. The SEC is a rather small, full-time body with substantial staff. Yet it really doesn't guarantee a timely and speedy response to the public needs in the field of securities regulations if the Congressional criticism is justified.

What guarantee is there, therefore, that a small, full-time APB would be more timely in its response than the present one?

MR. KAPNICK: You never have the assurance of timeliness with any group. I think, however, that a full-time group dedicated to achieving progress in a specific area is a lot different from the SEC where they have a multitude of responsibilities--for the securities industry, for the accounting profession, for registrants, and many other things.

Further, I would like to make it very clear that the number of people involved in the determination of good financial reporting under my concept would probably be broader than it is today. I do not look at whatever group would be agreed upon, whether it's five, seven, nine, as being the ones that would do all the research and do all the back-

ground development. I look to other people being deeply involved. The main group would do the motivating, handling of priorities, and the final decision-making.

I don't know that there's a conflict, here, when we're talking about one area.

PROFESSOR SOLOMONS: What other aspects are there-- you've referred to the efficiency of full-time versus part-time board; you have referred to the problem of independence. There is a third dimension, of course, which is of concern, and that's the degree of support the opinions of these bodies would command in the profession.

Are you at all concerned that a small, full-time board would by its very nature have a smaller, narrower base of support than a larger, part-time board would have?

MR. KAPNICK: I made the statement before and I make it again, that if people think the acceptability of present opinions rests upon the fact that the various firms are represented on the Board, then I think they are going under a misapprehension.

That is not the basis for acceptability. Speaking for my own firm, we would much prefer to follow a well developed and reasoned opinion, supported by solid research, than to follow a set of rules that might come out just because we happen to sit on the Board.

I'd like also to point out for the record that firms that have dissented on opinions of the APB, have followed them. Therefore, I'm not sure that the question of acceptability is important as it relates to whether or

not you have a volunteer or a full-time group.

MR. PRYOR: I have two or three questions I'd like to ask. You mentioned independence as an important consideration in speaking about self-regulation.

In your opinion is the problem of management services by accounting firms an important element of the problem of independence?

MR. KAPNICK: I think that the question of independence on management or consulting work has gotten out of context from time to time. If you like, I will try to summarize what I think this whole thing leads you to.

First of all I don't think that the question of whether or not we do management consulting type of work, which we prefer to call administrative services, is really the key issue. If we are helping to improve accounting controls, if we are helping to develop management information systems which produce a better product in the accounting field, this is part of our role and a proper role for an independent public accountant.

There are certain areas, which I don't think we need to talk about at this point, where we feel that management services do lose the independence. However, this is a firm philosophy rather than a professional position, so I'll leave that alone.

If you open up this question, then you have to raise the question of fees and their relation to an engagement.

I would not zero in on management consulting per se. If you receive a \$50,000 audit fee and \$500,000 for installation of a management information system, it might look as though you've lost your independence. But I have to look at it in perspective, because if you say that, then you are saying a \$550,000 audit fee robs you of your independence just as quickly.

I get around to the point that the whole issue of management accounting is not one of the things that bothers me or affects the appearance of independence on the part of our profession, so long as we stay out of the decision-making role.

This is the way in which I analyze that particular problem.

There is one problem that has been talked about from time to time within the profession, and that is that an investment banker, for example, doesn't know the relationship of management consulting fees to our total income. Therefore, there is no basis to say whether \$50,000 or \$1 million dollars is important in relation to a total firm.

All of this still has to be resolved, but I do not consider it as important to the appearance of independence as others might.

MR. PRYOR: You mentioned the problem of conflicts within Government agencies that have responsibility for accounting. Do you think this problem is getting better or worse, and how might you suggest that it be resolved if it is getting to be more serious?

MR. KAPNICK: I don't think it's getting any worse. I think there are conflicts, and I think that the present structure is acceptable, so long as the SEC is the sole one to determine what is sent to the investor.

When other agencies regulate it, there can be serious conflicts between two agencies which at some point in time must be resolved. All of us know that the SEC and some of the other agencies can insist that certain things be done. But I think that over a long period of time a whole new procedure will be developed to appeal these conflicts. I'm not sure we need to discuss or develop that area at this point, but over a long period of time I am satisfied that that issue must be solved.

MR. PRYOR: One last question, and George, I think this is for you: What staff size do you envisage being necessary to support the smaller board that you've recommended?

MR. CATLETT: I don't know that we've given any particular thought to the exact size of staff. It's certainly important to have a very effective staff, both on the research side and the administrative side.

The organization and quality of the staff and management, and the manner in which subcommittees or task forces are used, are very important to the success of any such organization. With a smaller number you still have a lot of work to do, and the staff would have to do certain things. I would prefer the concept of task forces. The Board has used subcommittees, but these teams have been limited way too much to Board members.

Originally all the subcommittee members were Board members; there are a few subcommittees now that have non-Board members on them, but it's still a minority. We're all on four or five committees. It would be better to pick people who are particularly knowledgeable in the areas under study.

Present Board members are not experts in all areas either, so that the work would have to be spread.

A great deal depends on the type of management--

MR. PRYOR: Do you think you could still get volunteer help to work on these new task forces?

MR. CATLETT: That's being done now. I would in this way bring the knowledge of the profession to bear, by having a hand-picked task force on every subject. These people do not need to be CPAs, they can be whatever you need for a particular subject. Much of the work would be done by these task forces.

CHAIRMAN WHEAT: Is it a fair statement that in your judgment you would include on these task forces representatives of business and industry who have particular experience in the area under study?

MR. CATLETT: It certainly would. Some problems involve some industries more than others.

CHAIRMAN WHEAT: In other words, you wouldn't limit it to lawyers and actuaries and so forth?

MR. CATLETT: I wouldn't limit it at all. I'd have anyone who would make an important contribution.

That has never been done under our present setup. You could have 100 or 120 people working on 15 or 20 task forces; and I don't think it would be difficult at all to get people on a volunteer basis.

This leads me to one other thing mentioned this morning on which I would like to comment: the question of whether practices and procedures should be separated from statements of principles. I feel strongly that these are so interrelated that it almost has to be an organizational setup. That doesn't mean that the Board has to issue all these things, but certainly you can't draw a very precise line between principles, procedures and practices.

I think opinions ought to be limited somewhat more to principles than they have. The principles ought to be set forth very clearly. You can look through most Board opinions and not even find the principles; they're all mixed up with a lot of rules and practices. Perhaps a principle is buried someplace, but you certainly have to hunt to find it. I believe opinions ought to be backed up some with a statement saying, "This is the principle; this is the reason we've done this," and have another document, or a second section of the document with the application aspect.

Some of this could be done by the staff; you could have two or three levels of documents. Some interpretations are now being sent out, but I think that procedure could be improved, too. They should be sorted out and treated on different levels, and not combined.

I would certainly hate to see the thing split apart organizationally. You might have two different groups, but they would be part of the same organizational setup and responsible to the chairman of the board. Once you work with this, you realize that the application is all intertwined.

MR. LEVINE: I would like to ask two questions in regard to the desirability of appeal procedures which you apparently are favoring in your brief.

Assuming that the body that formulates accounting principles is a properly constituted operating body, working with the close cooperation of the SEC, why do you feel that appeal procedures are necessary? Secondly, what type of appeals do you envision being brought forth--specific or general?

MR. KAPNICK: I think the appeals procedure is one of the most delicate that you have to deal with. As a profession we are giving to the general public our opinion on financial figures. I can find in that responsibility the corresponding responsibility to determine what is good accounting.

But you go to the next question: the application of accounting is not by public accountants. Rather, it is by management and by financial officers in management, and by boards of directors of companies.

So there is an interest on their part in having good financial information presented to them. And as more of them get into lawsuits involving these areas, I think

this is going to become even more important.

Therefore you have to think of it more in the thrust of giving industry a way of appealing what we decide is good, fair accounting. And if a public accountant disagrees with what we are saying, shouldn't he have a way of appealing?

If you get it into that context, then the only way to make management follow a rule is to make it the law of the land. We, as accountants, can't say, "You must follow this rule." Therefore the whole purpose of an appeal procedure would be to give the right of dissent, the right to be heard, and reviewed. We have already concluded that most people already have this; you could take a problem to the SEC. Then you would be outside the permissive power that we have and into the actual rule-making powers of the SEC.

Quite often you do not get a proper review, if a review at all, in these regulatory bodies. That's when you should be able to go to the courts to determine whether or not a specific procedure or a specific principle was followed.

As you get into more and more of the sensitive areas that need attention in the accounting profession, there can be significant dangers in financial reporting.

How does an industry go about challenging that? I don't think they should challenge it by threatening to change from Firm A to Firm Y. They must have a way to appeal.

MR. LEVINE: I don't understand whether you're confining that appeal to a specific set of facts under a given

set of circumstances, or you're talking about a general appeal from the principle as it is formulated.

MR. KAPNICK: I would say both.

MR. LEVINE: If that's available, it would leave something to be desired in the entire system.

MR. KAPNICK: Why?

MR. LEVINE: You appear to be making a case for legislation, if, in the long run, principles formulated in the private sector are subject to--and I'll use the words lightly perhaps--willy-nilly appeal, which is what it could amount to.

MR. KAPNICK: If you get a willy-nilly appeal, then the whole profession has lost its ability to determine good accounting. Then you go back to George's earlier statement that it's going to rise or fall on whatever comes out of this group.

On the other hand, the alternate to an appeal procedure is to say that all industry must follow what we decide on, and I'm not so sure that I can buy that. I think that you have to allow industry--and let's leave the public accountants out, because if we have this as part of membership in the profession, then everybody that's a member would have to follow that, some way of appealing, either on a specific case or general basis.

MR. CATLETT: I'd like to make one comment.

When you get into the appeal area, you must consider that people have the legal rights; it's not up to us to grant them

or withhold them. Any company subject to the SEC can ask for a hearing either on specific applications or on a broad principle. They have that right, whether we like it or not, and I think we've got to operate with that in mind.

There are undoubtedly going to be court tests of some of these things over the next few years. The rights of people and the real legal procedures may be determined for us.

MR. LEVINE: I think your brief in essence suggests that the type of procedure be altered in some way; that it is not a satisfactory procedure as far as you're concerned.

MR. CATLETT: I don't believe we think that.

MR. LEVINE: That's what I'm asking.

MR. CATLETT: No, we do not.

MR. LEVINE: Is the present appeal mechanism satisfactory, under the circumstances?

MR. CATLETT: The context in which we wrote this brief was that for the present, and as far as the scope of your Study Group is concerned, we would suggest that you just leave that alone because the right of appeal to the agencies exists anyhow. I think the only thing you have to think about is how that relates to the legal basis of the operations of the board.

MR. SMITH: On page 26 of your brief you say, "...we believe that acceptance results more from the quality of the pronouncements than from who are the members of the APB." With that as background, on pages 20 and 21 you say, "Suggestions

have also been made for an APB outside the AICPA...However, a group so constituted would not be responsible to any organization or entity, and we believe that an approach of that type would not be effective." I wonder if you could expand on that a little?

MR. CATLETT: What we're trying to say is that in the present context, the American Institute is probably the best organization in which to place this entity. But the people who serve on it should be the very best people we can find, and that the members of this group need not necessarily be members of the Institute. Structurally it has to fit into some organization, and the American Institute is probably--at the moment, anyhow--the best place for it.

MR. OLSON: We've been concentrating very much on the machinery for setting principles, which of course is our prime concern. But Mr. Trueblood this morning seemed to give great emphasis to the self-discipline of the profession.

You touch lightly on this on page 31 when you talk about the legal aspects of enforcement. But you really don't get into talking about the legal aspects. I wonder if you might expand on that a little bit?

MR. KAPNICK: I think the need for self-discipline, as Mr. Trueblood mentioned this morning when he quoted from an excellent legal authority, is in my mind one of the overwhelming criterion for any professional organization.

I think that is a beginning and you go then to the question of the individual's ability for self-discipline.

When you get into the accounting principles area, there is a conflict between the self-discipline that's needed for a profession on the one hand, and the lack of self-discipline in the development of accounting principles.

I think you get into even more of that in the legal basis. If the laws of the country are such that you are going to follow the writing off of receivables, then I have no alternative. But if you ask me as a professional accountant what is good in this area, I have to decide whether it's good from a professional standpoint without the legal basis. If we can't get to that, then we're going to have to go back to having a legal basis for accounting.

MR. CATLETT: It's certainly our position that the Institute, in connection with whatever is done, has to develop a disciplinary enforcement procedure to go along with it or it will not be effective. We have no quarrel with that.

CHAIRMAN WHEAT: This has been a valuable discussion. Thank you very, very much.

We have held up Mr. Wayne Keller of the National Association of Accountants. I hope you'll forgive us.

MR. I. WAYNE KELLER: You're forgiven.

Mr. Chairman, Members of the Commission, Ladies and Gentlemen: Let me say first that I am substituting today for Frank Meyers who is chairman of the special committee of the National Association of Accountants appointed to draft this report. Mr. Meyers could not be here because of business

commitments.

I would also like to state that we are deeply cognizant of the work of the present Accounting Principles Board, and the progress that they have made. And if I may interject a personal comment, since I have been chairman of the NAA's Committee on Management Accounting Practices, I have developed a much deeper appreciation of the problems of the Accounting Principles Board.

I will take time only to emphasize certain points which have been made in the report which has been presented to you. We think that we should refer to financial accounting and reporting standards. In our discussion today we are not going into all the ramifications of accounting principles, as for example, they may pertain to accounting for internal control, pricing and other matters. We're talking only of reporting.

There has been a fair amount of discussion this morning as to different levels, if we want to call them that, of principles and different bodies. These subjects consumed quite a bit of discussion during the early deliberations of the NAA Committee. We finally settled on three terms: concepts, principles and rules.

Maybe these to a degree parallel what are referred to in Statement 4 as pervasive principles, operating principles, and detail principles. In my personal opinion, I agree with Mr. Catlett that our definitions have been confusing.

What are we talking about? First, a level of basic concepts, and maybe understandability--verifiability, neutrality, timeliness, this sort of thing.

Then we move down to principles. These may relate to obsolescence, to prices, to the accounting entity, to residual interest, to exchanges. Next comes a set of rules by which these principles are applied.

Concepts would be almost like Holy Writ. They wouldn't change very often. Principles would change more often, but not every day. Rules would have flexibility to adapt to the changing social and economic circumstances.

With one dissenting vote in the committee, we favor a non-governmental body, supported by private funds, sponsored by the American Institute of Certified Public Accountants. We feel that it is important that this body, however it's constituted, be closely associated with the Institute as the principal body of the profession.

As to composition, we recommend a full-time, paid chairman who would be selected as much or maybe more for his executive ability as his accounting ability. And then a volunteer body, with three-year rotating terms. We have no strong feeling as to three or five year terms, but we recommend three.

Not more than fifty per cent of this group should be practicing public accountants; and not less than twenty-five per cent should be drawn from industry or commercial organizations--men who are qualified and are intimately

associated with the preparation of financial reports. The remainder should be selected from the academic field, the financial community, and so on.

Of course, we have placed full emphasis on adequate and capable staff, and we also feel that this body must operate with a number of committees.

In this connection we believe that there should be, at least initially, a committee on concepts, a committee on principles--there may be several committees on principles, and then committees relating to rules. These committees need not be appointed from within the body, but might be chaired by a member of the body. The composition of the committees should parallel the composition of the body that we are recommending.

We think we need a new name to indicate to the public that this is a complete change.

We have outlined certain steps, and in these we want to emphasize empirical research. We feel that before an exposure draft is submitted there should be empirical research through simulation, with actual testing in the field to determine what the effect of that opinion would have been had it been in existence.

This we feel is a most important part of research.

That is a summary of our report. I'll try to answer questions from the committee.

CHAIRMAN WHEAT: Mr. Keller, I have just one question on your excellent report. On page iii, at the

very bottom, you mention, as a criticism of the Accounting Principles Board, that it has reversed itself on several occasions.

One might argue, as one gentleman did this morning, that it's desirable for the Accounting Principles Board to review after a few years, a controversial opinion on which there was considerable dissent, to see whether or not it's really working in practice. And if it isn't, to have the courage to reverse it in the light of that experience.

Do you regard that as a bad practice?

MR. KELLER: No. It's a matter of how quickly you reverse yourself. But again, it's the opinion of our committee that had there been empirical research in some of these areas, there wouldn't have been the reversal; the first opinion would have been better. They would have had more unanimity of agreement.

MR. PRYOR: I don't think you mentioned whether you wanted a majority vote or two-thirds vote?

MR. KELLER: We have not. That's sort of a house-keeping thing that we didn't address ourselves to. I think it would be the opinion of our committee that we would certainly have to have a majority and probably a two-thirds vote.

I might mention that the Management Accounting Practices Committee of NAA requires a three-quarters vote.

CHAIRMAN WHEAT: On page 8 we observe that you

believe that the new body does not require an appeal procedure.

MR. KELLER: That is correct.

CHAIRMAN WHEAT: I take it that you would generally agree with the representatives of Arthur Andersen who prefer to leave the situation as it is.

MR. KELLER: That is correct. We feel that there would be no need for a court, because the very people who make up the body would carry sufficient weight, and because of existing procedures--the SEC and so on.

CHAIRMAN WHEAT: Let me just ask one last question: I take it that despite the fact that there are different levels of activity, concepts, principles and rules, you believe that they should be under one sponsorship--

MR. KELLER: That is correct.

CHAIRMAN WHEAT: (Continuing) --who--

MR. KELLER: We had considerable discussion within our committee on that and finally agreed that it should be one group.

CHAIRMAN WHEAT: Some have suggested that there be a separation. You do not favor that?

MR. KELLER: We do not.

MR. OLSON: Mr. Keller, I assume it's fair to conclude that your group is substantially dissatisfied with the way things are now.

MR. KELLER: Maybe substantially is a bit too strong; we feel that there is definite need for improvement.

MR. OLSON: You cited a number of areas in which you feel there are deficiencies in the operation of the present machinery.

If you were confined to a single observation, what would you cite as your major concern?

MR. KELLER: I don't know if I can cite any single one as being the major concern of our committee. We did discuss the fact that pressures make fire-fighting necessary, and that the way in which the Board has been operating has kept it from fire prevention work.

Probably our basic objection would be that underlying objectives or concepts have not been developed as a test for rules.

MR. BIEGLER: Mr. Keller, on pages 7 and 8 of the document you filed with us, you lay out nine essential steps that seem to be designed to guarantee very effective input from all interested parties. And on page 5 in discussing the composition of the board, you recommend that not more than fifty per cent of the membership be practicing CPAs.

Would you care to amplify on your reasoning for this restriction?

MR. KELLER: We don't think the board should be too large. We latched onto eighteen because that's the present size. We have no strong feeling about a somewhat

larger or smaller board, but we do think that the board should have representation from those who are actually preparing financial statements and also from the academic community.

PROFESSOR SOLOMONS: When you say that no more than fifty per cent be practicing CPAs, this doesn't imply, I presume, that the other members either should or should not be non-practicing CPAs?

Let me put my question another way: Is it a requirement of your scheme that all members be CPAs?

MR. KELLER: No. These men from industry may be CPAs.

PROFESSOR SOLOMONS: But they need not be.

MR. KELLER: They need not be.

PROFESSOR SOLOMONS: You envisage a full-time chairman, and approximately eighteen voluntary members. How would the NAA feel about a body which had more than one full-time paid member, but might still consist substantially of part-time volunteer members?

MR. KELLER: I think you're speaking now of staff.

PROFESSOR SOLOMONS: No.

MR. KELLER: Our idea was one chief executive over the body. Yes, under him you may have a director of research--

PROFESSOR SOLOMONS: But what about a body which had a full-time chairman and two full-time vice chairmen?

MR. KELLER: I can only answer that by saying we

didn't get into it.

PROFESSOR SOLOMONS: But you wouldn't see any strong objection to it?

MR. KELLER: Not if you had the broad representation in the body; I wouldn't think so.

CHAIRMAN WHEAT: Does anybody else have a question for Mr. Keller? (There were none.)

We're very grateful to you, Mr. Keller, thank you.

MR. KELLER: Thank you.

CHAIRMAN WHEAT: Next on the list is the Accounting Policies Committee of the Independent Gas Association of America. Mr. Allen, we would greatly appreciate having your views on the record.

MR. C. M. ALLEN: Mr. Chairman, as I told you at the lunch break, I did not come prepared to make an oral presentation today.

On the other hand, for the benefit of those here who may not have had an opportunity to be aware of our written statement, I offered to summarize it and, of course, be available for any questions. Mr. Luke Patrick is here to assist in fielding any questions.

Our committee agrees with APB Statement No. 4, issued in October, 1970, that responsibility for the reliability of an enterprise's financial statement rests with its management.

In recognizing this ethical and legal responsibility, financial management must have an active part in the establishment and development of accounting principles, and financial

reporting policies and practices.

Our committee believes that membership of the APB, or whatever name might be given to it, should contain equal representation from the accounting profession and from business financial management; and some lesser number of members selected from other groups, such as financial analysts and academicians.

In addition, in changing the makeup of APB membership, the committee also believes that serious consideration should be given to making the APB function a full-time activity.

The APB's total membership, in order to be effective, should be established with not more than twenty and not less than twelve members. Pronouncements or opinions of the APB should require the affirmative vote of at least two-thirds of its members.

The term of APB membership should be so established that it will maintain a continuity of purpose and direction, with new replacement members coming in at suitable intervals of time on a staggered basis.

The financing of the program should be undertaken on some equitable basis by the independent accounting firms. This manner of funding it would assure uniformity in spreading the cost of this activity over the entire business community through the accounting fees paid by business concerns.

The research facilities of the AICPA and similar research resources of business financial management and

other groups should be made available to the APB. The newly-constituted APB, from the time research studies are commenced, should seek the advice and participation of all parties on such studies; it should also conduct information conferences and public hearings on the subject matter. It should expose drafts when appropriate, disseminate information concerning pertinent views expressed by respondents, and provide for rebuttal-type responses to such views.

In summary, the committee believes that business financial management is in a unique position of accountability to its stockholders, to the general investment public, to the financial community, to governmental agencies and to others for the accounting principles relied upon in keeping its accounts and records.

Accordingly, it carries with it a right and an obligation to play a major role in the establishment of such principles and reporting practices.

I think that summarizes our position. I'm sorry if I took too long to read it.

CHAIRMAN WHEAT: Not in the slightest. I have one question. Mr. Keller, representing the National Association of Accountants, indicated that his team wanted substantial representation from business financial management, but he specifically wanted the body to be under the basic sponsorship of the American Institute. I notice that you indicated that the financing should be by independent accounting firms, but

I didn't find in your paper any specific comment as to whether you believe that the sponsorship should be under the American Institute. Could you clarify that for me?

MR. ALLEN: I think the feeling of our committee is that the business community could make recommendations for board membership. Likewise, the accounting profession could select members from the profession.

Obviously, we don't have answers to all of the questions that might come up. But it is felt that the business community should have an equal part with the accounting profession in the makeup of the board.

MR. LEVINE: I'd like to hitch-hike on that if I may, Mr. Chairman. Mr. Allen, did you consider the compatibility and feasibility of the first two suggestions in relationship to the full-time activity of a fairly expansive board?

Do you think there would be any problem in providing these people on that basis?

MR. ALLEN: Undoubtedly you would find some problems from time to time in any event. But it strikes me that there are people within the accounting profession, and within the business community, who have a dedicated interest in this effort. I believe you could find highly qualified men to fill the positions.

MR. LEVINE: Do you anticipate that they would be moving into this position on a temporary basis, on a leave of absence, or how would that work?

MR. ALLEN: Our committee didn't face that problem directly. It was considered basically that they would serve a three to five year term, possibly subject to reappointment; they would be a full-time board; they would be funded through some means by the public accounting firms; they would be paid, perhaps by remaining on the payroll of the companies they come from. I don't think this would materially depart from the independence question we have today.

PROFESSOR SOLOMONS: I'm still somewhat dissatisfied with your answer to the question that the Chairman put. I think it's worth pressing, because it will arise again in connection with the position the FEI will take later this afternoon.

If this newly-constituted board, consisting partly of CPAs and partly of non-CPAs is not to be sponsored by the AICPA, then it had better be sponsored by somebody else--it can't hang in mid-air. It has to be responsible to somebody. Arthur Andersen made the point in connection with a different kind of board, which they were rejecting, and said "...a group so constituted would not be responsible to any organization or entity, and we believe that an approach of that type would not be effective." In the context in which they made that statement, I think that was a sound statement.

In the present context, if you accept this view that the board has to be responsible to somebody, not just to the community at large or the business world, who would your board be responsible to?

MR. ALLEN: I will give you my own opinion. I believe the board could very well report to or be a basic part of the AICPA and have it function under the auspices of that organization. I think it might be a very workable situation.

I think our main concern is that management have an equal part in the establishment of accounting principles and reporting standards.

I must admit I had a question I wanted to ask of Mr. Kapnick, but didn't get an opportunity to do so. Mr. Kapnick made the statement, "We are responsible to the public for proper reporting." My question to Mr. Kapnick was: Is he talking "we" the public accounting profession, or does he agree that that includes business management? I don't know his reaction.

CHAIRMAN WHEAT: Is Mr. Kapnick still here?

(Mr. Kapnick was no longer present.)

CHAIRMAN WHEAT: Thank you, Mr. Allen, very much; we appreciate it.

Does anybody have a question for Mr. Allen?

MR. OLSON: I'd like to ask one question, if I may. Mr. Allen, I'm still a bit confused about participation in this body by members of industry. I can understand the desire to have the viewpoints, the input and the expertise which is available through that source. But unlike the accounting profession, which virtually has one organization representing it, I am under the impression that there are hundreds of organizations representing the various segments of industry.

If the desire to have members on this body stems from a desire to be represented, who, in fact, speaks for industry? Who can say they speak for industry? This is a large segment of our society.

And if it isn't a matter of representation, if it's merely a matter of input, could that not be accomplished through other means and other machinery, such as an advisory group to the rule-making body?

MR. ALLEN: As some of you may know I'm very actively involved with FEI. That would be one means and one source, perhaps, of input membershipwise. There are other organizations, obviously, the financial analysts, the banking community, the investment community, that would conceivably be similar sources for business representation on such a board.

MR. OLSON: I gather that you're basically concerned with representation from industry, which is somewhat parallel to talking about representation from the large public accounting firms. Is that correct?

MR. ALLEN: That's substantially correct.

CHAIRMAN WHEAT: We're very grateful to you, Mr. Allen, thanks again, and thanks to Mr. Patrick, also.

Next on the agenda is Mr. George Gibbs, Professor of Accounting at Claremont Men's College in Claremont, California. Mr. Gibbs.

PROFESSOR GEORGE GIBBS: We've mentioned a little bit about self-regulation. I put in eight years on the State Board of Accountancy in the State of California, and I helped to

remove two CPA licenses after due process and hearings.

So it seems to me sort of interesting that we worry about self-regulation when we already have self-regulation to remove a CPA certificate. We have plenty of self-regulation.

I have a few written remarks; I'll try to summarize them. I would like to call to your attention that we've already discussed today one answer to the question, "What is meant by the term accounting principles?" There are two parts to this, and I hope we adopt the suggestion made by Professor Solomons in a letter to me. He said that the basic things be called fundamentals and the other things be called procedures.

So we have fundamentals and we have procedures, and between the two we hope to set some standards; that comes from a letter Professor Solomons wrote. I'm not speaking for him particularly, except he put it in writing.

I do think that we have to consider these fundamentals a little. These are things that you cannot quantify-- disclosure, materiality, consistency, comparability, conservatism, determination of income. There have been several efforts at trying to put them in shape without success.

I took up all five of the questions of the committee and I'll get on very quickly. My friend, Mr. McMonnies from Scotland, wrote an article entitled, "Accountants Are an Unprincipled Lot": True or False? (Laughter)

He reviewed three studies of the Accountants International Study Group, which nobody bothered to edit, I'm sure, because he found that consistently it was referred to as a standard, a convention, a principle, a requirement, a criterion, a tenet and an attribute.

Now, what are we talking about? No wonder the public is confused when we continue to repeat, as we have done for so many years, "generally accepted accounting principles."

Also, we never cleared up the idea of generally accepted. What groups in the financial community are these? That's already been mentioned, but I'll mention it again. By what groups are they generally accepted? My contention is that they cannot be made generally accepted by edict. I don't care who edicts it; the President of the United States can't make it generally accepted, if it isn't generally accepted.

Obviously, if the practice of accounting is to be changed, then the wording of the auditor's report letter should be changed. Probably there should be several versions, and I haven't heard that mentioned today, not just one pat statement that you can teach a parrot to say.

It should really tell the reader more than it does now as to the opinion of the auditor, and how and why he arrived at it.

A recent booklet, "The Auditor's Report...Its Meaning and Significance," prepared by bankers, says that

no bank officer should make a loan without studying the booklet. And then it refers to Accounting Research Study Number 7 by Mr. Grady which lists 121 items called principles.

I just told you all the uses of the terms; there cannot be 121 fundamentals, if we agree with Mr. Solomon's definition of fundamentals.

Question two, responsibility for establishing the board--we've discussed that quite a lot today, and I agree it should be nongovernmental. I have just one thing to add, there. It would appear to me that if the revised board did a bang-up job, it would remove some of the tedious duties from Government agencies; individual standards could be referred by other organizations and Government agencies.

Of course, it's obvious some Government agencies would need to supplement basic standards with rules, and I suppose we had better use the word rules.

I have only one additional comment on the composition of the board. I just went a little further, like the Supreme Court, and said it should not be more than nine men chosen for life tenure, serving full-time with an adequate salary. I didn't guess what the salary should be.

And then I suggested the majority represent the medium and small practitioners rather than being dominated by the larger firms. I admit I'm prejudiced because I have an office and I'm the sole practitioner.

Then I suggested that board activity be directed from a city other than New York--and this may be prejudiced,

too--to avoid undue influence of the financial world.

Of course, the cost of board activity should be borne by the members of the profession.

I think that alternative procedures should be permitted, provided that the significance and results of the choice of the particular alternative are disclosed.

The basis must be straightened out and we must stop being illogical. Rule 58.1 of the California State Board of Accountancy is a good example of being illogical. It says the term accounting principles is construed to include not only accounting principles and practices, but also the methods of applying them. How can intelligent men have rules like this; how can A include A plus B plus C? It is logically impossible, and yet I'm stuck with it because it's Rule 58.1.

Having recently commented on drafts of six proposed pronouncements of the present Board, I'm convinced the operation could be improved. In one case I recommended the deletion of forty-six repetitions of the phrase, "Generally accepted accounting principles." I counted them--forty-six times that same phrase appeared and it didn't mean a thing, because it was circular reasoning.

You don't say to yourself, "I hereby develop a principle because it's generally accepted." You haven't even got to the principle yet.

Now what about research? Being that some of us here today are semanticists, I suggest perhaps it should be called "search'." What are you doing a "research" for? Let's

do the search; we haven't done that, yet. (Laughter)

I have often thought of this, and it should be search if it's the first time a subject is really being studied.

I have a comment on interpretations. A very recent ruling by somebody said that any written procedures promulgated by the Board will call for interpretation. However, it seems improper to me to suddenly state that interpretations written by two staff men bring about a situation wherein it can be stated, "members (AICPA) should be aware that they may be called upon to justify departures from the interpretation."

Now we do need investigation before any action is taken toward adoption of the procedure. The staff should investigate the problem and report to the Board. This report should include references from many sources, including the results of the more systematic searchers. I tried to break this up into three parts, both in the United States and in other countries.

I would like to conclude by saying that it is hoped that the new Accounting Standards Board--it's a good phrase--if it acts promptly, will restore the confidence of bankers, Government officials, labor, businessmen, investors, analysts and the general public in the reports made by certified public accountants. Thank you very much.

CHAIRMAN WHEAT: I take it that you would prefer to get through this semantic haze with at least a change in the name to something like the Accounting Standards Board?

PROFESSOR GIBBS: I just added that. I think that's the best thing I've heard today (Laughter)--Accounting Standards Board. I just had the word "board" and added "accounting standards." I didn't invent it; it came out of the meeting today.

CHAIRMAN WHEAT: What should the members of this board be paid if they're full-time? What should be the range of the salaries?

PROFESSOR GIBBS: I admitted that Professor Dickey and I were not in that bracket. But if we're applicants for the job, we're not talking about the same scale. I have heard all your discussion, Frank; I've been here all day.

I didn't realize until today that we considered that the Accounting Principles Board was to such a degree subsidiary to the SEC. I didn't remember the formulations of Congress on the SEC until you read them today. And I haven't studied the SEC as much as other people have.

If that's true, I think your point is well-taken that we might have difficulty in paying \$75,000 to \$100,000.

I appointed them for life tenure because I didn't think about the age. But, if you're up to the age of fifty to fifty-five, as you've already mentioned, a ten-year term would bring them to the end of their active career. I said life tenure because I thought that then they'd really be independent.

CHAIRMAN WHEAT: Just a short question: Suppose, for example, that you have a salary range of \$35,000 to \$40,000

a year. Would you be able to get people on that board for life tenure or a shorter term, who are the type of person now on the Accounting Principles Board?

PROFESSOR GIBBS: I think you've got to pay more and I think it would be a problem, because a lot of competent people have been giving free time to this Board. They are the leaders of the profession, and they've been doing it.

CHAIRMAN WHEAT: If you have a salary range of about \$100,000, and, as you suggested this morning, a board of about nine people, that's a basic cost of \$900,000. Add to that the usual cost of supportive staff and the overhead that goes with salaried people, which is usually 50 per cent of their salaries, and you're up to about \$1½ million.

Is that amount of money raisable from the private accounting profession? And would you consider it better spent on these nine men, or would it be better to spend that much money on better research, higher salaries for the researchers and stronger staff?

PROFESSOR GIBBS: I think it should be spent on full-time men, because they're the ones who are bearing the decision-making process and responsibility. I've learned something else today--that their results could be appealed to the SEC; I didn't realize that before. They have to be responsible.

CHAIRMAN WHEAT: You don't consider them responsible today?

PROFESSOR GIBBS: From what we've heard today, the Board meets three days every six weeks or so; and we've heard how things are going. They're responsible, but we've heard that they aren't effective; they were unable to work consistently on things that were urgently needed, because they weren't meeting.

CHAIRMAN WHEAT: With matters as detailed, complex and difficult as some of the opinions of the Accounting Principles Board, could they be accomplished in a few days? Certain things require gestation time, thinking time, reflection, redebate, and so forth, before they are adopted.

Do you think you could get as good a job done if you locked people in a room and told them to come up with a principle or an opinion? Or would it be better to give them a little time to reflect upon the comments and criticisms from industry and others?

PROFESSOR GIBBS: There are really two parts to the answer. I think some items could be decided fairly quickly because there's been so much done in some fields in previous years.

Others, I grant you, would require time. I don't know, when they go off for five weeks and then meet again, how much time they spend in that intervening period thinking about these things.

CHAIRMAN WHEAT: I might add that we have received input from some of the members of the Accounting Principles Board.

Some of the Board members represent that they spend 90 per cent of their entire working time on Board matters; others maybe 75 per cent; and in one or two instances 100 per cent.

PROFESSOR GIBBS: Maybe money doesn't have anything to do with it if you can get all these volunteers. But a sole practitioner couldn't afford to give a year; he probably wouldn't be chosen, anyway.

Even a firm with ten partners would find it a burden. If a firm had ten partners and, say, sixty employees and one of their partners was chosen to give a year, certainly his year's compensation may not be as big as Arthur Andersen's, but it isn't spread over nearly the number of partners.

CHAIRMAN WHEAT: There are differences, as you know. One chairman of the Accounting Principles Board, who served for a period of five years, was a partner of a very small San Francisco firm; with substantially less than ten partners.

PROFESSOR GIBBS: Granted. But if he took full-time for five years, or 90 per cent of his time, then he put an awful burden on his other partners, did he not?

CHAIRMAN WHEAT: Yes

Does anybody in the audience have a question for Mr. Gibbs, who has come all the way from California to give us of his wisdom?

PROFESSOR SOLOMONS: I don't have a question, but just want to set the record straight. I did not use principles or fundamentals in my letter to Professor Gibbs.

PROFESSOR GIBBS: Excuse me. You used the word "standards;" I made a mistake. I don't know where the word "fundamentals" came from at the moment.

PROFESSOR SOLOMONS: I would like to read this paragraph, although the purpose of this meeting is not for members of this committee to reveal their position. In my letter to Professor Gibbs, I said that, "I am myself somewhat favorably disposed to the change in the name of the Accounting Principles Board, to something like the Financial Accounting Standards Board." I went on to say, that since we already talk about standards of air safety, engineering standards, building standards and the like, I see no reason why the word should be reserved for use in connection with auditing. I myself would have no qualms about extending its use to accounting as well.

I haven't seen any reason since I wrote that letter to change my position.

PROFESSOR GIBBS: I might make one comment on that, Professor Solomons: the fact that in auditing we have general standards, standards of field work and standards of reporting. It appears to be that we have achieved a higher degree of understanding with reference to auditing standards than we have in accounting.

Someone mentioned today that a revised board should take over both the auditing and the accounting functions. If they did, and we adopted the word standards for one, we would

adopt it for both. I think that probably you are right; the word standards doesn't have so many philosophical connotations. Thank you very much.

CHAIRMAN WHEAT: Thank you, Professor Gibbs.

MISS MULCAHY: I am Research Director of the Canadian Institute of Chartered Accountants.

CHAIRMAN WHEAT: We're honored to have you here with us, today.

MISS MULCAHY: I really haven't anything to say except to offer a word of consolation, if you're considering a change in the name to incorporate accounting standards.

The English Institute of Chartered Accountants has a committee called the Accounting Standards Steering Committee, which issues pronouncements in that country.

CHAIRMAN WHEAT: We're very much interested in the work of the English Committee.

Our next witness is Mr. Thomas Hogan of the firm of Haskins & Sells.

MR. THOMAS B. HOGAN: The managing partner of my firm, Mr. Michael Chetkovich had hoped to be here. Unfortunately he's out of the country, so I'm pinch-hitting for him.

What I am about to say is both the view of my firm and his personal view.

Our view is that the Accounting Principles Board despite the difficulties under which it had to operate, has done an excellent job of establishing standards for financial reporting during the past twelve years. While some segments

of the business community may disagree with certain of the conclusions reached by the Board, there can be no doubt as to the dedication and the integrity of each member of the Board.

The difficulties under which the Board has had to operate have stemmed largely from the fact that it has had to react to events occurring in the business community, rather than being able to consider the whole question of accounting principles in an orderly fashion.

The problem is further compounded by the fact that each member of the Board has substantial outside responsibilities to the firm of which he is a partner, to the university with which he is affiliated, or to the industrial concern by which he is employed. No matter how dedicated he might be, or no matter how well-intentioned, he has had, by force of circumstances, to spend only a part of his time on the work of the Accounting Principles Board.

The Board has also been hampered, in our judgment, by the absence of detailed and penetrating research studies in many of the areas in which it has been called upon to express an opinion.

These problems are not apt to go away in the future. On the contrary, they will increase. The complexities of business life, the growth of multinational companies, and imaginative innovations in business transactions which we witnessed during the 1960s will undoubtedly continue in the future.

Our proposal is intended to make the task of developing standards for financial reporting more efficient and to alleviate some of the difficulties under which the present Accounting Principles Board operates. In our view, the development of these standards falls into two separate functions: (1) the development of broad, general principles; and (2) the application of those principles to particular circumstances.

If I may borrow your illustration of this morning, Mr. Chairman, the recent considerations by the Board on how to account for certain types of investments illustrates the point I'm trying to make. The Board was faced with the problem of how to carry investments; should they be carried at cost, at their present values, or on some other basis?

The Board concluded as a general principle that a corporation having significant influence over the operations of another company should account for its investment using the equity method of accounting. This was a broad statement of principle.

The Board, having decided on this general principle, went forward to apply this principle in particular circumstances. It established some arbitrary rules as to when a corporation had the ability to exercise significant influence. The Board described the methods by which the accounting should be reflected in the financial statements, spoke of the types of intercorporate transactions that should

be eliminated, and established procedures for disclosure in footnotes. All of these latter considerations merely provided the rules of application of the general principle.

Haskins & Sells proposes the creation of two separate groups, working in parallel. The first group, which we have called, for want of a better name, the Commission, would be charged with the responsibility of developing broad principles of accounting.

It would be a relatively small group--large enough to be representative, but small enough to be effective. The members of the Commission would be required to sever their present professional or business connections and spend full-time working on the affairs of the Commission.

The second group, which we have called the Committee, would be part-time volunteers appointed by the American Institute in the same manner, and by the same selection processes as are now used with respect to both the Accounting Principles Board and other committees of the Institute.

This Committee would be charged with the responsibility of formulating the rules for applying the general principles established by the Commission. In establishing these detailed rules for recording and disclosure, the Committee would be required to conform to the principles enunciated by the Commission. The Committee would also have the right and the authority to interpret the general principles as to individual industries, classes of transactions; and, on occasion, would be available to respond to questions raised with respect to an

individual transaction or to a type of transaction.

In order to ensure that the rules and interpretations issued by the Committee were in conformity with the opinions of the Commission, our proposal comprehends that any pronouncement by the Committee would be subject to review and concurrence by the Commission.

If members of the business community felt that a pronouncement by the Committee was not in accordance with the principle enunciated by the Commission, they would have the right to appeal directly to the Commission. If the business community felt that an accounting principle previously enunciated was no longer applicable, it would also have the right to appeal to the Commission. Similarly, if the business community felt, because of changed circumstances, that a prior pronouncement of the Committee was out of date, it would have the right to request the Commission to direct the Committee to reconsider the matter.

Underlying all of the pronouncements of the Commission and the Committee must be extensive research, both empirical and analytical. The research effort must be directed to developing fundamentals to fulfill the objectives of financial statements, as well as the analysis of problems, including extensive testing of proposed principles and applications. We recommend that the research effort be supervised by a full-time director of research who would report directly to the Commission.

Another element of our proposal comprehends that a Foundation would be created under auspices of the American

Institute of Certified Public Accountants. The Foundation would be governed by Trustees initially appointed by the Institute, but thereafter self-perpetuating, so that as a Trustee's term expired, or after he died, retired or resigned, his fellow Trustees would appoint his successor. The Trustees would be non-salaried and drawn from all segments of the community having an interest in financial statements, including practicing accountants, preparers of financial statements, users of those statements, and representatives of the academic world.

The Trustees would appoint members of the Commission and establish both their salaries and their conditions of employment. Our thought would be that the salary level would be commensurate with that which the Commissioner might expect to earn elsewhere. In order to provide a sufficient period of time for him to be useful and effective, we would think that his term of appointment should be for a period of not less than seven years.

We estimate that the annual cost of operating the Foundation would be somewhere in the neighborhood of \$2 to \$3 million. We would hope that a significant proportion of these costs would be borne by individual members of the accounting profession, especially the larger firms, and that other members of the business community would volunteer to absorb some part of the costs of operating the Foundation.

To the extent that these contributions were not

forthcoming, the cost would be borne by the American Institute of Certified Public Accountants. The partners of Haskins & Sells would commit themselves to contribute \$1 million during the first five years of the Foundation's existence.

We at Haskins & Sells are dedicated to the proposition that accounting principles and their applications must be established speedily and efficiently. The first chairman of the Accounting Principles Board, the late Weldon Powell, was one of our partners.

We always have had close historical ties with the work of the Accounting Principles Board and have supported it in the past. We are committed to supporting the Board or whatever form of organization emerges from the considerations of this Study Group. What we have tried to do is to suggest an organizational arrangement which makes the work of establishing standards of financial reporting more relevant, more timely and more effective. Thank you very much.

CHAIRMAN WHEAT: Mr. Hogan, I would have to observe that the dedication of your firm to the task at hand is certainly amply indicated by this extraordinary commitment you have made publicly today, and I am impressed by it.

I am even more impressed by your statement that although recommending this very careful structure upon which you have commented, your firm would support whatever comes

out of this study. I think that that is a most generous, statesmanlike comment and I would like to have the record reflect it.

MR. HOGAN: That's very kind; thank you very much.

CHAIRMAN WHEAT: I'm sure that all my colleagues on the Committee feel the same way about it.

MR. HOGAN: Thank you.

CHAIRMAN WHEAT: The history of the Accounting Principles Board, as I read it as a lawyer, has been one of a serious and strong effort to arrive at a system of basic principles. Back in the days when Weldon Powell was chairman, proposed principles were carefully put together by highly competent men, but these simply did not satisfy the members of the Board at that time.

The effort was continued over a period of several years with still no results. At that point it became obvious that there were a number of very serious matters with which the Board had to deal. The Board simply had to tackle some of those areas where alternatives existed, and proceeded to do so starting in about 1962 and continuing to the present.

I am a little bit concerned about how the structure you suggested would operate. It would seem, if first things come first, that you would have to put together the Board of Trustees; and they would then have to select the Commissioners. The Commissioners then would have to develop a structure of basic principles; a job which the most distinguished professors

and others have attempted unsuccessfully over a period of years. Only then could the Committee commence to do its work. If it started to do its work before that, there would be no principles on which to found its work.

I am concerned that this effort to narrow the alternatives, which everyone tells us must go forward, would come to a grinding halt while we went through what might be a substantial period of time in order to have these Commissioners do this task which so far has eluded the best minds of the profession. How do you regard that problem?

MR. HOGAN: I think, Mr. Chairman, two things: First, during this transitional period from the time the Foundation came into being and became an active organization, we would comprehend that the present Accounting Principles Board, which now has a fairly lengthy agenda, would continue to function. As the Foundation came into being, with its Trustees and with its Commission, the Accounting Principles Board would phase out of the principle-making function and phase into the application of those principles to specific circumstances. You would have a normal transitional period.

How long the transitional period takes depends upon how quickly the Trustees are appointed, how quickly they form the Commission, and the learning period of the Commission.

I think that the Commission itself would not have a great learning period. We would expect that the Trustees

in their wisdom would pick the seven best accounting minds in the country, and put them in a locked room, somewhere. (Laughter)

CHAIRMAN WHEAT: Mr. Hogan, you will recall the testimony of Mr. Kapnick of Arthur Andersen, whose experience led him to conclude that basic principles are so interwoven with the matter of application, that it would be exceptionally difficult to divorce them and put into one body the task of formulating the basic principles and into a separate body the task of developing the standards of application. He said it would be desirable, organizationally, for the same body to have both responsibilities.

Are you of the view that these must be separate organizations?

MR. HOGAN: I think in the natural course of events they should be. An accounting principle is an overall, guiding rule which governs a whole series of transactions. They can be set by a group which has considered what the principle ought to be.

When you come down to applying that general principle to a certain kind of a transaction, a certain kind of industry, or to a certain set of circumstances, that could be done by a separate group.

The Commission would deal with the theories of accounting and disclosure; but they wouldn't be incommunicado. If you don't mind my mixing a metaphor, they wouldn't be contemplating their navel in some ivory tower (Laughter), but they would at least be considering the theory of accounting

and the theory of disclosure.

They would then turn to people who are in the business every day and say, "Now under this kind of a principle, how would this be handled in this particular circumstance." You would have an exchange of information between the Commission and the Committee.

CHAIRMAN WHEAT: I recall that Mr. Trueblood, who is now working in this area, pointed to Opinion No. 18 as an example of a principle that could be stated in perhaps a paragraph or two. He said the rest of that opinion is application.

Judging by the experience which we have listened to over the period of our deliberations, a great deal of time and effort has been spent on the problem of the application of accounting principles.

I am, therefore, a little bit puzzled by the fact that you would have these Commissioners, whose job it is to develop broad principles, on a full-time, paid basis. Their salaries would be commensurate with what they would receive on the outside, perhaps \$100,000 a year.

MR. HOGAN: That was the number I had in mind as being a fair target.

CHAIRMAN WHEAT: (Continuing)--However, the application function, which, if I judge correctly, has consumed by all odds the greater amount of the Board's time, you put in the hands of part-time volunteers.

Don't we have the cart before the horse if the

time-consuming job is making sure that opinions will work in practice. To make sure that it's effective, shouldn't that task, if anything, be in the hands of the people who are full-time, and the matter of the two paragraphs of principles be in the hands of a part-time group?

What's your comment on that?

MR. HOGAN: My reaction, Mr. Chairman is twofold. I think the deliberations of the Accounting Principles Board have been time-consuming because they've been getting involved with both principles and applications. If you can separate them, you can say in effect, "First we'll establish general accounting principles within the Commission. Then you fellows in the Committee, using that ground rule decide how to apply it."

Secondly, I think I want principles to be set outside the battlefield. When you start to apply those principles, I want it done by people who are engaged, day-by-day, in preparing financial statements, in reading them, and in certifying to their fairness.

I don't want someone in an ivory tower deciding how something should be done. I want that to be done by someone who's on the battlefield every day.

I can liken it to the Ten Commandments. The Ten Commandments don't take up very much space, but the explanation of those Ten Commandments have taken a great number of books.

CHAIRMAN WHEAT: On the other hand, I would comment that the question of the application of the Ten Commandments is

rather important, also. It's pretty easy to lay down a commandment; the application takes a lot of effort.

MR. HOGAN: Oh, yes!. It would take a lot of effort and time--

CHAIRMAN WHEAT: In the accounting field, is it possible for some group to lay down this commandment, this great principle, without having to intimately concern itself with whether or not it can be applied effectively?

MR. HOGAN: I think that the Commission, having arrived at a conclusion with respect to a principle, would then expose that proposed principle to the financial community through public hearings, such as this.

Before arriving at that conclusion, they might very well have talked to members of the Committee who would be on the day-by-day firing line. As to the application of the principle, I think that the Committee could apply that general principle to particular circumstances by enlisting the aid of experts in that particular area.

You would decide on some general principle for handling pension accounting. The Committee would then enlist people who knew how to handle pension accounting and get their views on how it should be disclosed in a financial statement and how it should be reported in the financial statement in accordance with general principles.

CHAIRMAN WHEAT: If the Commission in charge of setting basic principles is going to hold hearings and have complete input, the input it gets will focus on whether

the principles are workable. How can that Commission divorce itself from practicability?

MR. HOGAN: I would have enough confidence in the Commission to say that they could sort out real problems from the individual likes and dislikes.

CHAIRMAN WHEAT: One last question: You have indicated the importance of research and the significance of getting the best possible research. You indicated, as I recall, that a research director would report to the Commission.

A number of witnesses today have told us that empirical research is the most important form of research. To me, this goes to the question of application. Where is the Committee on application going to get its research?

MR. HOGAN: From the same group. All I'm suggesting is that the director of the research arm report to the Commission.

CHAIRMAN WHEAT: Suppose the Committee on application wants to have research done and the research director says, "Sorry, I don't take directions from you; you're going to have to go through several other people to try to get some time."

MR. HOGAN: If that unlikely event happened, the Trustees of the Foundation would have some influence over the decision.

MR. OLSON: I'd like to pursue the question that came up a little earlier. Would you like to hazard a guess as to how many principles we might wind up with some day?

MR. HOGAN: I don't know that I'd want to hazard a guess, Mr. Olson. I think there would be more than Ten Commandments, though. (Laughter)

MR. OLSON: Not as high as a hundred, though?

MR. HOGAN: It could presumably run up as high as a hundred.

MR. OLSON: The reason I raise the point is that, as Chairman Wheat said, this probably would not be a time-consuming task. I gather that what you have in mind is that the Commission would spend a good deal of its time hearing appeals. Is that correct?

MR. HOGAN: I think the Commission might very well spend a great deal of its time on appeals, in two senses of that word. Maybe appeal is the wrong word-- interpretations. The Committee will, from time to time, be issuing interpretations as to these general principles.

MR. OLSON: The Commission?

MR. HOGAN: The Committee. The Committee will be issuing interpretations of the principles enunciated by the Commission. I can visualize a set of circumstances arising in which the interpretation put out by the Committee doesn't quite fit the new circumstance and the Commission will ask the Committee to review the interpretation; also, principles enunciated four or five years earlier may no longer be appropriate, in which case the Commission will have to issue a new principle.

MR. OLSON: Do I assume correctly that the Commission would also hear appeals or inquiries from anyone

in the financial community, or would it be particularly from the Committee?

MR. HOGAN: No, I think the appeal would go to the Commission directly from the responsible member of the financial community. What they did with it would depend upon the nature of the appeal. Whether they referred it directly to the Committee or heard it themselves, would depend on the nature of the problem; how widespread it was; what kind of appeal it was.

MR. OLSON: In a sense, this Commission is sort of an appeal body, with very strong emphasis on acting as an appeal body. Is that a correct assumption?

MR. HOGAN: It would be one of the two functions they have. The establishment of accounting principles would be their primary function. Their secondary function would be to make sure that these principles, in application, pass what I call the smell test; that they fit in the financial community. (Laughter)

MR. OLSON: Except that the establishing of the principles would not be a tremendously time-consuming task. Or do you think it would be?

MR. HOGAN: I think it would, Mr. Olson. For example, the question of income in a franchising operation, and how that relates to the general principle of income recognition, would be a time-consuming thing.

PROFESSOR SOLOMONS: But isn't that application rather than a principle?

MR. HOGAN: I think it would be an application. But I can visualize a circumstance in which the Committee, having decided on how it wanted to handle income in the franchising field, could not issue the interpretation until it had been approved by the Commission. So the Commission would have to determine that the Committee's interpretation met the general rule of income recognition arrived at by the Commission.

MR. PRYOR: These two bodies, to a degree, would have to be working in parallel. Let's take earnings per share as an example. I don't know how much principle there is in that opinion but there's a lot of application. Wouldn't this almost have to go hand-in-hand with the Commission's work?

MR. HOGAN: I don't know how much principle is involved either, Mr. Pryor, but I think you're right. I believe that the Committee and the Commission would work not only in close cooperation, but that the views of one group would be communicated to and cleared by the other group.

PROFESSOR SOLOMONS: You don't seem to want to describe the Committee as, in fact, a committee of the Commission.

MR. HOGAN: No, I think not, for two separate reasons. What we're trying to do fundamentally, by the creation of this Foundation, is to give preparers of financial statements, users of them, the academic world and practicing accountants an active voice in the establishment of principles.

That's why we have recommended the Foundation with its Board of Trustees.

We then recommend that we turn over to the Commission, a group of seven independent people removed from the business community, the job of enunciating principles. But the establishment of the application of those principles in particular circumstances ought to be in the hands of a separate, representative group, answerable to the Commission, but independent of it.

PROFESSOR SOLOMONS: In your oral statement you said somewhat more than you said in your written statement about the connection between the Foundation and the AICPA.

I didn't find anything in the written statement which described what support the foundation had. When you were speaking, I thought I heard you say it would have some distinct relation to the Institute.

MR. HOGAN: Our notion was that to the extent that the contributions to the Foundation were not forthcoming from the public accounting sector and from the business community at large, the American Institute would underwrite any deficit. They'd insure that the money was there every year. The Institute would have the power of appointing the first group to the Foundation, presumably by the President with the advice and consent of the Board of Directors.

PROFESSOR SOLOMONS: So that the Foundation would be self-perpetuating.

MR. HOGAN: They would elect their own successors, again to provide the apparent independence that we think may

be essential to the business community.

And also, frankly, to give the business community a very active voice in the establishment of both the ground rules under which statements are prepared and the disclosures which are required.

MR. PRYOR: What else would the Trustees do-- appoint the Commission?

MR. HOGAN: Make sure they behave themselves and work; that they are responsive to the needs of the community.

MR. BIEGLER: Mr. Hogan, I'd like to get one point clear in my mind. The Committee which would deal with applications and procedures, would, in effect, be subservient to the Commission. Does this suggest that the Commission would have to approve or would have to have the right to veto the Committee's pronouncements?

MR. HOGAN: Yes, very clearly; the theory being the Committee's interpretation of a principle would have to be consistent with the principle. Otherwise you would have two separate sets of ground rules.

MR. BIEGLER: Do you see any difficulties in attracting and holding the kind of men you want on the Committee if, in effect, their decisions and conclusions are not final? This would effectively make the Committee an unpaid, part-time staff of the Commission. Do you see any problem there?

MR. HOGAN: No, I think you're downgrading them far too much, perhaps for purposes of illustration. If the Trustees of the Foundation pick seven men or Commissioners

who are highly regarded and well respected by the community, I don't see any problem in having a Committee, in your words, subservient to that Commission, interpreting on a day-by-day basis the pronouncements of that Commission.

MR. LEVINE: Mr. Hogan, do you envision any possibility that there might be an impasse between the Committee and the Commission at some time? Suppose, for example, the Committee concludes that there's just no logical way to apply a certain principle and throws up its hands in disgust. What will happen then?

MR. HOGAN: I think the likelihood of that happening is remote, because you would have on both the Commission and the Committee men of intelligence and goodwill. I can't believe that the Commission could enunciate a principle so improper that the Committee would refuse to interpret it. Conversely, I can't believe that the Committee would refuse to interpret a well-conceived principle.

MR. LEVINE: Yet the very fact that the Commission has to approve the interpretation could conceivably lead to a difference of viewpoints. Although subservient in that respect, the Committee is not subservient in its formation. It seems to me that there could be an impasse.

MR. HOGAN: If an impasse developed--and I have difficulty, I must confess, believing that it could occur--I think there would be two courses of conduct available. One would be to refer the problem to the Trustees. The Trustees

of the Foundation, in my definition, are leaders of the business community, responsible people who would have a considerable amount of influence over the views of the Commission.

By the same token, if that didn't work, you always have the one safety valve that exists today; somewhere along the line the problem will wind up on the desk of the SEC.

CHAIRMAN WHEAT: Does anyone in the audience have a question for Mr. Hogan? (There were none.)

Thank you again, Mr. Hogan. We greatly appreciate the generosity of your comments.

I think we ought to take a five-minute stretch.

(A brief recess was taken.)

CHAIRMAN WHEAT: The next witness is J. O. Edwards, of the Financial Executives Institute. Mr. Edwards.

MR. J. O. EDWARDS: I'm not sure I like that word "witness"!

Needless to say we are quite pleased to be here, and want to thank you for the opportunity to represent the Financial Executives Institute in these deliberations of your Committee on the establishment of accounting principles.

I have been told to assume that you have had an opportunity to read the FEI statement. Therefore, my formal remarks will be limited to a summation of the key points in the statement.

But there's another important reason, I think, for not straying too far from the text, and that is that our policy statement necessarily represents a mix of viewpoints

of business executives. I would like to make certain that what comes through to you today is a balanced representation of the views of our membership.

While we in business might each have some different views about what we'd like to see come out of your study, I believe it is safe to say that we are in total agreement on two points; first, that the matters you are attempting to grapple with are extremely complex, and of enormous importance to both business and the accounting profession. They are deserving of all of the constructive assistance that we and others can provide.

Second, we're hopeful that your deliberations will clarify any ambiguity that may have existed in the past about the role that each of the parties of interest should play in the accounting principles mechanism, so that we can get on with whatever we have to do to assure an even higher quality, more objectivity, and more credible financial reporting.

If you've had an opportunity to read the summary of supplemental comments relating to the FEI statement, you have about as good a flavor of the positions of individual FEI members towards the subject of your study as I could hope to give you.

If you haven't read these, perhaps you'll find a chance to do so.

As I mentioned, I will attempt to capsule the FEI position and will answer any questions you may wish to ask.

First, FEI believes that management has a responsibility for all forms of public reporting of financial information. This responsibility runs not only to the accuracy of the material, but also to the underlying principles, conventions or standards of reporting.

Second, this responsibility cannot be escaped. It requires an active participation by business in the formulation of these underlying rules. As we see it, the responsibility of business and the public accounting profession are co-equal, as each must have an abiding conviction of the fairness of the financial presentation.

And this conviction must be held when a management reports the results of its company's operations to the owners. Both the reporting management and the certifying accountant must have this conviction.

It extends to the whole framework of corporate reporting in industry. Here again management and the public accounting profession, we think, must have equal conviction in the soundness of the principles.

Third, this joint responsibility can more effectively be discharged in the private sector through a voluntary mechanism than it can by pleadings and hearings before a Government agency.

Fourth, this voluntary mechanism, or if you wish board, body, council, commission or whatever, should have equal representation from the two groups having primary responsibility for financial presentations: business and the public accounting profession.

Fifth, other interested groups, such as the academic community, analysts and other users, should be represented but should not, in the aggregate, have a dominant role, since theirs is a position of advocacy rather than one of responsibility. They can bring much needed and valuable viewpoints to the process.

Sixth, the members of the body--or at least most of them--should be part-time in order to assure participation by outstanding leaders of all representative groups. They should not be detached from the arena in which day-to-day accounting problems arise, and in which solutions must be implemented on a practical basis.

Proper utilization of support services such as research and full-time staff, as has been suggested here repeatedly today, can obviate the need for full-time participation.

Seventh, a satisfactory system of financing this body can be worked out with business bearing its fair share of the load. I don't believe I can top at this point Tom's commitment, but I think that we in FEI believe that business can fulfill its obligation.

Eighth, early involvement of all who can contribute to problem-solving should be the modus operandi. Potential problems should be identified early, and solutions developed before the problems get out-of-hand.

Ninth, there should be an appeals procedure, with interpretive pronouncements for unusual situations or circumstances. We're not talking about a court or a senate.

Finally, the cornerstone of all actions and all pronouncements should be research, both empirical and conceptual, with case study evaluation of the alternative effects of various actions under consideration.

Full utilization should be made of research agencies of the various associations that are active in the field. The body should take the lead role in coordinating and planning the research activities of these agencies so as to assure maximum utilization of existing resources.

If your Study Group recommends some of the changes that we have suggested, and hopefully should the AICPA in turn embrace those recommendations, we are confident that this would do much to improve support for the ongoing development of accounting concepts, improve their acceptability, and yes, if you will, even improve their quality.

That's all I propose to say. I would be pleased to answer any questions.

CHAIRMAN WHEAT: Thank you very much, Mr. Edwards. I suppose the question that has been raised today most frequently, and on which there seems to be substantial disagreement, is whether this body in the private sector should be under the auspices of the AICPA, as has been recommended strongly by several of the witnesses, or whether it should be placed under the auspices of several groups.

The principal comment along that line in the Arthur Andersen paper has already been quoted; "...a group

so constituted would not be responsible to any organization or entity and we believe that an approach of that type would not be effective."

I wonder if you could expand a little bit on the reasons you would advance as to how one could avoid the kinds of problems and difficulties that occur when you have divided responsibility, divided auspices, rather than a single line of responsibility.

MR. EDWARDS: That question was not unexpected.

In our text we deliberately avoided being too specific on this point because it was the one matter on which it was most difficult to arrive at an FEI consensus. There was almost an even split on the question, with perhaps a slight majority believing that it can and should be under the auspices of AICPA.

Something less than a majority, say forty-five per cent, feel it just isn't practical to expect the broadening and other steps necessary for improvement to be undertaken by AICPA.

There is a consistent thread running through the minority position, I think, that says that should AICPA decide to do these things that we think necessary to arrive at a better consensus, to get a broader representation, then the minority would be content to see it remain under the AICPA.

If AICPA doesn't buy the changes, members of FEI feel that there should be this superbody or volunteer consortium. We recognize the tough questions you raised about authority, financing, turnover, recycling of appointments and the like.

But, we think there are enough precedents in the public sector for such a voluntary consortium. It would have its backup through the overview of the Securities and Exchange Commission, just as the AICPA does today.

CHAIRMAN WHEAT: As you know, there is another rather significant issue which has been raised today: the basic question of whether or not this body should be representational. Some take the same position you do-- that the body should be representational. Others have an equally strong view that it should not be representational; that it should be composed of the very best qualified men clearly not representing any particular viewpoint. It should be independent and experienced in as broad an area as possible. Several people this morning, particularly expressed that view.

Among the documents we have in our records is a speech by Mr. Leonard Spacek who was then, I think, managing partner of Arthur Andersen. He spoke before The Conference Board on the outlook for agreement on accounting principles. This speech raises a question which I'd like to ask you.

Mr. Spacek talked about this representation issue. He says, "If representation were really essential, the profession would be confronted with the requirement for representation from labor, from investors, from investment analysts, from regulatory commissions, and from other interests that are vitally affected by accounting practices. ...If all segments of the public claimed representation on courts because they were affected by the decisions handed

down, a good share of each segment would be required to man the courts. But laws which are the criteria of decision making make such representation unnecessary. Proper criteria for the Accounting Principles Board would have the same result. The acceptance on the Board of members who have vested interests in every decision may well detract from its objectivity."

There are really two aspects to the question that I would pose to you. First, if the Board is to be representational, where do you stop? How do you assure yourself that you have responded to all of the demands of various interests that might want to be represented? If you did, you would have something so unwieldy from the standpoint of diverse interests, that it wouldn't really function.

The other aspect is that many people have a strong feeling that independence and objectivity are the criteria upon which members should be selected. You have a problem with that if you select people who have vested interests in a particular viewpoint or a particular business.

How do you solve that problem?

MR. EDWARDS: To take up the question of total, across-the-board, representation, I think what you're asking is where to stop.

We are saying that there is a priority order of interest among those who have responsibility for reporting on the performance of the business.

I think both management and the certifying CPA have

that responsibility, and I think it's about equal. I think it's shared in such a way that neither can say it's the responsibility of the other.

I don't think users have the same kind of responsibility. They have an interest, and a right to know.

It's a matter of judgment as to where you draw the line. We would feel that the responsibility of those who have a right to know and have an interest in these-- I think the term we tend to use is conventions--is quite different from the responsibility that management and the certifying accountant have.

I don't have a pat answer as to how many of these advocacy or user groups are needed to get a fair cross-section, but I don't think it should predominate.

CHAIRMAN WHEAT: How do you respond to the problem of objectivity?

MR. EDWARDS: Is that the same as independence?

CHAIRMAN WHEAT: Yes.

MR. EDWARDS: That's been given a fairly good going over today, I guess. I was impressed with the comment that independence was a state of mind. Independence depends on the integrity, ability, strength, and ethics of the individual involved. That doesn't say, on the other hand, that appearance of independence and appearance of objectivity are not important. I think they are.

The question of objectivity of industry representation tends to be one of degree--the same as the objectivity of the

practicing CPA. We don't believe there's any real conflict of interest when men of background and experience in business contribute to the resolution of controversial accounting questions. There may be on specific issues; or in specific companies. If there are, I don't know why the particular individual couldn't abstain from participating.

Perhaps during the deliberations of this body, there will be a problem with a conflict of interest. If that was to prevent the group from having the knowledge and the in-depth understanding of business inputs through this process, I think it would be too bad.

CHAIRMAN WHEAT: Let me add one other question.

I think it's fair to say that we're all immensely concerned with the matter of appropriate, substantial input from business interests. It's absolutely crucial to the workability of whatever is done. And, of course, the responsibility which you have alluded to, is critical.

It has been suggested today that it would be desirable to have people from business and other disciplines serve on subcommittees of the APB rather than limiting them to members of the Board or CPAs in private practice. With one or two exceptions, this has been the case.

The ultimate question of objectivity might be solved by having an Accounting Principles Board comprised solely of independent CPAs. They, under the Securities Laws, have the special function of checking financial statements to determine that the public interest is being served.

That suggestion has been made, and I wonder how you react to that?

MR. EDWARDS: As to part of the suggestion, I think that FEI would react quite positively. If subcommittees are developing or identifying a particular problem and trying to do something about it, anyone who can say something about the problem should be involved.

This would include business or other groups. We think that if this is done at an early stage, more practical solutions will emerge.

But we would not consider this a substitute for participation at the policy level. This goes back to something that has come up several times today--the role FEI thinks business should have.

FEI really thinks that the role should be more paramount in this matter of concepts and objectives, than in the area of applications.

A question was posed to Mr. Trueblood about how long opinions should be. He said the one on equity accounting might have been done in one paragraph.

I think this is a very interesting idea--the use of concepts, principles, standards. I believe we would like to see, ultimately, a distinction between broad principles and detailed interpretations.

I think that's a good idea, and is probably the direction in which we need to move. The whole question of research bears quite clearly on this matter, because the quality of the research will, to a large measure, determine

how well the principles can be applied in actual practice.

In effect, research would come up to the principle-setting level; principles would go out for application; and then there would be feedback. We think this idea is probably good, but will have to be done a few times before we really know the difference between principles and applications.

I want to reiterate that the main interest of FEI would be in concepts--fair value versus historical cost, for example. I think this is where we feel there needs to be more involvement on the part of business members.

MR. PRYOR: I have two or three questions I'd like to ask at this point. Who would appoint the non-AICPA members of this board?

MR. EDWARDS: AICPA would make the appointments. But we would think that they would be greatly influenced and would want to look to groups such as FEI, NAA and AAA for the candidates to represent business and the academic community.

In order to make that system work, the appointing level in the AICPA, whether it be the President or the Council, would have to be responsive to whomever the other associations thought were logical candidates for these posts.

MR. PRYOR: Who would designate the chairman, and might the chairman be a full-time individual?

MR. EDWARDS: Frankly, we didn't poll this question. I think, however, that the chairman--and I think our members would agree--could be a full-time individual. And if AICPA

designates the members, it would be logical for them also to designate the chairman.

MR. PRYOR: One other thing: Maybe I missed this in reading your paper, but I don't recall whether you indicated a majority vote or a two-thirds vote.

MR. EDWARDS: We didn't cover that. In some earlier committee discussion, it was our feeling that a two-thirds majority, or a two-thirds vote should be required.

MR. PRYOR: In effect that would give the issuer group forty per cent of the total. They would have a veto power over the decisions of the body.

MR. EDWARDS: I guess that's right.

MR. PRYOR: Then my last question is--

MR. EDWARDS: So would the certifying group.

MR. PRYOR: Do you feel that opinions of such a board would carry more or less confidence with the users of financial statements?

MR. EDWARDS: I think that in time they would carry more confidence, more acceptance with the users, assuming that we make this idea of objectivity and independence work. We think it can work. Users would know that the ingredient of practical constraints was in the decision-making process.

You'd be in a better position to form your own judgment about that.

MR. BIEGLER: Mr. Edwards, I'd like to raise a question: When Mr. Kapnick was speaking to us he said that the accounting profession was responsible for determination of sound accounting. The suggestion was that this

responsibility was the private preserve of the accounting profession.

According to your proposal, as I see it, you're raising a very fundamental issue in suggesting equal representation from the accounting profession and industry. This contradicts Mr. Kapnick's concept of a private preserve.

There is another consideration. Since the APB has the right to establish accounting principles because the SEC has given it that right, I wonder if the SEC would have difficulty in giving a similar right to a body which had a different composition: in other words, one with equal representation from both the public accounting profession and industry. Obviously, neither you nor I can answer that, but it might be interesting to speculate about it.

MR. OLSON: Mine is along the same line. I don't wish to be argumentative about it, but fundamental to the whole concept of an attest function, is the assumption that those who are being reported on could not expect to be objective about themselves. If that's a proper line of reasoning, it would be somewhat difficult to conclude that those who were being reported on were being objective in the setting of the standards with which they had to comply.

You indicated earlier that participation in a more formalized advisory capacity--and I'm thinking here of an advisory council to the Accounting Principles Board--would not be as acceptable to the FEI, as participating in the final

decision-making.

I recognize that that might not be quite as acceptable. But how serious a problem would it be if there was more formal machinery whereby the various groups did participate in an advisory capacity?

MR. EDWARDS: You have asked two questions.

On the question of objectivity, I don't think this comes up when you're sitting on a panel trying to set principles on which to report. It occurs when you apply those principles to a particular company's operations.

As I said, there are certain concepts or principles that would be so overwhelming in their impact on a particular company, that the question of objectivity could be real.

Here again we're talking about independence, and there are differences in degree. Independence and the appearance of independence are quite important; but there are other considerations. We must make certain that we have a viable, workable system of reporting for industry.

Independence is one of the ingredients and an important one, but there are other things against which we must balance it.

Your second question is a little different than the point we talked about earlier. I really haven't given the advisory council idea that much thought. I think some of the points covered by Tom Hogan in his remarks border on that kind of an arrangement. There might very well be some way of working that out. If however, this group was simply

acting in an advisory role on such important questions as fair value versus historical cost accounting, I don't believe it would be acceptable to FEI.

They're just too important.

CHAIRMAN WHEAT: Your suggestion, which is very interesting, raises a question in my mind. Let's say for example, Mr. Edwards, that a certified public accountant and his client are involved in some substantial accounting disputes. The company believes that it should have several million dollars classified as deferred costs, and the accountant thinks otherwise.

Further, the company has engaged in a lot of third-party leasing; it thinks that it's perfectly legitimate to proceed with those transactions and classify them as sales. The accounting firm is concerned and does not believe they should be classified as sales.

The company also has a pension plan which it would like to see as flexible as possible, so they can make sure that it doesn't have too much of an impact on income in a bad year. It has convertibles outstanding and doesn't like to show diluted earnings per share. These are theoretical problems.

I am a little troubled as to the objectivity of the financial vice president of that firm, were he to be on the Accounting Principles Board, on any matters of significance in areas of accounting principles. Wouldn't he have a conflict

of the type that you mentioned?

MR. EDWARDS: That's a most unusual company, I must say. (Laughter)

CHAIRMAN WHEAT: It's very likely that a number of the people in this room have companies with similar problems.

MR. EDWARDS: I didn't mean to say that companies don't have the problems you've mentioned. But I don't believe you're going to find many companies with all of those problems. If you did, and if the FEI or the NAA were to recommend a representative from that company, I think this might be one case in which AICPA would say, "We don't buy that one."

CHAIRMAN WHEAT: Are there any questions from the audience?

MR. EDWARDS: I have one other point to make, if I may, before we close.

CHAIRMAN WHEAT: Please do.

MR. EDWARDS: I think we would like to see your committee--whatever comes out of it--push business to do whatever you see business' role to be.

I would urge your committee to define business' role. If you don't agree that they should have an equal role in setting the ground rules, then let us know why. And also, let us know what you think we should do to contribute and be constructive in this field. If you think it's a matter of independence, we would hope you say so.

If you think it's a question of not having the

contacts or the ability to deal with problems, I think you should tell us so we can understand our role.

CHAIRMAN WHEAT: It is in the constructive spirit of those comments that we will be guided.

MR. EDWARDS: Thank you.

CHAIRMAN WHEAT: I might add that one of the main roles played by FEI was to publish one of the most constructive and prestigious research studies done in the field of accounting in the past decade. The subject was segment reporting. The FEI bears full responsibility for the study and has the full credit.

The next speaker is Professor Robert Dickey of the University of Illinois. We thank him for coming all this way.

PROFESSOR ROBERT DICKEY: Thank you for this opportunity to speak.

I do not represent any organization. I believe, however, that some of the changes I propose are desired by a large number of accountants. As a matter of fact, several of the preceding speakers have already advocated some of the same things that I am going to advocate.

However, there is no sign that the American Institute of CPAs is going to change its long-established policies; and further, I have some different supporting arguments for some of these same recommendations.

This presentation is directed to two pertinent questions of the five listed by this Study Group.

One, should the primary responsibility for establishing accounting standards reside in a governmental or a nongovernmental

body? And two, what should be the makeup of a nongovernmental standards board?

I believe that the wise policy followed by the Securities Exchange Commission of allowing a nongovernmental Accounting Principles Board to issue opinions should be continued. In spite of some shortcomings, this arrangement seems to be much better in the eyes of many accountants and businessmen than the detailed regulation of accounting which governmental agencies tend to follow, as in the railroad and public utility field.

Further, I believe that this nongovernmental Accounting Principles Board should not be completely under the control of one organization, which is the situation we have today. The present APB operates more or less as a committee of the American Institute.

The report of the American Accounting Association's Committee on Establishment of an Accounting Commission, published in the July 1971 issue of the Accounting Review, described the possibility of a governmental agency, such as the SEC, taking over the job of the APB as, "...a move which most people, including the SEC itself, seem to want to avoid."

It should be recognized that if a governmental agency were to take over the work of the APB, it would face most of the difficulties of the present APB. It is sometimes said that members of the Institute's Accounting Principles Board have been handicapped in agreeing on

standards by pressure from important clients, and that a governmental bureau would not have this pressure.

Although a governmental agency might not have these particular pressures, many persons feel that it might be subject to even greater pressures that would not be in the public interest.

Consideration should also be given to the generalization that it is easier to give a specific power to a governmental agency than it is to take away such power once it has been exercised.

I propose that the control and support of the Accounting Principles Board should be shared by the American Institute of CPAs and three other long-established national accounting societies: the American Accounting Association, the Financial Executives Institute, and the National Association of Accountants.

Each of these suggested organizations has conducted programs of research in important areas of accounting for many years. I believe that this proposal would have the following advantages:

First, the rules of the present Accounting Principles Board require that each member be a member of the American Institute of CPAs, and this means that he must be a certified public accountant. Although there is much to be said for the CPA examination as a test of accounting knowledge, I think it is unfortunate that every member of the Board must be a CPA.

There is a strong feeling on the part of many, not often publicly stated, against the doctrine that only CPAs are

well-qualified to legislate on accounting matters.

The requirements for the CPA certificate have varied widely, over the years, among the fifty-four jurisdictions in the United States. Even today, in spite of the general movement among the States for many years past to raise the educational requirements and to reduce the experience requirements, there is still a substantial variation among the States on each of these.

For many years more than ninety per cent of all the candidates throughout the country taking the CPA examination have had some kind of college degree, a number of them having a master's degree. Nevertheless, in the year 1971, according to the record, there are still fourteen States where the educational requirement for a CPA is no higher than a high school diploma.

I wish to mention that I have been a certified public accountant since 1942, and a rather active member of the American Institute of CPAs since 1948. I am proud of these affiliations. Nothing that I am saying here today is intended to be derogatory of the certified public accountant or of the American Institute.

The point is simply that the possession of a CPA certificate does not imply as uniform a background as might superficially appear.

There presumably are a number of financial vice presidents and controllers of large and intermediate size corporations, with experience over a wide range of accounting

and related business activities, who were barred by law from taking the CPA examination years ago because their State required one or two years of public accounting experience, with no substitute experience accepted.

Attention is called to the fact that a recent study showed that a little less than one-third of the chief financial officers of the largest corporations in the country possess a CPA certificate.

Notice the very strange contrast that we have here. Approximately two-thirds of the more than 400 chief financial officers of our largest corporations, men who presumably have demonstrated on-the-job, actual performance are ineligible to serve on the Accounting Principles Board.

On the other hand, every last one of the 80,000 members of the American Institute of CPAs technically is eligible for service on the Board.

This type of policy is not designed to win friends and influence people for the Accounting Principles Board.

Another point is closely related to the one I've just made. I believe there should be an increase in the number of accountants from industry serving on this Board. Even when the Accounting Principles Board had twenty-one members instead of the eighteen today, the number of accountants in industry did not exceed three. At present, with eighteen members, only one of them is from industry.

There are two professors of accounting; one professional security analyst, and the other fourteen members are in public

accounting practice. As usual, the big eight public accounting firms have one member each, with six from other firms.

It has been said repeatedly that a company's published financial statements are representations of the company's management, rather than the independent public accountant. This being the case, it would seem logical that the accountants who are closest to the management, and in many cases are themselves part of the management of business enterprises, should have a stronger voice in the establishment of accounting principles than they do at present.

Mr. Leonard Savoie, Executive Vice President of the American Institute, has said, and this is a pretty strong statement, "Corporate financial management contains a vast pool of knowledge on accounting and financial reporting matters which must be made available to the Board if it is to establish principles wisely. Management must be involved in determining accounting principles, to provide assurance to all that the Board is not acting arbitrarily, without regard to real practical problems."

I feel that the most logical way in which to accomplish this would be to increase the number of men on the Board, and appoint to it high-ranking accountants with a strong background in broad business management experience.

The issuance of an official pronouncement of an accounting principle by such well-known national organizations as the American Accounting Association, the Financial

Executives Institute, or the National Association of Accountants presumably would constitute substantial authoritative support within the meaning of the special Bulletin of the Institute of October 1964, which was titled "Disclosure of Departures from Opinions of the Accounting Principles Board."

If such pronouncement was in conflict with some APB opinion, this would tend to encourage the use of different accounting procedures in the same circumstances.

It seems fairly likely that the issuance of just a few such opinions would lower the status and usefulness of the APB, and tend to push the Securities and Exchange Commission toward taking over the writing of the rules.

In my written presentation to the Study Group, I showed that there were some signs that at least two organizations might, in the future, issue accounting pronouncements on their own. If one accounting organization makes public pronouncements on accounting matters, this may increase the likelihood that others will follow suit, in part to give the members of that organization "a voice that will be heard," in the words of Julius Underwood, current President of the National Association of Accountants.

It seems preferable to make an attempt, before it is too late, to have one Accounting Principles Board, supported by the four major national accounting organizations which can speak for the accounting profession as a whole.

One of the proposals made by Mr. Trueblood in his speech at the American Accounting Association convention in 1969 was to increase the amount spent on research for the Accounting Principles Board to at least \$5 million a year.

This is approximately ten times the amount that was spent during the past fiscal year ending August 31, 1971, which in turn was substantially above the \$142,000 spent in the APB's first year of operation, fiscal 1961.

Officials of the American Institute of CPAs indicated in 1968 that the expanded research needed in accounting would soon be too costly for the Institute itself, even with the help of the Accounting Research Association. They thought that it may become necessary to go to the larger foundations or to the Government for the vast sums of money that will be needed in the years ahead.

I believe that the chances of getting substantial sums from the above sources and from business concerns would be improved if most of the research in accounting was centered in one accounting research foundation, sponsored jointly by the four accounting associations named above.

It would be worthwhile, in this direction, to examine carefully the organizational operation of the Accounting Research Foundation established in 1967 jointly by the Institute of Chartered Accountants in Australia and the Australian Society of Accountants and also the Canadian

Tax Foundation, now in its twenty-sixth year of operations.

The Canadian Tax Foundation is sponsored jointly by the Canadian Institute of Chartered Accountants and the Canadian Bar Association, but it is not supported financially by these organizations as such. Its revenue currently comes from about 4,700 individual members--accountants, lawyers, professors, businessmen--and some 400 companies holding corporate memberships.

It should also be noted that the Accounting Standards Steering Committee, mentioned early today, established in 1970 by the Institute of Chartered Accountants in England and Wales, in association with the Scottish and Irish Institutes, has now in this year, 1971, issued the first in its series of statements of standard accounting practice. These will be similar to the opinions of our American Institute.

Now for some possible disadvantages of these multi-association boards. It is said that when Mike DeSalle was Governor of Ohio some years ago, he had a little sign on his desk which read, "I do not know the secret of success but I can tell you the formula for failure--try to please everybody."

I believe that no principles board, no matter how appointed nor how constituted, is going to please everybody. We might take a more modest and more realistic goal such as that expressed by Justice Benjamin Cardozo in a complicated tax case years ago when he said, "The assessor's task is to find the least erroneous answer to an unanswerable problem."

It is recognized that the establishment of a multi-association board would not be easy, and it would take some time to implement. I believe that there is a reasonable probability that the unfavorable aspects can be minimized.

Time permits the mention of only a few of these problems. It has been said that war is too important for the generals; education is too important for the educators; and in the last few years some critics have been saying that accounting is too important to be left to the accountants. They have been urging membership on the Accounting Principles Board for non-accountants, and from groups that use accounting reports, such as financial analysts and bankers; this was advocated this morning.

I believe that the representatives of these non-accounting groups should be invited to express their views on exposure drafts and opinions; they might be asked to serve if they're experts in certain fields; they might be asked to serve on the task forces and subcommittees of the Accounting Principles Board. But only persons trained, experienced and demonstrably competent in accounting itself should be on the board which actually votes on these proposed opinions on accounting.

The establishment of this proposed body would not rule out Mr. Trueblood's proposed five or seven-man, full-time and fully compensated board, which also has been advocated today by several other groups, if I understand correctly, Arthur Andersen and Haskins & Sells.

Such a board would simplify the question of just how many members each association would appoint, as the representatives of the four associations could meet and decide on the hiring of the best accountants available, without consideration of firm or society affiliation, or other background.

It seems, however, that it would be more in keeping with the spirit of the coalition organization, which I am advocating, representing a diversity of accounting backgrounds, to have a volunteer board no smaller than the size of the present Accounting Principles Board.

It might well be headed by a full-time, paid chairman, supported by a strong staff of assistants, larger than at present. This would lighten somewhat the burden of the volunteer members, and thus make membership on the Accounting Principles Board more attractive to highly competent individuals who feel they cannot devote an extremely high percentage of their time to work on the Board.

In closing, let us recognize that the Accounting Principles Board of the American Institute of CPAs is a very powerful body in the world of finance. Its rulings have an important, though frequently delayed effect on the reported earnings of corporations, large and small, and eventually on stock market prices.

In issuing opinions, when all the material has been studied and all the witnesses from many sources have had their

day, in other words, when the moment of decision comes, let's remember, the voting is done by only eighteen individuals, each one of whom must be a certified public accountant; must be a member of the American Institute of CPAs, and all of whom have been chosen by the group which controls the electoral machinery of the American Institute of CPAs.

This is real power, and it's in the hands of a very small group of men. On February 19 of this year at the Conference Board session on the prospects for agreement on accounting principles, Mr. Herbert C. Knortz, Vice President and Controller of International Telephone and Telegraph Company, said in a speech that the AICPA was "...a comparatively small private club."

Now some of us might think this is rather strange language to use to describe the largest organization of accountants in the world, with over 80,000 members and a substantial net growth in membership year after year. Nevertheless, we should recognize that this is the viewpoint of some who are outside the American Institute of CPAs.

In essence, I am suggesting that this great power of the Accounting Principles Board be broadened--that the power base be broadened somewhat--and thus be less vulnerable to criticism. This could be done by including some additional elements of the accounting profession itself. It is believed that this change would also improve the usefulness of the opinions of the Board.

Some of these suggested changes could be accomplished within the framework of the present APB. The Institute could drop its requirement that all members of the Accounting Principles Board be CPAs and members of AICPA.

It could name to the Board certain individuals who are chosen formally or informally, perhaps, by the other accounting associations that I have named. It seems appropriate to give thought to the warning of Winston Churchill's great ancestor, the Duke of Marlborough, who said, "Those who resist improvements because they represent change may later be forced to accept changes that are not improvements."

Thank you for the privilege of speaking.

CHAIRMAN WHEAT: Thank you, Professor Dickey, you've given us some notable quotations. There was a Duke of Cambridge, back in those days, who may have stimulated the Duke of Marlborough. The Duke of Cambridge was alleged to have said, and I quote, "Any change at any time by anyone for any purpose is to be deplored." (Laughter)

PROFESSOR DICKEY: He was a real progressive, I gather!

CHAIRMAN WHEAT: Does anyone on the panel have questions for Professor Dickey? I think the Accounting Principles Board would be particularly happy with your quotation from Justice Cardoza. I think they sometimes feel that way about their task--the least erroneous answer to an unanswerable problem.

CHAIRMAN WHEAT: Are you really sure that's from the Duke of Marlborough?

PROFESSOR DICKEY: You mean the last one about change?

Yes, I have the recollection that this was quoted in a book review in The New York Times in January of 1940. The reason I remember it is because the book review was written not by a professor of history or some other well-known writer, but by a successful president of a well-known corporation. He was not very well-known to the public at the time, but in the next few months he became very well-known throughout the United States because he rather unexpectedly won the Republican nomination for President. His name was Wendel Wilke. He wrote the book review and he quoted the statement from the Duke of Marlborough with great emphasis.

CHAIRMAN WHEAT: Anyone from the audience?

PROFESSOR SOLOMONS: The board that Professor Dickey would name would not consist entirely of CPAs. Do you have any idea of the kind of mix that you might have on it?

PROFESSOR DICKEY: In my paper I quoted Messrs. Barbatelli and Keller of NAA. Mr. Keller gave a slightly different mix in his testimony today. I don't think that the exact numbers are too important.

CHAIRMAN WHEAT: Where is this?

PROFESSOR DICKEY: This is page 21, toward the bottom.

Mr. Barbatelli, at the Federal Government Accountants Association convention in June 1971, criticized the present APB as being too heavily weighted with public practitioners. He suggested that the eighteen-member Board--and I wouldn't hold out for eighteen members exactly--should be composed of nine members from public accounting, six from business and three from the academic world. You may have noticed that Mr. Wayne Keller had a slightly different lineup this afternoon. He said not more than fifty per cent would be practicing CPAs, not less than twenty-five per cent from commerce and industry, and the remainder from academia and finance. This fifty per cent outside of the practicing CPAs would not have to have the CPA certificate.

I wouldn't argue as to the exact number, whether the total board should be eighteen or twenty, and the exact percentage. I think the CPAs perhaps should have fifty per cent.

PROFESSOR SOLOMONS: The point, of course, is that apart from the enforcement of APB Opinions by the SEC, enforcement depends on machinery within the Institute. Do you see any difficulty in enforcing pronouncements made by a body which had non-CPAs on it?

PROFESSOR DICKEY: If the ruling body of the American Institute of CPAs accepts this, presumably their members will, unless it's a very close fight. This is a danger.

CHAIRMAN WHEAT: Thank you very much, Professor Dickey.

I think because we're a bit late we'll move on. Mr. Ralph Kent of Arthur Young & Company is next. We are pleased to have you here.

MR. RALPH KENT: Thank you, Mr. Chairman, Members of the Panel.

Arthur Young & Company has submitted a position paper; I appreciate the opportunity to appear before the Study Group to briefly summarize our views and to respond to your queries.

Insofar as the auspices for determining accounting principles are concerned, we believe that the Institute should continue to perform the principles-setting function. We think AICPA is equipped to provide a foundation of authority; we believe it's equipped to provide a requisite supply of competence.

That doesn't mean that we necessarily urge the perpetuation of the status quo, nor do we believe that the performance cannot be improved.

On the matter of who should serve, we believe the preponderance of members should be CPAs in public practice. In saying that, we suggest that the viewpoints of others can and should be obtained through the process of briefs, public hearings, inclusion as members of subcommittees assigned to study special subjects, and in other ways.

Insofar as the term of service is concerned, we find no fault with the present setup of a maximum of two, three-year terms, or a seven and one-half-year maximum, whichever way it's defined.

We detect no rationale for a formal appeal procedure. We think the analogy that should prevail is with the legislative function and not with the judicial function.

We believe that the SEC does operate as an effective restraint which may very well serve the purpose of the appeal function. We would be concerned if there was an appeal function undermining the work and authority of the Accounting Principles Board.

Insofar as operating procedures are concerned, it's been said that opinions are too detailed at times, and possibly they are. We believe that the APB has the ability to decide this matter for itself. It may well be that certain opinions should be more detailed than others. Others might be quite brief.

On the matter of increasing volume of output, obviously this is a result to be desired. We think that this can be accomplished in a number of ways.

One of the steps, obviously--and I'm sure it's been mentioned by every speaker here today--is that we increase the number and quality of staff assistants. I'll comment separately on research.

We believe the present two-thirds voting requirement makes good sense and should not be changed to a majority.

We would seriously urge that as much time as possible be given before opinions must be implemented. We believe the Board at the present time unnecessarily irritates the business

community by deciding things and making them effective almost immediately. We think the world might go on if some of the implementation dates were delayed somewhat.

On the matter of interpretation, we feel that an opinion should not be altered by the interpretation process. We do not believe that it was the intent to issue two classes of authorized pronouncements, one by the opinion process and another through interpretations. We are a little troubled by recent changes in the wording that goes with the interpretations.

Insofar as the accounting profession is concerned, we think the present financing arrangement makes sense. It can be added to as reasonably necessary. This anticipates that APB representatives from accounting firms and from other occupations are paid by their employers. We think, in addition, that the concept of direct financial support by accounting firms has merit.

We believe it is possible and practicable to look to other organizations, not for direct financial support, but more for assistance in the preparation of position papers, research, et al.

We believe that the effectiveness of research can be improved. Various studies of this have been made in the past and submitted to the APB and the AICPA Board of Directors. One of the suggestions made in the past, which we're merely repeating, is the policy of giving pros and cons in research studies without the author necessarily taking a position.

We think it would clearly be desirable to go into the prospective proposed changes more in detail. We feel that we haven't really tapped all available sources of research in the effective way that we should and need to: accounting firms can perform research; members of the staff of the Institute can perform research; and particularly, the academic community can be tapped much more effectively, on a time committed basis.

I will be glad to answer any questions.

CHAIRMAN WHEAT: Thank you very much, Ralph.

The question that's uppermost in my mind was raised today by Mr. Trueblood and was seconded vehemently by Mr. Catlett. Is it conceivable that the Accounting Principles Board--or whatever we call it--operating essentially as a volunteer body, meeting for three days every month and a half, can possibly deal with the number of important questions presently on its agenda, and at the same time deal with the fires that must be handled quickly? Can it also develop with care and make some progress on this business of gathering a body of fundamentals everyone seems to want?

Can all of this be done by a volunteer, part-time group, or do you really need a group of people working full-time?

MR. KENT: All of you have had a chance to observe full-time groups--the Supreme Court and many others. I don't know of any group that stays on top of its work assignment, so we start from that perspective.

I do believe that the APB as presently constituted, with increased staff and a paid chairman could be much more effective in staying on top of its job. I think better organization of the research function can substantially ease the task of the Board, which now bogs down in writing its own opinions, and doing some of its own research.

This isn't a perfect world, Mr. Chairman. There's no way that any group can stay totally on top of such an assignment. I believe the Board as presently constituted with additional research, additional staff assistance, a paid chairman, can satisfactorily stay on top of the job.

The existence of a paid chairman would make a big difference because he would then be thinking about the job full-time. He presumably would be someone with a practice background; he would be able to anticipate problems and do a better job of observing these sparks in the woods and the fires which are about to ignite. He can start the spade work to prepare the Board to deal with those things.

CHAIRMAN WHEAT: A number of people, both those who are accountants in public practice and those who are not, have advised us that it is extremely difficult in this day and age and at this stage of evolution, to justify the matter of having automatic seats for each member of the Big Eight firms.

We have had people comment to us on the importance of objectivity and independence. Something about the automatic seat troubles them as to that particular objective.

Could the Board continue to function adequately on a volunteer basis if the Big Eight no longer had automatic seats?

MR. KENT: I'd like to add number nine, number ten, number eleven, and number twelve, also, Mr. Chairman. I don't think it stops at the so-called Big Eight. The facts of life are that the larger firms, wherever you draw that line, are more deeply involved with public financial reporting requirements. I think the world of experience that comes to people in those firms is valuable to the APB. Obviously, the Board would survive if six out of the twelve top firms were on it, but that isn't our question. Our question is what should we do to make our process more meaningful? I do believe that when you begin to draw away from the larger firms and the world of experience they have, you're beginning to erode the pool of competence that is available and is needed by the Board.

CHAIRMAN WHEAT: You do not regard this as a critical matter of principle; it is a matter of what is the most efficient, bringing the greatest depth of knowledge to bear. Is that what you're saying?

MR. KENT: Yes, I think we're looking for the most competent people, and I think we're going to find the most competent people in the organizations that have the greatest amount of experience.

CHAIRMAN WHEAT: One last question. On the subject of the two-thirds vote which you mentioned, a number of people have made the comment that this requirement invariably, or in

many instances, results in an extraordinary amount of compromise, which not only dilutes the product and makes it more complex and difficult to understand, but produces something which is not satisfactory to anybody.

Therefore, a number of people have strongly urged us to deal with this two-thirds vote. They note that other bodies--the SEC, the legislatures, the courts--handle controversial matters on a majority vote basis.

What is your reaction to that viewpoint?

MR. KENT: Admittedly, compromises are required in reaching even a majority vote on a difficult and complex question. I think there is greater security, greater consistency of well-rooted thought if you require two-thirds. I think when you're dealing with controversial matters it probably isn't sound to say that they should be determined on the basis of a vote of seven to six, or nine to eight.

I personally like, and our firm likes the two-thirds vote and don't think it has been a handicap.

CHAIRMAN WHEAT: Gentlemen?

PROFESSOR SOLOMONS: This is a repetition of what the Chairman has been asking, and I know it's quite late in the day for repetition.

I'd like to come from a different angle on this question of representation. There is this sentence in your written statement, Mr. Kent: "...we think it unlikely that the accounting firms would uniformly and effectively support statements of a body on which they were not represented."

You make that statement in a paragraph in which you are rebutting the people who want quite a small board, possibly six members.

Now if the Big Eight are to be guaranteed membership on the board at all times, then this Study Group could hardly recommend a board smaller than the present one. Suppose we decide that a board of twelve men would be more effective, then there couldn't be eight members from the Big Eight all the time without their dominating it to quite an excessive degree.

How would your firm feel about an arrangement whereby you are more or less guaranteed that every second go-around, so to speak, your firm had a member on the board; but didn't have a member on the board every year.

Would that kind of representation be satisfactory to secure your support?

MR. KENT: I think the support we're talking about in our presentation relates to the fact that the APB is sponsored by the American Institute, which subjects its members to the various restraints and controls of the professional body.

To go to the question as to whether our firm would feel happy to have a seat every other time, I think if you were able to find people more qualified to serve, and could demonstrate their competence to serve, we would have no basis for complaint.

CHAIRMAN WHEAT: Anyone from the audience?

(There were none.)

Thank you very much.

MR. KENT: Thank you, Mr. Chairman.

CHAIRMAN WHEAT: The last gentleman on our program today is Mr. David Norr, a member of the Accounting Principles Board, a CPA, and also an experienced financial analyst. Mr. Norr, we appreciate your willingness to talk to us.

MR. DAVID NORR: I appreciate the opportunity to make some observations.

I think the Board should have the best brains among CPAs. An analyst need not be on the Board. Service on the APB is demanding; it's a full-time job; it is not a part-time job as some have suggested. I would strongly oppose forty per cent management representation; I would strongly oppose twenty-five per cent management representation; I would strongly oppose equal representation of management and accountants.

The veto possibility is frightening.

If anything like that were to be done, I would question the progress made in narrowing areas of difference. The business community, from my experience, makes its voice heard now, loudly, clearly, directly and indirectly.

I have developed a healthy respect for the knowledge of accounting practitioners, especially from the major firms. And I doubt the efficacy of economists, lawyers and non-CPAs. I think they have limited expertise.

My suggestion for improvement is through research, a massive stepup in the work. First, help finance it. Besides the accounting profession's help, we need increases in analysts' dues, contributions from banks, publicly owned companies and stock exchanges.

Regrettably, some of these fields--including my own--have limited views of their responsibilities.

Secondly, what kind of research? More accountants taking time from staff duties, and more professors to be hired to do studies. More staff should be employed to do this work full-time; conceptual work and empirical work.

Staff should be increased. Each committee of the Board, I think, should have one full-time staff member. Board members who feel the need could get full-time staff help.

J. O. Edwards issued a call on the role of business, and I would like to take advantage of it and call on the FEI, the NAA, the trade associations, industry by industry, to set up accounting standards; industry by industry to inventory their accounting principles. Then, stimulated by the office of the Chief Accountant of the SEC, we could quickly settle some of these areas of difference.

Closely related, I suggest the start of self-policing by the business community of its members' reports.

This morning, George Catlett referred to the cumbersome mechanism of the APB. A good case study might be the problem of foreign translations which suddenly arose in mid-August. I think it most important to handle this in the annual reports of

1971. We must work under forced draft on several of these problems.

Would a small, full-time, independently financed group reach prompt answers? Perhaps so.

Perhaps with the existing system all Board members and their very substantial support staff could renounce all other duties in their firms; and perhaps for some this is exactly what is now done.

It means more meetings and more time on Board and Board-related activities. This is vital. The source of payment I think is less consequential. The Board and its activities, I feel, are a full-time job.

Will a majority vote be helpful? That, I think, is something to be studied more. Quite possibly the answer is yes.

In summary, my solution is more fire-power through the AICPA. It means more men on accounting research; more dollars on research; more time from staff; more staff; more time from Board members; more time from task forces and professors and others, all providing input to the Institute.

CHAIRMAN WHEAT: Mr. Norr, when Mr. Edwards was speaking to us we discussed the possibility that task forces of the Board, sometimes called subcommittees, working on particular projects include financial executives and accountants from industry who have a particular expertise in that area.

What is your reaction to this?

MR. NORR: Fine! If they are bright and knowledgeable in their area, it would be good, helpful input. I think

they may have asked an analyst to be part of the recently-formed real estate committee.

CHAIRMAN WHEAT: Professor Solomons has noted the suggestion that a board of eighteen or twenty, with their supporting staff, is a rather large and possibly unwieldy group when it has to consider complex matters. A board of maybe five persons is arguably too small, and maybe there is a compromise area of eleven or twelve.

Would you have any strong feeling about a board of a slightly smaller size?

MR. NORR: I really don't. I don't think I have any clear view as to which way it should fall.

CHAIRMAN WHEAT: Do you have any views on the subject of the automatic seat for each member of the Big Eight?

MR. NORR: I'm impressed by their knowledge and experience. It makes considerable sense.

MR. LEVINE: I'd like to ask a question that's related to that one, Mr. Norr.

I would ask that you pause to reflect upon your answer. Since you as a member of the Board could be considered to be from one of the non-pressurized groups, would you have any feelings about independence, in fact as well as in appearance, of public accounting members?

MR. NORR: There can be pressures on me, too. I have not been concerned about a lack of independence. The men seem independent, dedicated and call the shots as they see them.

But I could not object if the commission were to decide that the board should be independently financed with men severing their ties to firms.

PROFESSOR SOLOMONS: You draw a very striking distinction between the independence of the practitioner and the incapacity for independence which you attribute to representatives of management. It's one of the most striking things that's been said here today.

I don't really have a question on it, except to press you to tell us on what this is based.

MR. NORR: Experience. (Laughter) Perhaps we can cite, for example, Mr. Hornbostel's speech before the American Petroleum Institute meeting in Miami.

I don't see, in the business community, the seeking out of abuses; the willingness, let us say, to expand SEC funds to search out the problems. Yet in the FEI talk, it is suggested that the APB should not go after problems. I think it important for the APB to also go after problems.

So that, among other talks and statements, is what led me to my conclusion.

CHAIRMAN WHEAT: I suppose beyond that there is, at least in theory, the proposition that the independent practicing accountant has a professional job to do which is partially statutory. He's supposed to be a surrogate, in a sense. He is to make certain that the financial statements of a corporation submitted to stockholders and proposed stockholders under the 1933 and 1934 Securities Acts, represent fair and full disclosure.

There is no such obligation under the law, at least, on the businessman, except to the extent that a businessman and businesses have to face severe penalties if their disclosures are incorrect or false.

It was deemed appropriate at the time these Acts were established, to have this additional safeguard. Does that proposition reflect itself in reality: does the independent practicing CPA tend to look upon matters of financial reporting with a greater degree of objectivity than do the chief financial executives of business corporations?

MR. NORR: This is possible, and of course the Board member who is from industry now behaves in the most responsible professional fashion.

Perhaps some of the fault may lie with a financial community that produces pressure for improvement in earnings as representative of progress, so that all--including accountants, management and analysts--seek out those systems that will produce the best improvements and the best showing.

MR. OLSON: Do you have any feelings as to what specifically has contributed to these abuses? Do you lay them primarily at the door of industry, or do you place equal blame on the practicing public accountant?

MR. NORR: All of us seem to be involved in the problem of abuses and their proliferation. One could perhaps philosophize and say that it's all of society. And as I said, perhaps it's the mechanism of earnings per share;

improved values that make all want to do better. Somehow this system has produced, I think, the pressure for less conservatism in our statements.

MR. PRYOR: Don't you think that part of the problem is the pressure on the part of investors and management for more prompt performance? The whole of society has become more equity oriented than it was twenty years ago.

MR. NORR: Yes, we're all involved.

CHAIRMAN WHEAT: Does anybody in the audience have a question? Mr. Edwards!

MR. EDWARDS: You said that you would be very unhappy with forty per cent representation from business; and you'd be just as unhappy with twenty-five per cent representation. You stopped there. Do I assume you'd be more comfortable with zero representation? If this is the case, would you please elaborate on why you think that business representation should not be counted on to act responsibly.

My second question is this: You say you're frightened at the idea of a bloc vote of industry representation. Do you seriously believe that industry representatives could get together and vote as a bloc; is it possible to have that kind of a dream?

MR. NORR: In answer to the first, my experience says one in eighteen is quite good; perhaps it could go, as it was before, to two representatives from industry.

As to the second part, I think there is too much of a feeling that management should pick the principles it wishes. It came through in some of today's papers and statements. I think there is an important need for checks and balances.

CHAIRMAN WHEAT: You've all been extremely patient.

We conclude this first day of the hearing with renewed appreciation to all of you for sticking with us and giving us the benefit of your wisdom, your thoughts and suggestions. We will reconvene again tomorrow morning at ten o'clock. Good night.

(The meeting closed at six-ten o'clock.)

THURSDAY MORNING SESSION

November 4, 1971

The Thursday morning session of the Study on Establishment of Accounting Principles convened at ten o'clock on November 4, 1971, Mr. Wheat presiding.

CHAIRMAN WHEAT: Ladies and Gentlemen, welcome to the second day of our seance. (Laughter) There is no need for any remarks on my part. As I said yesterday, we all know why we're here and we continue to be most grateful to all of you for participating with us.

We'll follow the practice we did yesterday of affording the audience an opportunity to ask questions of the gentlemen who are giving oral comments, unless any of the gentlemen would prefer not to have that done.

Before the day is over we will have a chance to open ourselves up to comments, suggestions, or questions from the floor, to which we would be most receptive.

At the outset of our program this morning, we have the privilege of having with us four gentlemen from the Machinery and Allied Products Institute: Mr. Derr, Mr. Schirmer, Mr. Steward and Mr. Wearly.

MR. CHARLES DERR: As we presently appear I am more nearly a ringmaster than a witness.

I am Senior Vice President of the Machinery and Allied Products Institute. We are a national organization of capital goods and allied industrial equipment manufacturers. The Institute very much appreciates the opportunity of

appearing before this committee. The Institute, and particularly its executive committee--its board of directors, as it were--has long been especially interested in the work of the Accounting Principles Board and its parent body, the American Institute of Certified Public Accountants.

On October 25, 1970, in a letter to the Executive Vice President of AICPA, we suggested that the AICPA consider the possibility of appointing a senior business executive to the APB. We have referred to this in our written statement, and will elaborate upon it in the course of our testimony this morning.

Our testimony is to be presented, in order, by Mr. Walter Schirmer, Chief Executive of the Clark Equipment Company, and Mr. William Wearly, Chairman and Chief Executive of Ingersoll-Rand Company.

I should add that Mr. Frank Foster, Chairman of Sperry Rand Corporation, desired to be with us but could not. However, he prepared a statement addressed to Mr. Wheat, and with the Chairman's permission, I would ask for leave to include it in the printed record of the hearing.

CHAIRMAN WHEAT: We'd appreciate it.

MR. DERR: Thank you.

If time remains, and again with the permission of the Chairman, at the conclusion of our testimony by these two gentlemen, Mr. Charles Stewart would appreciate the opportunity of addressing a question or two on the general philosophy of the Accounting Principles Board.

One more word and I shall desist. Mr. Schirmer, our first witness, intends to discuss generally our suggestions on the advisory committee, along with a number of other matters on his mind.

Mr. Wearnly intends to illustrate and to exemplify to this distinguished committee the need for input from top management to APB deliberations, by discussing the potentialities for his business and for industry generally of a matter now under active consideration by the Accounting Principles Board. With that, Mr. Schirmer.

MR. WALTER E. SCHIRMER: Thank you very much, Charley.

Mr. Chairman, and Members of the Commission:

I'm going to be very brief, speaking only to certain points in the statement which MAPI has produced. It has always been my philosophy that business is not run by numbers alone; that there are elements of judgment and decision completely unrelated to the figures which the accounting profession produces.

I believe that in some of the things which are under consideration by the Accounting Principles Board, that advice and counsel, or at least the opportunity to discuss these problems at their inception, is of considerable importance. After an exposure draft has been made, it is almost too late to provide any basic comments of this type, as the comments are directed mainly to the specifics of the exposure draft.

I also believe that the Accounting Principles Board should have the advice of what you might call the industrial

advisory committee, in order to solve problems which industry itself may offer and which do not arise as a result of government bodies or the professional people themselves.

I believe also that the Accounting Principles Board should adopt or develop basic accounting principles and standards. It is very difficult from the industrialist's point of view to have to worry about the detailed rules and opinions which are provided in some of these draft exposures, and which are immediately scrutinized, I believe, by those who would like to avoid them through possible loopholes. This produces a second round with more detailed rules and regulations, and still further opportunity for lawyers as well as accountants to see how they can be avoided.

I think that we should all accept the fact that the great majority of business is honest and tries to do a good job of disclosure, and that most of these opinions are for the purpose of trying to fence in and prevent the unscrupulous. I think there are other ways of dealing with those who would like to make exceptions to generally accepted accounting principles.

I have two other points which I will mention very briefly--the investment credit; the Board has produced an exposure draft recommending a way of handling this credit. I believe the principle of the credit, the reason that Congress probably will adopt it, is to provide a stimulus for business, and a stimulus for capital expenditures. That stimulus will

be a deferred stimulus, if we follow the APB proposal. This seems to be completely contrary to the purpose of the credit. If it is, in effect, a tax reduction, it ought to be taken in the year when the tax is being paid.

Another example is product-line reporting, upon which Mr. Wearnly will comment from a slightly different standpoint. I comment on it from the standpoint of the difficulty involved in doing this for an integrated corporation.

A specific example is my own company. We manufacture fork-lift trucks, construction machinery, trailers, all of which receive certain automotive components from our automotive division.

It would be completely arbitrary, in my opinion, to develop product-line reporting for these individual products. Our automotive division sells about 50 per cent of its output to outside customers. How do we classify the machinery and equipment which they use, as to capital employed in the business? How do we allocate certain overhead, certain general administrative overhead, between these divisions?

We have tried to develop specific earning statements and we think that we would hesitate very much to spend the amount of money and effort to develop this.

We also have some nineteen overseas companies each with different methods of accounting. When we try to combine them with our methods, we run into exceptional difficulties.

The final point is the question of including in financial statements the 20 per cent or more joint ventures that you may have. This is very difficult, because of the differences in accounting and the differences in fiscal periods. We would probably have to have our accountants go overseas and develop a whole new set of books that might not be compatible with the local requirements in those countries.

We think that in certain cases, where there is a minimum of influence on the basic corporation, that you ought to be excused from that kind of accounting. Thank you very much.

MR. DERR: Mr. Wearly, you're next.

MR. WILLIAM L. WEARLY: Mr. Chairman, Gentlemen:

I have given you a copy of my proposed testimony, and in the interests of time I would like to briefly cover certain parts of it and dwell more on other parts, particularly those parts at the end of the paper.

As a starting point, I would like to remind you that I am quoting from the October 4 issue of Industry Week, that as of right now "...nine out of ten home radios used in the United States are produced in foreign countries. One out of six new cars is produced in a foreign country, and this ratio is rapidly changing; seven out of ten sweaters, nineteen out of twenty motorcycles...."

I won't read any further.

I'll identify my company briefly, just to give you an idea of what I mean in the way of world competition. Ingersoll-Rand will have total sales of approximately \$800 million this year, of which \$300 million is outside the United States, and \$200 million of it is exported from the United States.

I'm going to deal with the principle of separate accounting for product lines. It is not clearly stated why this is necessary. I believe regardless of the necessity that it does, in fact, cause disclosure of confidential information which is important to the future well-being of the company. It would be very damaging to have this type of information get in the hands of worldwide competitors, or for that matter any competitor.

This is not materially different than requiring a company to disclose its product research and development programs as they are being formulated. I think you will agree that if an individual employee or an outsider were involved in disclosure of a research program, or of a marketing strategy program, he would be subject to discharge and a suit for damages.

I will try to demonstrate that the proposed disclosures might become even more damaging and broader in scope. I will deal for a few moments with things that are particular to the Ingersoll-Rand Company.

Our business segments, product-lines, are by intent designed to have certain relationships to each other. Mr.

Schirmer made the same comment about Clark Equipment Company.

Our so-called segments involve some 27 product divisions, and 300 or 400 different lines. We charge our management--and I want to emphasize this--we charge our management with creating and putting together our divisions in such a way as to optimize, again I repeat, to optimize customer service, impact, engineering, technological proficiency and deployment of fixed assets for the most efficient production. This is management's stock in trade. If we succeed, we have a highly profitable growth; conversely, stagnation may indicate failure to develop proper relationships.

Thus we do not feel that our various businesses, units or segments can have the same vitality if operated in separated, unrelated units. If they do, there is little purpose in putting them together.

Clearly, there should be no inference made that segments could or should perform the same if operated independently. Therefore, what is a valid reason for an investor to have this information? He cannot invest in a segment. Is it to permit him to invest in a new business venture to compete with only the favorable segment?

The management of Ingersoll-Rand would like to know many things about our competitors; we try to find out these things; we don't know them for sure. These disclosures, as I see it, would lead to a list of things--I'm not going to enumerate them--but it's things such as unit production of various product-lines, the growth rate by product-lines over a period of years,

profitability and cost trends, and so forth.

We believe the proposed APB opinion would effectively lead to disclosure of this type of information. And I remind you that a little bit of disclosure ultimately leads to greater disclosure. Pretty soon the whole picture is disclosed, as I see it, to not only domestic competitors, but to worldwide competitors.

I doubt if you have had experience with what I call the "experience curve." I'd like to ask you to take some time and look at Chart A at the back of my paper.

Chart A is a price pattern. Price Pattern X is rather a normal pattern. Let me show you what the ordinate means. We have accumulated volume over time. We don't plot it in time, but rather we plot it in cumulative units of volume. On the vertical ordinate we have unit prices.

So the price volume, in constant dollars, of most products follows this over the years; and over increasing volumes the price actually reduces. Now Price Pattern Y shows a company that held the price too high, and at some point in time found its competitors chewing it up. They tried to lower their price, but went out of business because they couldn't turn the company around in time.

Price Pattern Z is also very common, in that the company does hold too high prices for a period of units or years, then they lower the price and again they become competitive.

Now if you turn to Chart B you will see the typical Price Pattern B plotted on top of a cost--a unit cost per.

Typically, these unit costs, when plotted, are a straight line. They are a straight line having a slope somewhere between 70 per cent and 90 per cent. This is a typical pattern.

On Chart C you can see the price pattern when they introduced the product at low cost; after a number of units were built they began to come down; finally the price was ahead of the cost and showed profitability, and the price followed the cost curve down over a period of units or years.

On Chart D, I am actually showing you an Ingersoll-Rand product which is, needless to say, not disclosed. This cost curve is the actual cost curve for this product. If you will look down in the right-hand corner you will see an X on the cost curve marked "I". "I" represents the actual cost achieved at the end of the year, December 1970, for this product.

If you will move up, the price curve shows where our price was, actually, at the end of the year 1970. I have further projected where I think our cost experience curve will go in 1975. That's what is called "I 75" on this curve, on down a number of units.

Now I have competitors A & B. I think competitor A's cost experience is where we have shown it on this curve. I don't know that, but I think that. B is where he thinks he rests.

Now let me show you what I can do. If I know for sure that A is the correct number for competitor A, I can drop my price down to below A's level, and certainly discourage

him from making any further investments in this business. He will probably gradually retire from the business.

If I knew for sure where B was, I could drop down there and project myself in a low profit position for four or five years, until I got out to my next cost experience point and be profitable; have my units out and have most of the competition effectively stifled.

I suggest to you gentlemen this is precisely what the Japanese are doing to us in America today. Will you look at Chart E. Chart E is from MITI, the Japanese Government agency, and it shows the cost price experience curve on monochrome television receivers.

I need not tell you what has happened. The American television industry is out of business.

The next one shows only the price curves, because I could not get the cost curve on the Japanese steel industry. I remind you that steel and television are highly visible industries. They stand on their own. They don't need disclosure because the disclosure already exists, in this industry. That's all I have to say.

MR. CHARLES W. STEWART: Would it be permissible for me to take a couple of minutes?

CHAIRMAN WHEAT: Please do.

MR. STEWART: I think that it's perfectly clear that what we were trying to do here was not only address ourselves to some of the matters that are before you, but also to illustrate the kind of interchange that we recommend the Accounting Principles Board undertake through regular

consultation with chief executives of companies. These men should be a combination of those who have not come up the financial route, with a sprinkling of men who have come up the financial route.

We think also that such consultation should take place at an early stage in the conceptual period of a new opinion or directive. We do not say this in any way to demean the role of the financial officer of a company. You have him represented on the Accounting Principles Board, and as an aside I think this committee might want to take a look as to whether the representation is adequate in terms of numbers. We think perhaps it should be enlarged somewhat.

With due respect to the financial officer, it is our judgment, and has been our prior recommendation and we reiterate it here and illustrate it here, that you would benefit by the exchange with chief executive officers of the type who are with us today. They are not necessarily volunteering for the job, but we are glad to try to give you a picture of what we have in mind.

I'd like to say just a few words about philosophy beyond the question of organization. I think, really, that your agenda is too limited in terms of your scope of assignment. You really ought to be looking at the thrust, the philosophy of the Accounting Principles Board activity in addition to the organization of that activity.

I was struck, for example, in reading a little pamphlet that the AICPA issues called The Accounting Principles Board, with the last two paragraphs, which read as follows:

"The information produced by accounting is used by different groups for different purposes-- credit grantors, investment advisors, stockholders, regulatory agencies, and by management. In performing its work, the Accounting Principles Board keeps all these diverse interests in mind but its primary concern must be for the investing public and credit grantors.

"By adopting this position in the development of accounting principles, the APB contributes to preservation of confidence in the free enterprise economy--and thus serves the long-term interest of business as well as the public."

I have two comments. First of all, it seems to me that the flat statement that the primary concern of the Accounting Principles Board must be for the investing public and credit grantors is not wholly appropriate and reasonable. Obviously, as suggested earlier in one of these two paragraphs, the Accounting Principles Board must and should keep all the various diverse interests in mind.

On the other hand, financial reporting is not reporting in the air. It is financial information which in turn in many instances reveals, as Mr. Wearnly has demonstrated, directly or

indirectly corporate facts which are not necessarily financial in character.

It is our judgment that the Accounting Principles Board has indeed been following the criterion to which I have just referred. We believe that business management considerations should be larger than they appear to be from the conduct of the Accounting Principles Board as we see it, and from the statement which it attributes to itself in terms of its motives.

Now again with regard to philosophy, it seems clear that the Accounting Principles Board concerns itself with two important motivations--not exclusively--but certainly it is giving high priority to these two motivations.

One is the matter of further disclosure; the other is the matter of comparability in terms of being able to compare one company, or one group of companies, with another company or group of companies. This again goes back to some extent to what these gentlemen have said.

In this connection we have one general observation to make. It seems to us that there is some evidence that the Accounting Principles Board on these two points is operating either deliberately or inadvertently on the theory that it should anticipate what the Securities and Exchange Commission might do in the foreseeable future. This, presumably, in order to keep rule-setting under the aegis of a private institution as distinguished from a public regulatory body.

A private institution, at times, has some responsibility to hold the line. If it believes that a trend in government regulatory matters is not the appropriate answer, it should resist, rather than merely attempting to anticipate government action.

To cite as an example, look at the history of the development of the concept of uniform cost accounting standards. This has now proceeded to the point where a board is actually developing those standards. The AICPA started out as resisting this concept in kind of a qualified manner, and then progressively softened on the issue. Now-- and I don't think the word is entirely inappropriate--it is almost in the position of a collaborator.

This is not to say that AICPA or the Board should not maintain its independent professional integrity and status, but I do believe that it's going down a fairly dangerous road. And I think with respect to those two objectives of disclosure and comparability, that some rule or reason must be applied. Some of the total top management objectives must be taken into consideration in connection with the activity of the Board.

Organizationally, we have a further recommendation. I'm a little fuzzy about the organization of AICPA in total; I know that there's a Council; I know that there's a Board of Directors, and I know that there's an Accounting Principles Board. Recently we watched an interesting exercise when there was a difference of opinion, apparently, between the tax

division and the Accounting Principles Board. It was resolved by the President, who appointed an advisory committee, and then the Board of Directors issued a statement, this one being addressed to the problem of conformity of tax and book accounting.

This was a rather unique approach, and it raises the question in our minds as to whether or not an appeal procedure, beyond the APB, might be worthy of your consideration.

It is interesting, incidentally, to look at the rationalization in the statement of the Board of Directors with respect to conformity between tax and book accounting. One of the important points made in the rationalization was that certain things are done for tax reasons, in terms of national public policy objectives. These have nothing to do with accounting, in a theoretical or practical sense, and therefore, it would make no sense to act to enforce conformity between tax and book accounting.

I would suggest that if you apply that same reasoning to the investment tax credit, which clearly has an objective that goes beyond anything approaching an accounting question, you might come out with a totally different answer than is in the present proposal of the disclosure report.

In brief, we're suggesting--and we do this quite humbly, at least I do, because I'm not an accountant--that you enlarge the scope of your inquiries; that you examine the

philosophical aspects of the work of the Board; that you look at its prime motivations or prime goals or thrusts; that you look at the question of whether or not there should be some guideline or deadline or cutoff with respect to some of those individual thrusts.

We made our suggestions regarding organization, principally the creation of a kind of advisory committee, perhaps enlargement of financial officer representation from industry on your board, perhaps an appeal procedure.

But the thing that concerns us most of all is not organization. It is the direction in which the Accounting Principles Board is moving, and particularly with regard to those two key objectives of disclosure and comparability.

I think there's one other thing to keep in mind, and that is that a security analyst has an insatiable appetite for information, whether it's relevant, misleading, or whatever it is. You'll never satisfy it, and the impact on top management in an effort to satisfy it to a maximum degree, we feel might be quite serious.

Speaking for MAPI, and for the gentlemen who have helped with the illustration of an approach that I would like to see you consider, we greatly appreciate the opportunity to be here. I have gone beyond your time limits; my sincere apologies.

CHAIRMAN WHEAT: We are greatly honored to have a group of distinguished chief executives like yourselves take the

time and trouble to come and talk with us. The comments you've made are very significant. I'm sure that the gentlemen who are sitting with me have these interests in mind, but it's well to be reminded of them.

I would like to comment on your statement, Mr. Stewart, on the question of philosophy and objectives of financial statements. As you know, for historical and other reasons, the American Institute decided to put together two committees to work simultaneously on these problems. The Trueblood Committee has as its chief task the business of trying to determine the objectives of financial reporting, and in particular just exactly for whom are financial statements intended.

I would hope, and urge you, to make your presentation to that committee at the appropriate time. They could benefit from the things that you are commenting about.

MR. DERR: If I may say so, Mr. Chairman, we're actively working on it.

CHAIRMAN WHEAT: Our objective, as you know, and our assigned task is more limited. And although inevitably we need to be apprised of the particular areas of criticism of the work of the Accounting Principles Board, as well as any other comments on that work, we are not in a position to delve with great depth into the details of the opinions or proposed opinions of the Board itself. That project would take us several years, and would be far beyond my competence

as a layman. I have had some experience of another sort with the matters about which Mr. Wearnly talked. When I was on the Commission we had this problem. And I am sure that all of you gentlemen recognize the various counter-vailing pressures which operate in this field, including the very real concerns of business, which you have so eloquently commented upon.

I think it might be well for the record just to reflect for a moment on the fact that when rather severe demands for product-line reporting were being made in powerful Congressional committees and by powerful agencies of the Government, the Securities and Exchange Commission elected to hold up on this project until a study could be made under the auspices of the Financial Executives Institute. We were impressed by the progress of that study and it rapidly became apparent that the author, Professor Mautz, was a man of great competence and diligence. He proceeded swiftly about his task. He was, to my way of thinking, very much aware of some of these difficulties which Mr. Schirmer mentioned: allocations of costs, and so forth.

His report and recommendations so commended themselves to the Commission that when it acted in this area, it did so greatly influenced by the work that had been done under the auspices of this private organization.

It is, in my judgment, the best example of the type of cooperation between Government and the private sector which one looks to find. The matter has been, and is in kind

of an experimental stage. It obviously has to be reexamined and looked at carefully.

There are increasing demands for expansion on what has already been proposed and embodied in the rules. It's highly significant that the matters upon which Mr. Wearly commented be taken into account. I'm certain that if you look at the record of the Securities and Exchange Commission in this area, you will find a caution which should commend itself to you.

And of course, I think personally that it's incumbent upon the Commission. After all, the accounting profession has awaited the action of the SEC in this area.

But certainly it is incumbent upon the accounting profession to examine with great care whether or not it is feasible for the auditor to perform an attest function with reference to these figures which become very important in the minds of some investors. I think that you would find, as we have, that there are increasing numbers of investor-oriented groups which consider this information very important.

It is important, of course, that this be done with great care, and I am sure that it will be.

I would like to make one comment by way of a question and comment together. This is a point that Mr. Stewart made about the philosophy of APB activity. We should--he is entirely correct--be concerned about that and be alert to it.

As you know, it has been recommended to us that opinions of the Board have not adequately, in the judgment of

the critic, set forth the purpose of the particular opinion; what it is designed to accomplish from the standpoint of the public investor, and what alternatives were rejected.

The question which this raises is whether or not these opinions on financial accounting, as opposed to management accounting, are really for the primary purpose of maintaining the information and confidence level of the investing public.

As I judged your remarks, your principal concern with that objective is that adequate attention is not being given to the harmful effect the opinion might have on the corporation.

In other words, the question is one of making sure that this is being considered. I wanted to be sure that that's correct.

I have an example with which I'm working at the moment. Corporate management is very much concerned about its reputation and the difficulties it will have with the stockholders and others if it cannot maintain a sizable quantity of deferred costs on the asset side of the balance sheet. And management doesn't want any qualification in the auditor's report as to recoverability of those costs.

It's a question, in this instance, of management's concern for its reputation, with a lesser regard for the problem of the person who may invest in that company based upon undisclosed deferred costs.

The areas of accounting standards which apply here are designed to protect the public investor. I wanted to be sure that it wasn't your feeling that that particular aspect of management, which one encounters from time to time, should be taken into account as opposed to the interests of the public investor.

MR. STEWART: The implication of your question is perfectly appropriate. Under no circumstances do I suggest that a coverup be tolerated. On the other hand, I do feel that there's quite a difference between what might be called a selfish coverup and the revelation of information which does not involve any impropriety on the part of management, but does have some serious management impacts.

If you break down product-lines in a way that reveals where a particular product is manufactured, a union is then in a position to pinpoint the profit center that is doing the best job. I do not think that is in the interest of accounting; I do not think it is in the interest of management; I do not think it is in the interest of stockholders, and it does not involve anything approaching an impropriety such as you suggested.

I do not wish to imply what is implicit in your question. Could I comment just for a--

CHAIRMAN WHEAT: Excuse me just a moment. Just to be sure that I understand what you are saying--it is not the precise interests of management that you're concerned with. It's the interest of stockholders in a broad sense. It will

be injurious, in your judgment, for certain things to be revealed; injurious to the stockholders of the company. That interest has to be taken into account along with the interest in full disclosure. You want to ensure that the broad interests of investors are taken into account. Isn't that a correct statement?

MR. STEWART: It's a correct statement except that you end up with the word "investor", which is not an inaccurate terminus to your point, but really doesn't put the proper emphasis on what I'm saying.

I'm not speaking of management as an individual interested in what his profit performance as an individual is going to be next year, except to the extent that our system happens to reward that. I'm not interested in the selfish protection of individual members of management; when I refer to management I'm referring to the responsibilities of management to the corporation, to the stockholders, and I think to the system that we live with.

There is no difference of opinion between the manner in which you have stated these propositions, as long as proper weighting is given. If you read the statement of the AICPA, it is clear that a heavier weighting is being applied to two areas--credit grantors and investing public--than is applied to the company in terms of its proper functioning.

CHAIRMAN WHEAT: The question that I'm raising is the correctness of that statement as it stands. The reason I raise the question is because it seems to me that, properly

interpreted, management's role is to do the best job it can for the stockholders--not for the management.

If that's true, management should be concerned about the interests of stockholders in accounting and financial accounting matters. It is obviously apparent that those charged with developing standards for financial accounting--and I'm limiting myself, now, to financial accounting--must take into account all these aspects that you gentlemen have been reciting to us this morning.

But I do not comprehend that meaning that there are interests of a significant nature to be protected apart from the interests of the stockholders. I'm a little puzzled as to what those interests might be. I'm not terribly concerned about credit grantors. I put this to you in order to elicit your reaction, because I have the strong feeling that the major banks can take care of themselves (Laughter). They get from you all kinds of information, not necessarily appropriate for public distribution nor would anyone deem that appropriate, necessarily.

The public, however, is not in a position to demand those things from you and to secure them. And accordingly, the interests of the public in financial reporting and accounting seems to me to be a relatively paramount interest. No one is going to look out for the public unless the accounting profession, and ultimately the Government, hopefully to a greater degree, watch out for this matter.

Our whole system is based upon the investments of more than thirty million Americans. I just want to make sure that the concern I have is adequately reflected, at the same time that your concerns are given their appropriate weight.

MR. STEWART: Really, we're not very far apart.

CHAIRMAN WHEAT: I'm glad to hear it.

MR. STEWART: We're stating something in different terms. When I say you need to look at management's considerations, management, obviously, even to the question of susceptibility to suit, has a responsibility to the corporation as an entity; to stockholders. It is in that context that I am referring to it.

CHAIRMAN WHEAT: I don't think we're far apart at all.

MR. STEWART: We're not far apart, but I want to be absolutely sure that I am not leaving the record unclear as to the point which I'm trying to make: and that is that there are management considerations in the interests of stockholders, present and potential, which should be given a proper weighting in the development of the opinions of the Board.

CHAIRMAN WHEAT: I am in one hundred per cent agreement with you.

MR. STEWART: I would like to say one thing about your opening remark regarding the scope of your assignment. Of course, it is for you to judge that scope.

I believe that it is almost impossible to make intelligent judgments regarding organization by itself; that you do have to take into consideration these other factors to which I have referred.

I am also a little bit mystified about the overlap between the two groups to which you refer. There's a third now active on the matter of segmented reporting.

Obviously, if you want to play on words, it appears that AICPA is segmenting its effort by having these three groups operating somewhat autonomously, but I hope not in terms of playback among the three groups. I suggest, as I already have mentioned, that you can't separate organization from substance; you can't separate organization from philosophy, because they have a bearing on how you organize.

The committee that you referred to, or the study group, which I believe Mr. Trueblood is responsible for, deals with the question of financial reporting. Another group is--

CHAIRMAN WHEAT: Forgive me, I think that the Trueblood Committee is dealing on a much broader scale than that; it's financial reporting and all other kinds of financial statements, for various types of users--

MR. STEWART: I see; I abbreviated it too much.

There is another committee which has the assignment to come up with something on segmented reporting, a much--

CHAIRMAN WHEAT: I believe that that is a committee of the Accounting Principles Board.

MR. STEWART: That's all right. My point is that the last committee mentioned is dealing with a very important aspect of financial reporting, and apparently has a mandate to come forward with a proposal before the very broad study--which I believe is contemplated to be a two-year study--is completed.

So that to the extent that the larger scope study brings light upon the subject of financial reporting in other matters, we could argue that it would be premature for the Accounting Principles Board or the AICPA to address itself to such an important segment that has been assigned to the other committee.

CHAIRMAN WHEAT: I recognize the thrust of your argument, and it has been well-stated. You will recall my questions yesterday to the gentleman from Haskins & Sells. They were addressed to this same problem; can you wait to make progress until there is a final decision on some of these broad fundamentals. His testimony yesterday, if you will recall, was no; you must proceed while you phase in.

I suppose you might say that that is a practical judgment by the gentleman?

MR. STEWART: Incidentally, I would anticipate that that would be the practical or pragmatic answer; the only question is whether you are really making progress, or merely making decisions.

CHAIRMAN WHEAT: That's a debatable question.

(Laughter)

I would like to ask one more question before turning it back to the committee. The proposal you have made of a senior advisory committee to the Board is an extremely interesting one.

I wonder if you could take just a moment to tell us whether or not you have viewed that matter from the standpoint of its specifics. Have you considered how many persons should be on such a committee; how they should be selected; would it be designed to be representative of all aspects of publicly-held business, or only a selection of top executives who have an interest in these matters and are therefore willing to spend the time? Under whose auspices would they be selected, and would they contemplate any given amount of time?

MR. STEWART: We spelled out some of that in a letter which is attached to our statement, but I welcome the opportunity to abbreviate what we have in mind.

It's been our experience that very large committees do not function well. Our thinking has gone this far, and assuming some receptivity to the notion of its general terms, it should be a relatively small group, five, six, or something in that range.

I believe I mentioned previously that I would mix those who had financial background and had reached chief executive status, and those who have not. I believe that in our letter we indicated that the advisory group should be representative, consistent with its size, of segments of business in the United States. In this way you would not get

the point of view of only, let us say, heavy goods manufacture.

I think these men have to be chief executive officers or men who have advanced from that level to long-range planners. I would distinguish clearly from the chief financial officer.

I would assume that it would be selected by the President of AICPA or by some appointed individual; I would obviously avoid--because we have a stake in the public interest just as the Accounting Principles Board and the accounting profession do--I would avoid loading the committee. And I think that a further stipulation would be that these men would be brought in at an early stage on conceptual matters, as distinguished from a disclosure report.

We do a great deal of work with Government, and our experience has been, for example, that when something is printed in the Federal Register under the Administrative Procedure Act, there's quite a bit of ice on that particular proposal. I have a hunch that a similar experience occurs within the operation of AICPA.

That's about where our thinking has gone. I think that there is a growing recognition in business today that, to a large extent, it's business' own fault because there isn't a proper communication between the accounting profession and top management.

We do not recommend that you fill that gap by placing chief executive officers on the Accounting Principles Board. I think your present system of using industry

representation in terms of financial officers--although that might be enlarged--is appropriate.

I think that you mentioned time. This will take time. But business has to learn, if it hasn't already, that if it's going to get input it has to take time. And I think you would find competent, interested, broad-gauged chief executives who would welcome an invitation. They should be rotated probably in order that you have exposure to various segments of the economy.

As I say, we deliberately structured our presentation today along the lines that we did in order to illustrate the heart of our suggestion.

CHAIRMAN WHEAT: Thank you very much, Mr. Stewart.

Anyone on the committee?

MR. PRYOR: I have one question I'd like to ask and one comment I'd like to make. Did you seriously suggest that corporate disclosure was the basic reason that imports from foreign countries have become as large in this country as they have?

MR. SCHIRMER: I guess you're aiming that at Mr. Wearly.

MR. WEARLY: The reason why I said that is because their thrust has been at visible industries. I can't disclaim the fact that low labor rates give them a big advantage; but I would point out that we can compete today in the world in many, many products because we have a productivity advantage.

They have great difficulty in finding out what I'll call the thousands of hidden products that lie in the industrial world. But steel is visible. All they have to do is analyze steel reports, and they know how much tonnage is produced in the different classes of steel; they know what the labor rates are; and they could plan and did plan roughly ten years ago to invade the world steel market.

They did it first by tieing up raw materials; they tied up technology, and then they went to work. Television became a visible industry. It didn't require segmented reporting; it was already out in the open. They did that.

Now, as you know, in the invisible industries, if I may call them that, the Japanese have not been particularly successful. This is a factor; not the only one.

MR. PRYOR: I don't want to debate the question, but the basic economic realities of size, profit opportunity, and return on investment far outweigh corporate disclosure as a factor in producing the effect that you describe. One other point--

MR. STEWART: May I supplement that statement, because I think you may be overlooking something. One of the great mistakes that we made in the United States for many years was to assume that we know more than our foreign friends about a lot of things.

Technology in many areas, even in the so-called high technology areas, has caught up, and in some respects has gone beyond. And Mr. Wearnly was not implying that import

competition which has already taken place, is primarily attributable to information in the form of disclosure. He's not implying that. He is saying, however, and if you will analyze some of the dumpling applications that have been made by the Treasury Department, that where the foreign competitor, as able and as shrewd as the Japanese, can break down a product-line into the most profitable sizes and types of goods, it will move accordingly. He is being anticipatory to some degree.

But it so happens that I know of situations in which breakouts have enabled foreign competitors to be very selective about the products they hammer at. Miniature bearings is one; it happens in that particular instance that there is a sufficient number of exclusive manufacturers of miniature bearings so there wasn't any breakout problem.

But you get into the other types of bearings and the selectivity technique, for example--and I'm just using it as an example--of the Japanese is very clear. The same thing has happened in certain types of machinery.

There isn't any difference between you and Mr. Wearnly on the point. Is that not true, Bill?

MR. WEARLY: They have only so much capital to deploy. If they deploy their capital in the most favorable spot, they can be vicious in their results, because they don't make any mistakes.

We go around making, let's say, fifty per cent of our decisions wrong, just because of the lack of disclosure of

the real market.

You can't believe how many wrong industrial decisions are made because we don't have the facts when we start. The Japanese made a remarkable number of right guesses, because they have the facts. If we give them more facts, I think they will be more right. That will enable them to exploit their low labor rates and their good productivity to knock us off on products one by one.

CHAIRMAN WHEAT: Are there any questions from the audience?

MR. WEARLY: I would like to make one more comment. I think we all believe in proper, conservative reporting. I think what some people seem to get away with is abominable. As a company that is fairly conservative, we don't like to see wild accounting practices used, because it puts us in an unfavorable light with others. I don't think any of us will be advocating that.

CHAIRMAN WHEAT: I appreciate that.

PROFESSOR SOLOMONS: Could I just comment on one thing? I've been restraining myself somewhat because it seems to me that if I were asked to sum up what the witnesses have said about disclosure and comparability, they would sum it up by saying they were against it; it's as simple as that.

MR. STEWART: That's quite erroneous.

PROFESSOR SOLOMONS: Well, that will give you an opportunity, Mr. Stewart, of making a more positive statement on what you think the philosophy of the APB should be. You

told us, on the whole, what you thought it should not be. Could you make a more positive statement on what you think it should be?

MR. STEWART: My central point, with which the Chairman and I have reached an agreement, is that the philosophy should properly weight. By philosophy I mean your operating theory, management considerations which are in turn related to the interests of the corporation, and the interests of the stockholders, present and prospective.

You misread me completely if you thought that I was suggesting that we're against disclosure and that we're against comparability. We are suggesting that--and I'll spell this out in the written supplement so that there will be no ambiguity--there is a reasonable line beyond which you perhaps should not go in terms of the degree and the depth of disclosure, and in terms of your notion of achieving comparability. I'll give you an example which is not necessarily attributable to the APB, but it is an example of what I'm talking about.

We have proposed changes in Regulation S-X of the Securities and Exchange Commission. In a number of places you will see that if the proposal sticks, the reporting company is required to report in the alternative. This applies to several accounting items. Compute one way; compute another way.

My personal judgment is that this is going to produce very little more than confusion among the investing public, which you have a responsibility to protect.

I would suggest that that is the kind of thing that goes beyond the line of reasonableness.

I think that the Accounting Principles Board has accelerated its activity, and there's nothing inappropriate about that per se; it is moving more aggressively; it is active in more areas than before. It is not for me to say that is wrong. But I do feel that there isn't any action, be it governmental or otherwise, that can be workable or sensible, unless it has balance.

How much disclosure in a particular case is necessary to accomplish your objective?

To what degree are you, by taking a certain action, really improving the comparability, and to what extent do the stockholders or the investing public really have anything more than they had before?

There is no difference of opinion between you and me with respect to the fact that there should be proper disclosure and that there should be a reasonable goal of comparability. We're talking about degree; we're talking about balance, and we're talking about using just plain old common sense.

So your summary of our position is wholly in error.

CHAIRMAN WHEAT: Thank you, gentlemen. I think we should probably move along. We appreciate the time you've taken with us.

MR. STEWART: We appreciate this opportunity.

CHAIRMAN WHEAT: Next on the agenda is Mr. LeRoy Layton, Managing Partner of Main Lafrentz & Company. Mr. Layton was the last previous chairman of the Accounting Principles Board.

MR. LEROY LAYTON: Mr. Chairman, I appreciate this opportunity to present my views on the subject before you.

I will attempt to offer fewer solutions than I might be expected to. But the main purpose of this presentation is to afford a better understanding of present problems and thus aid your Study Group in arriving at sound and lasting solutions.

The main thrust of the presentation that you have before you is in Appendix A of our position paper. It is a paper that was presented several weeks ago at a Northwestern University conference. It is entitled "A Critical Analysis of the Present Institutional Framework For Formulating Financial Reporting Standards."

It includes, among other related matters, a candid review of the Accounting Principles Board's role in history; its strengths, its weaknesses, and its relations with other groups. It is felt that this information is relevant, and there is much to be learned from the present system; its struggles to cope with changing conditions, as well as its problems, and in some areas its failures in so doing.

The Appendix is 30 pages long and would take far more than the allotted time to cover. The area on the changing conditions that it did cope with is presented because I believe

that any organization that comes out of this study **m**ust also have the capability to change with changing times. Conditions existing today will not be the same as those that will exist ten years from now.

I thought a review of the APB's current problems was important, because from my standpoint, as a member of the Board for seven and one-half years and as chairman for almost three of those years, we covered most of these areas; Board manpower; voting rule; the quality of opinions; the need for quick decisions; the need for an early warning system, and the appearance of independence.

I won't cover all these in my oral presentation; but will try to hit a few of the highlights.

First, as to loss or erosion of confidence in financial reporting. This has been one of the main concerns, certainly, of all of us. The Accounting Principles Board has attempted to make sure this does not happen. I believe, however, that the primary cause of the erosion of public confidence in financial reporting stems from the action of a very few managements and independent auditors. I stress auditors here rather than accounting principles, because I think this is part of the problem--the auditors' inability or unwillingness to cope with these situations.

In this area let me be a little more specific. I won't waste time on the management portion of this; but will discuss my own profession. I think CPA firms must improve their performances.

First, I think most are already spending large sums in recruiting, training, developing and supervising professional staff. These programs apparently need to be more effective. Each firm should consider having key decisions and work papers reviewed by or under the control of an independent partner, prior to the issuance of reports.

Accounting gimmicks--innovative accounting approaches apparently within the confines of generally accepted accounting principles, but of questionable soundness, should be reported to the AICPA as part of an early warning system, rather than being used, as I believe they have in some cases, to enhance client relations.

Let me add that more effective auditing could do much to control accounting gimmicks, even with today's accounting alternatives.

If the Utopia of accounting principles is ever reached, I think effective auditing will be needed to control a whole new set of accounting gimmicks. When I say effective auditing I mean the use of sound judgment, and the guts and the willingness to lose clients on occasion.

Now as to the independence of the Board. I firmly believe that the independence issue is a false one and has little to do with either the loss of public confidence in reporting, or the Board's inability to operate more satisfactorily.

The eighteen-month struggle with business combinations, and its final conclusions have subjected the Board to the

criticism that it was too responsive to the wishes of management. Some elements of management, however, have been equally critical that the Board was not sufficiently responsive to its expressed viewpoints.

In my personal experience, I flatly reject both criticisms as being completely groundless.

I appreciate that the appearance of independence or the appearance of lack of independence is a different matter than actual independence. However, I recommend strongly against making any changes solely for the sake of appearances.

I feel quite strongly about the Board's voting rule, although I may be in the minority. The necessity for a two-thirds majority vote to issue an opinion or a statement has taken its toll on both the quality of opinions and the efficiency of the Board's operations.

On a number of occasions, periods of constructive analysis and consideration of the input of others were followed by voting which left the Board short of a two-thirds majority. There was then no other course but to redebate the issues and seek compromise solutions. It is my estimate that the rehashing and compromising on Opinions 16 and 17 added at least six months to the time schedule, and caused a 180 degree shift in the purchase-pooling conclusion.

If lack of confidence in the organizational structure or performance of the present Board or a similar type board is such that it cannot be endowed or entrusted with a simple

majority vote, then I would favor whatever changes are necessary to create an organization that could be so entrusted.

And I am hitting only the highlights.

As to the small, full-time, paid board, I am concerned that proponents of this solution may not have given it as much depth study as I believe it must have. This, of course, is now the responsibility of your Study Group. My chief areas of concern are five.

It is assumed by those who propose it that better, sounder opinions will flow from a small board. This may be so but is this a safe assumption, and if so, why?

Second, no matter how sound future opinions may be or how efficiently the new organization performs, or how it is constituted--whether it is interdisciplinary or AICPA sponsored--its actions will affect many, and it will be subjected to criticism and severe pressures. Under the circumstances, real acceptance of a small board in the private sector can last longer or evaporate sooner than a broader-based board. That's the second question I think must be answered, if you move in that direction.

If at a later date a degree of disenchantment develops in a smaller board, will the source of its operating funds continue or will they dry up? Today the major portion of operating costs represents donated time and out-of-pocket expenses borne by the Board members and their firms.

In my opinion, a larger firm would be extremely reluctant to withdraw from a larger board similar to the one that exists today. To do so would put it at a competitive disadvantage in serving its clients. That may be a wrong reason but I think that's a practical situation as it exists today.

Much has been made of the off-again, on-again inefficiency of the present, part-time Board, and the greater added efficiency that a full-time board would have in being able to continuously consider a single matter.

Actually, neither type board can give continuous thought to any one subject. Both must pause for gestation periods, while other views are being sought, while public hearings are being tabulated and digested, while decisions are being drafted on opinions after exposure. On balance, though, I do believe a small board would spend less time on deliberation than would a large board.

My last concern is the manner of selecting members for a small board. This must be given very careful consideration to avoid any suspicion of "packing the court."

My seven and one-half years on the Board convince me that the experiences and nature of individual members and their firms have molded them so that their voting pattern was predictable, to some extent. Some were basically conservative, and by this I mean less susceptible to consider change. Others were more liberal or progressive, and far more willing to consider new approaches.

The last general problem area is research. I've spent a full page on my ideas there, and also included recommendations made by the APB to AICPA.

I won't repeat them here, but the problem of realizing more support for research must be solved. It will represent the same challenge regardless of the structure of the board itself.

Now for some personal conclusions. There is no question that continued improvement in financial reporting is needed and will be accomplished, if not by an arm of the private sector then by some agency or board of the Government.

There is also no question in my mind that the initiative should stay in private hands. To accomplish this there are two basic requisites as I see them: general acceptance of the changes that are promulgated; and second, there must be some method of enforcement.

Presently, the APB strives for general acceptance through close cooperation with other organizations whose interest in accounting principles is just as great as theirs. This effort includes public hearings.

Second is a structure which provides broad representation from firms handling the bulk of publicly-held opinion work. Hopefully, sound opinions will be the product of the Board's semi-public, legislative-like procedures.

The enforcement factor is at the moment a tenuous linking of the accounting profession's discipline, which binds

practicing public accountants to its official pronouncements, and the insistence of the SEC and stock exchanges on opinion reports. At the moment, without legislation of some sort, I see no substitute for this in the private sector, and, therefore, believe that the Board should stay under the control of AICPA.

I have one further observation. The APB is currently moving at the fastest pace in its history and has just issued its fourth opinion in eight months. It has at least fourteen projects on its current agenda, in varying degrees of development.

Also, there are ten research projects scheduled for publication in the next three years.

I hope that the recommendations of your group will ensure that this momentum be maintained. Of course, while most critics want faster action, there is a limit as to how fast the preparers of financial statements can safely absorb intricate changes in accounting principles.

This concludes my oral remarks.

CHAIRMAN WHEAT: Thank you, Mr. Layton, I have several questions. A recommendation was made yesterday that it might be desirable for the board to allow a longer lead time between the publication of its rulings and their effective date.

What's your reaction to that point?

MR. LAYTON: The Board has given thought to this fact; it was always a matter of concern. If you prescribe a principle that eliminates an alternative or selects one

out of several, you've now cast doubt on the one eliminated. What happens when you come to this conclusion, but allow three years to make a change?

If something goes wrong in the intervening three years, and someone was using the principle that's been eliminated, he might be hard-pressed to say why he had not adopted the change much sooner.

In other words, it could be dangerous not to adopt the change once it had been put into print.

CHAIRMAN WHEAT: Mr. Layton, you referred to the desirability of having the experience and input of the major firms in public practice. What is your reaction to the desirability of maintaining what has been a kind of automatic seat for members of the Big Eight accounting firms? What impact does this have on the objectivity and status of this body in the private sector?

MR. LAYTON: I think this is indefensible. I was asked that question after becoming Chairman, and I gave the same answer. I said that so long as I'm Chairman, I hope all eight are on the Board. Their input in terms of time, money, and other resources is tremendous; not only a tremendous amount of time by the individual himself but the time of his advisors and other staff. While I was Chairman, from a practical standpoint, I was pleased to have all eight.

I was told that Cliff Heimbucher was asked the same question and gave the same answer. In principle, I don't think

you can defend it.

CHAIRMAN WHEAT: You have heard the strong recommendations for strengthening the role of the task forces to this board so that they have the benefit of more regularized input from financial officers in business. These task forces would have a staff member assigned to them to help projects along, and would have the benefit of highly experienced public accountants outside the membership of the board.

Along with that suggestion, in part, has come the suggestion to reduce the board to a size which would not be as small as you have spoken of in your testimony, but to an intermediate size, say eleven or twelve members. This final decision-making body, proponents say, would rely heavily upon the work of the staff.

What is your reaction to that suggestion?

MR. LAYTON: All right. There are in existence already special industry committees which are appointed by the AICPA and operate outside the aegis of the APB. These special committees are preparing audit guides which involve both audit and accounting principles considerations.

So what you suggest is already functioning in special industries. I don't know why it could not be expanded upon to give subcommittees of the Board added strength, or to take the place of special committees of the Board. I think this would be practical.

I think that an intermediate size board, with proper input, could function. It would have to satisfy the five questions I have raised regarding a smaller board.

From my standpoint I would like to see it operate with a simple majority. If you pick an even number, a simple majority gives you an edge of two votes which is maybe a little more acceptable than a one majority.

CHAIRMAN WHEAT: Mr. Layton, you have heard the recommendations of a number of people that the board should be representational. In other words, there ought to be a certain number of seats on this group for accountants in public practice, and that there should be an equivalent number of seats for financial executives in industry. Along with that suggestion has been a series of suggestions as to who might be appointed to represent other interests, including lawyers, investment bankers and others.

Would you comment on that?

MR. LAYTON: You're speaking of what I call an interdisciplinary board. I've had trouble defining its authorization and its legal backing. These are necessary for the enforcement factor, which is one of two things I think it ought to have.

I can assure you also that you would need a simple majority, because of the diverse views. I think you're bound to come up with four or five solutions to any one subject.

I do believe you will have to solve its legal foundation and the measure of its authority before that is practical at all. Lacking that, I favor continuation of the AICPA's control.

MR. BIEGLER: Mr. Layton, you expressed concern about the legal foundation of an interdisciplinary type of board. This suggests to me that you're satisfied with the legal foundations of the present Board.

Would you like to amplify that?

MR. LAYTON: I said before that enforcement is a tenuous linking of the accounting profession's discipline, our respect for the pronouncements of the Institute.

MR. BIEGLER: Do you think that the Board's opinions have any legal backing?

MR. LAYTON: I think they have a practical backing.

MR. BIEGLER: I'm trying to distinguish between your concern over the legal backing of an interdisciplinary type board and your apparent lack of concern over the legal backing of the present APB.

MR. LAYTON: I said it's tenuous and I see no substitute. Am I satisfied? No, not particularly.

MR. LEVINE: Mr. Layton, being a past Chairman of the APB, do you have any views about the need for a full-time chairman?

MR. LAYTON: Yes, I would favor that. It came up while I was Chairman, and the Board voted quite strenuously for it--I think the vote was something like 14 to 4, or 15 to 3, in favor of a full-time chairman.

I can assure you that no matter how many hours a chairman might spend, he can always spend more.

MR. PRYOR: Mr. Layton, I would like to summarize your views as I would understand them: you would be willing to have a full-time, full-paid chairman; you would like research to be somewhat better than it is now. But by and large, however, you are satisfied with the system as it now stands. Is that a fair summary of your views?

MR. LAYTON: I was not satisfied with the performance of the APB while I was Chairman. However, I was always comforted by the knowledge that I had done the best I could and I hoped the Board had done the best it could. We were constantly looking for better ways of accomplishing what we were doing.

To say I'm fairly well satisfied is not really putting it properly.

MR. LEVINE: To put it a little differently, these are the only changes you would suggest to make it more effective?

MR. LAYTON: My position paper more fully discusses the changes I think necessary.

PROFESSOR SOLOMONS: Mr. Layton, you have placed considerable importance on a change to majority rule--simple majority rule. In your Northwestern paper, you said that the initiative should stay in private hands. You went on to say that this could be accomplished in two ways. First, there must be general acceptance of the changes that are promulgated by the APB. I find it difficult to square the emphasis placed on general acceptability with your advocacy of a simple majority.

It seems to me that the best way to secure general acceptance within the Board itself is to require something more than a simple majority.

MR. LAYTON: I am sure that when the two-thirds majority was proposed it was with the belief that twenty-one men, eighteen men, any number of men would thrash out the issues until two-thirds were certain that the best solutions had been obtained.

I think my paper also says that that has been accomplished in some cases; not in all cases. If it's not in my Northwestern paper, it's in one of the other speeches I've made.

But in a number of areas, the will of the majority has, in effect, gone down the drain. I think the compromises that came out represented poor solutions and satisfied almost nobody; neither the dissenters nor the assenters.

Quite frankly, at the time the final vote was taken on Opinion 16, there were still twelve Board members who would have preferred purchase accounting rather than pooling. You may find that hard to understand, but it's a fact.

PROFESSOR SOLOMONS: You aren't concerned that an opinion pushed through by a simple majority would leave such a large body of dissidents that the opinion itself would lack cogency; would lack support outside the Board? I don't mean to push this too hard, but it would seem to me that the two-thirds rule does, in fact, on the face of it, provide

some assurance that there is a body of support for the opinion before it's promulgated.

MR. LAYTON: My paper says that if a large board cannot be entrusted or endowed with a simple majority, then I would favor a size that would permit a simple majority. Does it bother you to say that seven could decide something on a four-to-three basis?

PROFESSOR SOLOMONS: If we had a board as small as seven, then a simple majority would be much easier.

MR. LAYTON: I think the voting rule is extremely important.

PROFESSOR SOLOMONS: You heard the very strong representations made to us about the need for more effective representation of the views of industry and management.

I'm not going to ask you what your opinion is on that. But it would be useful to us, I think, to hear from your experience as Chairman of the Board, how you would evaluate the inputs that the Board received from the representatives of industry. I don't mean the representatives of industry who were members of the Board, but the representations made to you by outside bodies?

MR. LAYTON: I think their criticism was constructive and helpful during the period in which we were developing opinion. I found it a little difficult to reconcile that with the lobbying that went on once we had determined our position and moved on an opinion.

Upon reflection, I said to myself that perhaps this is properly part of the process that a quasi-legislative or a semi-legislative body is going to have to go through.

On balance I would say the efforts on behalf of industry to make constructive input was just that. I think in a number of cases they felt that they had failed if they didn't gain all the points they were mentioning. This, of course, is an impossibility, because you're getting opposite views from different groups.

I don't think our methods of involving other groups were consistent. I think in some subcommittees the flow of information and communications started early, and were quite effective; in other cases the procedure left something to be desired.

It was a procedure that we kept working on and trying to improve. We held meetings between our planning group and their steering groups, and worked out improvements in it. Even these were not as effective as they should have been, so we turned to public hearings.

A letter from the Machinery and Allied Products Institute was one of the factors that led to public hearings. Certain exposure drafts went to chief executive officers and chief financial officers of companies.

PROFESSOR SOLOMONS: Did you detect any tendency on the part of industry representatives to maintain the status quo?

MR. LAYTON: On balance, I would say the answer would be yes. I think in some respects, and with some individuals, that might be an unfair answer. But on balance, they preferred to hold the status quo, or to hold the line as much as possible.

MR. OLSON: Mr. Layton, in your oral comments you expressed concern for confidence in public reporting, but said that the appearance of independence or the independence of Board members was a less serious issue.

You seemed to indicate that one of the greatest contributing factors to the erosion of public confidence in financial reporting was the performance of auditors. Does that imply that you consider the machinery for setting accounting principles a less important factor than the erosion of performance?

MR. LAYTON: By emphasizing one I'm not trying to relieve the other. Most concentration seems to have been on principles; that doesn't need further spotlighting. I think that our performance as auditors deserves more attention, and I tried to be specific in that area. There are many other areas that I could have commented upon.

MR. SMITH: I'd like to ask a question pertaining to the desire of industry representatives to maintain the status quo. Would you also say that was a trait exhibited by other members of the APB?

MR. LAYTON: I said that after a period of time I could judge a man's tendencies, and I categorized vote patterns as to those who appeared to be conservative and those who

appeared to be progressive or liberal.

The conservatives were those who were less willing to accept change. I attribute that not to pressures brought about by a client or any series of clients, but to the experiences and nature of the people themselves.

Members of the Accounting Principles Board, I can assure you, have clients on both sides of every issue.

MR. SMITH: I'm trying to clarify your answer to Professor Solomons question: did industry representatives appear to exude a quality for retaining the status quo? Your answer was yes, I believe.

Is that correct?

MR. LAYTON: A qualified yes.

CHAIRMAN WHEAT: I'm not sure, just for clarification, that Professor Solomons' question had to do with industry financial executives who were on the Board.

MR. LAYTON: I assumed he meant input and not members of the Board.

MR. SMITH: Is that a tendency peculiar to industry?

MR. LAYTON: It's a tendency on the part of anyone whose ox might be gored. Let me give you an example: We wanted to do something on price level accounting, and the biggest complainant was the Government. Price level accounting would really show hidden taxation and many other things that the Government would have a very difficult time in living with.

CHAIRMAN WHEAT: I might ask just one more question.

You referred to the Machinery and Allied Products Institute and its influence upon the Board in holding public hearings. I think there have been a number of references during these hearings to the expanded due process considerations of the Board. Various people have commented upon the absolute necessity of proceeding with this development so that all major matters are exposed and there is complete opportunity for input.

My question is: In your judgment, is it practical to expect a volunteer board to keep up with these demands, or must it, from the standpoint of efficiency, evolve into a five or seven-man paid board as recommended by Mr. Trueblood?

MR. LAYTON: Well, the eighteen men today with their ten or twelve advisors are putting in more than five or seven-man years at the present time.

A five to seven-man board can only put in five or seven-man years in one year. You will have to back them with far greater staff than presently is available to the APB. And maybe Mr. Trueblood's cost estimate is more nearly right than Haskins & Sells.

Also, I ask again how fast do we want to move in this area? Do we want to do everything all at once? Obviously, you can't wait until all principles fall beautifully into place.

CHAIRMAN WHEAT: You referred to the necessity for periods during which there would be digestion of drafts, and there would be careful scrutiny of input, briefs and recommendations; that these periods are necessary in order that the

fullest considerations be given before something is finally adopted.

I take it that it would be your view that the larger volunteer group could effectively keep the pace you deem appropriate, and at the same time conduct the public hearings and the processes you consider necessary?

MR. LAYTON: I would think so; I would hope so.

CHAIRMAN WHEAT: Mr. Layton, we're very grateful to you; thank you very much.

The next gentleman we have with us is Mr. Philip Defliese, who is Chairman of the Accounting Principles Board.

MR. PHILIP L. DEFLIESE: My name is Philip L. Defliese. I'm presently Chairman of the Accounting Principles Board, and I'm also Managing Partner of Lybrand, Ross Bros. and Montgomery. You'll have to forgive me for not having provided the group with advance copies of my presentation. It was my original intention to remain neutral due to the fact that I am presently Chairman.

But I do believe that in the light of the input that has been made to this group, I am obligated to state my position.

I'd like to do two things: first, to submit to the group for the record the report dated November 24, 1970 made by the Accounting Principles Board to the Board of Directors of the American Institute of CPAs. This report was a survey of the Board's operations conducted intro-

spectively, obviously, and contained a number of recommendations to the Board of Directors of changes to be made in the structure of the Board and its mode of operations.

I think that you should recognize that this report is essentially one year stale, but nevertheless it represented the consensus of the Board at that time.

I don't believe that I want to go into it in any great detail; it indicated the thought that there was a need for improvement in its operations. It recommended the appointment of a full-time chairman; it recommended increasing the size of membership to twenty-one in order to provide representation of more viewpoints from industry, analysts, investment bankers and perhaps more practitioners from smaller, national and regional firms.

It recommended the continuance of the two-thirds vote, and recommended considerable improvement in the research and technical support that the Board needed.

I think I'll leave the rest for the group to read. There are copies.

As to my own statement, I will furnish the group with a printed copy later. I have been out of the country and have been working hard, so you'll have to be indulgent with me in making this direct oral input.

I'm sure you'll be as indulgent as the Board is in its public hearings in taking late starters. We've certainly attempted to give everybody an opportunity to be heard.

In its 12-year history the Accounting Principles Board has produced four Statements, 21 Opinions, and a thousand critics. Criticism of operations of the Board comes from many sources. Too often, perhaps, the criticism veers from a constructive to a superficial base. Even within our own profession we hear some strident cries of a few who wax vocal whenever their pet theories are rejected-- or their viewpoints fail to withstand the two-thirds vote of the Board.

I am happy today to set the record straight, as I see it, since, in all hearings of this nature, those not seeking radical changes rarely come forward.

I think it essential that this Study Group examine the current status and operations of the APB, and the promise they hold for the future, rather than to concentrate on the past. The APB has had a tumultuous history in its short 12 years; it has dallied, procrastinated, erred, and even reversed itself. But, in all of this, it has achieved maturity through experience.

It would be foolhardy, indeed, to dismantle a machine that is now coming into its own. Further improvements are, of course, necessary and will be made unless the present forward thrust is seriously interrupted.

Both the responsibilities of the public accounting profession to the American investing public and the need for improving financial reporting to fulfill that obligation are well documented. Although the American investing public is

the best informed, much still needs to be accomplished in the area of standardizing and restructuring the accounting principles upon which our capital markets must depend. In this respect I am in agreement with much of what has been said at these hearings. I am convinced, however, that the present APB--or a simple modification of it--is the best vehicle for the task. The reason is simply that the Opinions of the Accounting Principles Board and the monthly Interpretations now published under its aegis are generally accepted and followed by business, the SEC, and the profession.

This is because the Board includes representatives from all the major accounting firms and most other large firms, and these practitioners operate with a sense of dedication and objectivity that cannot be surpassed. By virtue of their involvement, their firms in recent years have naturally committed themselves to adherence. Despite threats to the contrary, recent opinions have not been judicially challenged.

Moreover, the SEC has indicated publicly--and proven in practice--that it will support the opinions and interpretations. This has not always been the case, but has come about in recent years only because the Board has demonstrated its ability to cope with the issues. For many years the SEC was critical of the Board's reluctance to move rapidly or even adequately. In those years the Commission went so far as to threaten to exercise its legislative right to set accounting principles. It must be remembered that the ultimate authority for establishing accounting

principles for most publicly held companies does rest with the SEC. The Commission has in effect delegated this authority to the APB, with some strings attached, and I believe that it is satisfied that the Board is now moving along rapidly enough to merit that delegation.

Also, the financial executives of this country--no matter how much they may disagree--consider the opinions and interpretations as generally accepted and adhere to them. They know that the SEC is backing the Board, and they now have reason to be confident that the opinions will neither be far out nor incapable of reasonable implementation.

Finally, the publishing of opinions and interpretations is no longer inordinately delayed. The interpretations, although they are American Institute publications, frequently receive the attention of the full Board. These are issued on a timely basis, and give prompt assurance that practices will not diverge. The procedure assures quick answers to knotty questions. In a business environment that is becoming more complex and innovative daily, this promptness is essential.

What, then, is the problem? Some critics, particularly financial analysts, refer to the accounting transgressions that occur through the use of allegedly liberal--vs. conservative--principles. They do, however, concede for the most part that the disclosures are such that they can spot these and adjust. Some analysts consider it more important to expand and improve disclosures than to create rigid conformity. Of course, this is not good enough

for the typical investor, and financial reporting needs our attention even if, in some cases, we must become somewhat arbitrary in establishing greater uniformity.

In my view, much of the furor about accounting principles and the Board's alleged failures are, in many instances, the red herrings of publicity-seeking critics that divert attention from other and more serious problems, many of which are not directly related to accounting principles. Those problems fall within the purview of the Institute's auditing procedure committee, which is trying valiantly to catch up. For example, many of the "horror" stories of accounting--those involving lawsuits and accusations of fraud against the auditors by the SEC--are not as much a matter of accounting principles as a matter of auditing and reporting standards. These involve independence of auditors, valuations of reserves and realizability of assets, material accounting changes that are not disclosed because they offset, and interpretation and disclosure of relevant facts regarding transactions. Many of these are auditing questions, not questions of accounting principles.

In some instances, the issue may be one of materiality. The Board is criticized for not speeding up its study and issuing an opinion on this subject. But materiality is more a matter for the conscience and integrity of the auditor than pure theory, and no amount of study or opining will alter that.

I feel that however important criticisms of the ethics of the profession and the enforcement mechanisms of the Institute

are, they simply have no place in a discussion of the procedures by which accounting principles should be set. These are separate issues, and they merit the attention of those within the Institute who have the responsibility for dealing with them.

It is said that the APB has failed to fulfill one of its primary charges: to develop a statement of basic objectives and concepts of financial statements upon which all opinions could rest. It is generally conceded that the Board is working hard on the other charge, that of narrowing alternatives.

In the early years of the Board--soon after the first research studies--the debates on this subject quickly indicated that there was widespread confusion about the concepts as they existed vs. what they should be. The urgently needed brush-fire opinions got mired in this debate. The vexing question was: On which premise should these opinions rest? The Business Combinations Opinion was one that bogged down on this point. The Board committee that was formed in 1965 to formulate a statement on future concepts ultimately decided that it first needed to reach agreement on present concepts. And so it did. In 1968 another committee was formed to study future concepts. The latter, headed by a vocal critic of the Board's procrastination on this subject, awaited the results of the first committee's work and only recently began to work itself. But agreement on present concepts did not come easily. And so far, no one, not even one of the vocal critics, has come forth with any reasonable, well-integrated approach to future concepts.

It seems eminently clear that we need to narrow the alternatives and firmly establish present concepts before we move into a futuristic approach to accounting. While it is generally recognized that the historical cost basis of accounting falls short of presenting economic reality, we cannot move into an unchartered area without considerable esoteric, empirical, and implementary research. The underpinnings of our economic stability cannot be tampered with until the new foundation is firmly laid. Our recent attempts to give greater recognition to market values in accounting for marketable equity security portfolios is ample evidence of the profound effects such attempts can have.

In the meantime, the APB should continue its efforts to further the evolution of accounting principles. This can be done within its structure or through timely special efforts such as the Trueblood Study Group. The important element is the assurance of practical implementation before pronouncements are made.

The Board is scored for its long discussions and delay in issuing opinions. Arguments are repeated and changed; drafts and redrafts made. But anyone who has observed this process cannot help but acknowledge that no matter how time-consuming it may be, it ultimately provides the most workable answer. I have seen responsible people change their views radically through this process. The give-and-take debate among the top technicians of the country produces a far superior product than that which would result from a quick vote based on briefs. Here, again, one

should be realistic enough to expect intemperate criticism from some of the dissenters. When a better result is obtainable through reasonable debate, then I am all for it.

The Board is assailed at times for operating too slowly and at other times taken to task for moving on a "crash basis." Again, this "damned if you do and damned if you don't" attitude is something that must be accepted and dealt with. As Truman said, "If you can't stand the heat, get out of the kitchen." When you're charged with decision-making, the heat is an occupational hazard. Actually, when time permits, ad hoc committees of other Institute members are formed to produce a specialized paper or industry guide, as has been done in the land development and real estate fields. The results can be implemented with deliberation. When events create an urgency to move faster, the interpretation route is taken and the effect immediate, as in the case of computer leasing. This procedure is a recent development in the Board's operations, and many critics have not yet digested the full significance of it.

It has been said that many of the opinions involve matters that have faced the profession for many years, and that the Board, by not dealing with the issues earlier, let too many things get away from them.

This is true. But we are living in an imaginative and innovative business environment where things change very fast. Who, for example, could have anticipated some of the "funny preferreds" of the Sixties? During that go-go era we did not have the mechanism of the "official" Interpretations

of the Institute to which the SEC could refer its questions and problems, as it now does.

It has also been charged that there is absolutely no appeal from an APB opinion. In point of fact, in our country there is an appeal for everyone from anything. Rulings of regulatory agencies, for example, are constantly being challenged in the courts. In accounting we have a built-in appeals mechanism in the SEC. The SEC, as indicated previously, has the legislative right and responsibility to set accounting principles, and it has informally delegated this to the APB. Thus, appeals from APB opinions can be made directly to the SEC. This was done officially once, resulting in the issuance of Accounting Series Release 96, which permitted flow-through accounting for the investment credit despite APB Opinion No. 2, which forbade it. However one might feel about the merits of that issue, he must concede that the appeal worked. I know, too, of other cases where the SEC has issued rulings which departed from APB opinions because of unusual circumstances, and I feel that in most of these cases the decisions were justified.

Furthermore, rulings of the SEC can be taken to the courts, although this is rarely done. Nevertheless, the process is available.

Much is made of the fact that the Board members are voluntary, part-time people who, because of their responsibilities to their firms, cannot devote adequate time to the task.

What is overlooked is that these people, when not attending Board meetings, are just as deeply involved in Board matters as anyone could be. By virtue of their positions, these executive practitioners are making decisions hourly on all aspects of the issues confronting the Board. This hands-on experience adds a practical dimension to the theoretical, and provides insight that assures the workability of opinions. Board members who take this broader view of their efforts readily concede that they are, in reality, full-time members.

Are the Board members pawns of their clients? Are the Big Eight a united fraternity functioning as an arm of business? A quick look at the voting records should quickly dispel any such notions.

Let's examine the independence question more closely. When the size test for pooling was being debated, it was claimed that the Board "backed down" because of client pressure. Of course, clients were outspoken, and they had every right to be heard. But in this case, the exposure draft that called for a size test lacked the necessary two-thirds support when it was published. It was inevitable that it could not be passed without modifying or eliminating the size test. As a result of this experience, the Board's policy now precludes exposure of a draft before it has the necessary vote. This is probably unfortunate because a trial balloon is sometimes needed.

Some say that the top rule-making authority should limit itself to formulating broad principles and leave their

implementation to a lesser group. One suggestion would require the senior group to approve pronouncements of the lower group. This sounds fine--but it won't work. Under this system, broad pronouncements would need to be delayed until it became clear that their implementation was sound, practical, and feasible. The Board has frequently gone down a wide path only to back away when it was realized that practice could not follow. Once the Board unanimously issued an opinion embodying a very fine theoretical concept requiring allocation of the proceeds of convertible debentures between debt and conversion features, only to rescind it when the Board found that it was impractical and, in some instances, produced bizarre results. Since that time the Board has stressed detailed procedures.

Perhaps the most alarming of all the new proposals is that calling for a small full-time super-board. This proposal is categorically unsound.

First, this super-board implies a politics of selection. The biases of prominent accountants are pronounced and well known. Will we have a "Nixon Board" or a "Warren Board," or will we have a "balanced group" so that 4-3 decisions will set the future of financial reporting? The concept of a small group further implies decisions by an elite. I would rather have a larger group of the best volunteers--all peers--so I could rely on the safety of numbers to balance off the strong biases.

Second, the small super-board would slow, rather than speed, resolution. The small isolated group, withdrawn from the practice arena and restricted by new administrative rules, would

have more difficulty than the present Board in obtaining the necessary input. The result would be a need for expanded hearings and virtual dependence upon the submission of briefs and counterbriefs. Those being "regulated" by this process would require more opportunities to be heard. A look at the "speed" of our regulatory bodies and our courts should be convincing.

Third, it is the participation of all segments of the profession in the present body that provides an in-depth democratic support.

Fourth, a small courtlike body does not make for economies of either time or money. The efforts presently expended by accounting firms in the rule-making process would need to be increased in order to monitor the board's activities, prepare formalized briefs, request hearings, see what others are doing, respond to client requests for briefing, etc.

Finally, I would prefer that those formulating the opinions be deeply involved in day-to-day decision-making. The crucible of practice is the only test which tempers the most extreme theorist. And, in accounting, principles and practice cannot be separated. The term "generally accepted accounting principles" has been deemed to include the methods of applying them. This has been discussed before. I have also observed over the years the frequent metamorphosis of the charged-up theoretician into the pragmatic practitioner through close association with those Board members making day-to-day decisions.

I have said earlier that much still needs to be done to improve the rule-making function. Here are my recommendations.

A broader research program supporting the present Board is needed. The emphasis should be on both empirical and experimental research designed to satisfy the implementation demands of new opinions. Researchers recruited for a period of from one to two years from the major firms could augment the present research group. Drafting assistants are also needed. This follows closely the recommendations made by the APB to the Institute's Board of Directors in late 1970.

A full-time chairman would be able to monitor the research program more closely, be available for meetings with interested groups, and generally guide the Board better than a part-time chairman. Not that the chairman presently isn't almost, in fact, full-time; but some of his APB-related time is devoted to his firm and its clients, a responsibility he cannot completely shake off. This is not suggested to indicate that there is the need for him to be independent of practice; rather it is a matter of concentration. It should be possible to obtain at least one prominent accountant--at the peak of his career--to accept a full-time term of three years, with possible renewal. Apart from having occupied the top technical position in his firm for many years, he should be a good administrator and leader. This is a tough combination to find, but I am sure one can be found every three to six years.

Because the resolution of an accounting problem requires complete exposition of all its aspects and the need to consider all viewpoints, I feel strongly that it is undesirable to limit the number of those charged with the decision-making obligation. Some limitations must of course be set, as it would be impossible to accommodate an overly broad spectrum of views that could arise on some issues. Consequently, I am recommending both a fixed and a flexible Board membership, with wide representation, one that will provide for expansion and contraction, as need dictates. A frequent criticism from industry is that it is inadequately represented. I am sympathetic to this complaint.

I feel the Board should consist of 21 members, rather than the present 18, as follows:

One full-time chairman.

Thirteen practitioners--selected to include people from the major national firms at all times, the lesser national firms and the regional firms (on a rotating basis), and one small firm.

Three CPAs occupying responsible accounting positions in industry.

Two academicians well-known for their qualifications and interest in accounting theory.

One financial analyst.

One investment banker or practicing attorney active in securities registration work (alternately).

When the Board undertakes an issue that is concentrated in a particular industry or involves a specialized area requiring an expertise that may not be found among

the regular Board members, the membership should be temporarily enlarged by the appointment of four ad hoc members:

Two practitioners who are specialists in the area under study, selected to bring varying views to the Board.

Two industry accountants drawn from the affected industry, or who have had similar industry experience, chosen from the related industry or ad hoc committee, also to bring varying views to the Board.

These four members would join the three permanent members of the Board designated by the chairman to form a committee of the Board to oversee research, drafting, hearings, discussions, etc., needed to publish an Opinion. For this purpose, the four added members would be considered as voting members of the Board.

Most Board members should be CPAs, because many of the discussions and decisions require a profound understanding of the technical accounting and auditing procedures underlying the issues. This might seem to discriminate against some highly qualified non-CPAs in industry and universities, but since their qualifications are more difficult to assess, it had better be played safe. There is an ample supply of highly qualified CPAs in industry and in universities, so I consider it better to maintain this requirement at present.

Obviously, the practitioners chosen should be the best technicians their firms have to offer, with years of decision-making under their belts. Accounting decisions are frequently predicated upon a keen comprehension of the relevant

facts and the ability to ferret out those facts. And a sharp auditing sense is a prerequisite.

The permanent members of the Board should be named by a standing committee of the AICPA consisting of the President of the Institute and the four most recent past presidents. This would provide for considerable continuity in the selection group, making possible an in-depth survey of possible candidates in ample time before selection. Nominations should be solicited regularly from all the appropriate sources, and the candidates for selection should be investigated and interviewed in order to ascertain their availability, attitude, and competence for the task.

The ad hoc members should be selected by the Executive Vice President of the AICPA, with the approval of the Chairman of the APB and President of the Institute.

The present rule providing for a maximum of two full three-year terms seems appropriate. Interim appointments may sometimes extend a person's tenure to about eight years, but this, to me, is the outside limit. In rare instances, it may be appropriate to re-elect a highly qualified person who has had maximum tenure after an absence from the Board of at least one year.

In light of the recent record of progress, it is decidedly preferable that the Board continue operating as it is at present. The public hearings are developing well and our procedures are continually improving. It should be noted that hearings of some sort or other were begun in 1966. The

"official" interpretations aid in improving practice although they occasionally take too much of the time of the full Board. Committee delegation should ease this load and expedite issuances.

The present two-thirds rule is a great safety valve, providing the essential safety in numbers I referred to earlier. I would not like to see far-reaching changes in accounting made on the strength of one vote. On the other hand the two-thirds rule may strengthen the opposition unduly. I would recommend a 60 percent approval vote--13-8 for a 21-man body; 15-10 for a 25-man body. I would insist on similar proportions for votes on exposure drafts of proposed opinions.

Dissents and qualified assents should not be published or voters identified. These serve no useful purpose, and just provide a forum for tirades that are not only frequently irrelevant and demeaning, but also definite impediments to progress.

In summary, I believe that the Accounting Principles Board is a workable vehicle, that it has proven eminently progressive, and that it offers the financial community and the American investing public a good chance for bringing financial reporting up to a new level of dependability. I hope, in this spirit, that my own recommendations are weighed fairly and that the basic concept of the Board receives the support it deserves. Thank you.

CHAIRMAN WHEAT: Phil, I would like to clarify one point. You referred to the SEC having delegated the formulation of

accounting principles to the APB. I'm a little troubled by that term; I wonder if it wouldn't be more accurate to say that the SEC has been willing to urge the private sector to take the initiative, with the SEC assuming the role of reviewer and retaining responsibility for accounting principles?

MR. DEFLIESE: I'll accept that qualification. In fact, I think I said, "delegated informally with strings attached," perhaps shortening it too much.

MR. PRYOR: Phil, I think you said that most members of the group should be CPAs; but the tenor of your remarks made it sound as though all of the group should be CPAs.

MR. DEFLIESE: Generally, I think there might be an exception; I wouldn't make it a very hard and fast rule. I think we might occasionally find a non-CPA who was eminently well-qualified, and we could make an exception.

MR. PRYOR: Nearly everybody but not mandatory.

MR. DEFLIESE: That's it.

PROFESSOR SOLOMONS: Do you have any opinion on the Board's name? I know this isn't a matter of vast importance, but some people feel that it may be a stumbling-block.

MR. DEFLIESE: A rose by any other name is just as sweet (Laughter), and I haven't gone into that.

PROFESSOR SOLOMONS: I've heard some dissatisfaction expressed with the status of Statement No 4. Why was Statement No. 4 issued as a Statement and not as an opinion?

MR. DEFLIESE: To expedite the process of publication. Most members of the Board take their responsibility with respect to opinions very seriously, and want to fine-comb the language. We felt that to go through that process and also to go through the exposure process, required of opinions, would delay it and not necessarily improve it to any great extent. There was a need to indicate to the public that the Board had reached these conclusions, and that was a starting-point from where we would go in the future.

PROFESSOR SOLOMONS: I had it in mind when I asked Mr. Layton before about the input from industry, to put the same question to you.

Did you hear my earlier question?

MR. DEFLIESE: I believe so. I think there has been a tremendous improvement in input from industry; as this whole process has developed over the last twelve years, the various industry groups have been organizing themselves to cope with the problems and have furnished us with greater input as we have proceeded.

The evolution of the public hearing is part and parcel of that development. We started off with informal meetings of related committees of these various associations. This moved into "mini-exposures," symposia, and finally public hearings. I think we're getting substantially more input now from these groups than we've ever had and I think there's a great need for it. Does that answer your question?

PROFESSOR SOLOMONS: I was rather concerned with quality rather than quantity.

MR. DEFLIESE: I think the quality is improving considerably. Many of the groups--which formerly opposed any change--have come to recognize that change is needed.

CHAIRMAN WHEAT: Mr. Defliese, were you here when the gentlemen from the Machinery and Allied Products Institute were here?

MR. DEFLIESE: I didn't hear the entire presentation.

CHAIRMAN WHEAT: One of their concerns was that the interest of management as well as the public interest, be considered in the development of accounting principles. They said that many potential risks or hazards arise for business from particular kinds of disclosure, which risks and hazards also affect the shareholders of that business. These are concerns of the chief executives of business; they're related to competitive pressures with particular emphasis upon the competitive pressures from Japan.

Does the Board take these matters into account?

MR. DEFLIESE: Yes. In my opinion, the views of management are given considerable weight in all respects. I think Board members attempt to weigh the public interest and the private interests.

CHAIRMAN WHEAT: Is there any real private interest here, or isn't this a public interest just as well?

MR. DEFLIESE: Well, of course it is. In the final analysis the shareholders represent their own public interest and they need protection against themselves in some respects.

CHAIRMAN WHEAT: There's a balancing of all of these interests. Thank you very much, Mr. DeFliese. We hope you will all bear with us as we're running a little bit late.

Next on our schedule is Joseph Cummings of Peat, Marwick, Mitchell & Company.

MR. JOSEPH P. CUMMINGS: I'll try to be as brief as I can because you do have our paper.

I'm here on behalf of Walter Hanson who could not make the meeting because of a long-time commitment on the West Coast. He wanted me to be sure to express to this group his deep concern with the mission that you are undertaking.

We have written our paper in the light and expectation of very substantial output from the Trueblood Committee. We think that the work of your Study Group and the work of the Trueblood inquiry are inseparable in many ways. Therefore, we have to look forward to perhaps some far-reaching changes in the ways that financial information is communicated to the public; and in anticipation of that, the way this board should be structured to handle those communications.

I certainly don't mean to prejudge what they decide, but I'm sure their decision will be something that will get us away from trying to repair the old Graham-Paige as we are doing today. It is most important for the public and all users of financial statements.

We think there is very definitely going to be a concentration of public interest in terms of information flow:

whether they go to forecasting cash flows for the benefit of lenders, or the benefit of potential investors who are looking for dividends; whether they go to revaluing assets in terms of their current fair value; whether they go to the value of underground reserves upon discovery.

We would like to have you consider the possibility of replacing, over a period of time, some of the people who feel now that they should be represented on the Board, with people from other disciplines who can aid accountants in evaluating just what financial statements should be doing for the public.

We've looked at all the written proposals and believe that they fall into two or three basic patterns. We reject them for reasons which have been set forth by many others.

We think that the small, full-time, in-house board could not stay current. We don't think that a full-time board would sit in a room even four days out of the week; it would spend time doing much of the same things that the part-time members do when they're not at meetings or subcommittee meetings.

We find it difficult to avoid the bias which would naturally arise in that group and we question the ability to pay them. Most important, we question the ability of that board to get the empirical research which each of the present Board members can get now from his own organization.

We deplore the lack of any public interest representation on that group.

We resist the solution that the job be turned over to Government for many reasons that have been stated; we think that would stultify to a great degree the progress which we hope will be made.

We have also come to the conclusion that if there are just a few limited spots available in addition to practicing public accountants, that those spots could be better filled by representatives of other disciplines who are public interest oriented and not affiliated with any organization; are not locked into any policies set by the Board of Directors of their organization. We have reached this conclusion despite the substantial contributions made by industry representatives and groups like the FEI, API, and MAPI. These organizations have set up committees parallel to committees of the APB and who work with us very diligently in terms of input.

But generally speaking, industry groups are not decision-making vehicles. They are too diversified in their views. If you took the API representatives, the independent producers and the pipeline companies and some of those who are vitally interested in our accounting for extractive industries today, and tried to select one man that could represent the industry, you'd have two or three others who would be vehement in terms of their not getting a fair shake.

If you take an executive from a lease company and put him on the Board, you get one point of view. But I'm afraid there would be resistance to any change which would substantially

reduce income.

Board members need substantial input from all of these groups, but the decision-making and voting should not be in their province.

We have heard the recommendations for two or three separate groups, and believe it would be impossible to implement that kind of structure. We cannot in our own minds very clearly divorce concepts, principles, and applications. I think Phil covered that point; others have, too.

I won't dwell on it, but we think there should be only one body. The body should be guided by committees, such as the Trueblood Committee that have broad representation from many disciplines. But to give them voting power, or ask them to coordinate with the decision-making on a week-by-week basis would be impossible.

We finally come to our proposal, which we think will permit maximum utilization of the structure we have today. We think it should be gradual, and that there should continue to be eligibility for ten or perhaps twenty major national and international accounting firms. We believe this representation is important for several reasons: their input; the ability to communicate with clients and get their reactions to events as they are being considered; the ability to generate empirical research; the dedication an organization of this size can give to the problem.

I would say that any firm of this kind will certainly comply--we would comply if it became an Institute

policy. That isn't my point. I just think that something would be lost and unbalanced if at least ten of the major firms were not constantly there.

The selection process is open. Someone suggested a fifteen-man committee to pick five or seven; I think we'd be inclined to have five or seven men pick fifteen eligibles.

As far as research is concerned, we think that, in addition to a financial commitment, a firm should commit individuals as well. Perhaps firms should have the opportunity of sending staff people to the Institute for a period of time. Enough of these men who are skilled in auditing and accounting principles could be made available. It could be of great benefit to them individually, to their firms, and, I think, to the Institute and the financial community at large.

Below the voting body should be a structure of task force committees comprised of representatives of all phases of industry that relate to the problem. Someone mentioned the ad hoc committees on insurance, banking and other special areas; these could be expanded.

Similar subcommittees could be working in the inventory area, on depreciation consolidation, foreign exchange, and all the other areas which are on our agenda. That kind of input is most valuable. By denying the vote to these special interest groups, we are not suggesting that they not be heard, or not take a very direct part in the whole process.

We think the two-thirds vote is satisfactory. We would not like to see a simple majority. I think it's healthy that when a proposition is put to the Board and receives a ten to eight vote, that it is not considered the end of our deliberations.

Many bad decisions, I think, would have resulted from that. Perhaps many bad decisions result from two-thirds, because of compromise.

Certainly, if the body was structured as we propose, with fourteen public accountants and seven disciplines other than accounting, we would like to see the vote sufficient among the accountants to be sure that there is a two-thirds majority in that group. We think there is a safeguard in that procedure, and that any opinion or series of opinions that comes out with a negative vote from the public interest group would certainly dictate a change in the organization.

The term of membership is open. A full-time chairman and perhaps two or three other full-time people would accommodate the ability of a financial officer to leave his company for a period of time in order to become one of the full-time members of the board. An economist at a bank could do the same thing. An attorney need not necessarily sever his relations with his firm entirely, but he should sever his relationship from activity. Although an attorney is an admitted advocate, we don't feel that the independence of the accountants on the board will be impaired.

I've heard this time and again, but there is no question in my mind that no one goes to Board meetings with

a fixed position. Client views are all over the lot. I can't even get a fixed position from my partners, so I don't see how I can get it from my clients.

I think that's the sum and substance of the material in our paper. In view of the time I would stop there and be happy to answer any questions which you have.

CHAIRMAN WHEAT: Thank you very much Mr. Cummings, I regret to say that I haven't had a chance to read your paper as yet, because, as you know, it reached us rather late.

MR. CUMMINGS: It was late this week and I apologize for it.

CHAIRMAN WHEAT: We will read it with the greatest of care. I'll just ask one question.

A number of comments have been made about the Accounting Principles Board reversing itself. Mr. Defliese made a passing comment to that effect. On the other hand, some have said that the Board should have an ongoing procedure for reviewing and rediscussing opinions after some relatively short period of time; and should not be afraid to reverse itself if its experience indicates that there might be a better way.

What's your reaction to that? I'm a little puzzled by the problem that seems to be raised by those who think it is bad for the Board to reverse itself.

MR. CUMMINGS: I don't think it's all that bad. If you think you have a final answer imbedded in cement at any time, it seems to me that you're misleading yourself. It's embarrassing to reverse, as we have been doing on a couple of occasions,

decisions that seemed to have been made without all the testing and research necessary.

Part of the solution to that problem will be additional empirical research before the decision is made. I don't agree with the need for an appeals procedure, though, because it would, in effect, put the question of acceptability in limbo during the appeals period. On the other hand I have no objection whatsoever to some task force from the Institute, whether working directly with the board or apart from the board, evaluating the application of opinions and making suggestions for changing the agenda. This could be part of the coordination with others that a full-time chairman and his planning committee could undertake.

MR. LEVINE: Have you considered how your full-time chairman and planning committee might affect or displace the composition of any of the other members?

MR. CUMMINGS: If the planning committee included an accountant, he would have to sever from his firm to take that position. If it were an economist, or a lawyer, he would have to sever his connection in order to become full-time.

We have accommodated that full-time opportunity solely to give the board some flexibility in using talents that we think are presently in the private sector. We want to broaden it to the public interest.

MR. LEVINE: Would you say then, that it might reduce the respective composition as you have outlined it in your statement?

MR. CUMMINGS: No, they would be among the twenty-one.

MR. LEVINE: They would be among the twenty-one, but if it was an accountant, for example, would it reduce representation from the international or national firms?

MR. CUMMINGS: No, they would be both. A man from a national firm can serve in one of those positions and also be on the planning committee.

PROFESSOR SOLOMONS: Clearly the most striking part of your proposal is for public interest representatives as full working members of the board. I take it that you wouldn't be satisfied with something like a panel of public interest representatives which might provide input to the board and perhaps react in print to opinions of the board, but would not be full working members.

MR. CUMMINGS: I think that would be an improvement over what we have today. I would say that all these men should have business and financial background; it has to be something they're interested in, otherwise they'll go to sleep at the meetings. (Laughter)

The panel would be an acceptable alternative to what we have today, but I don't think it would be the same as having direct participation in decision-making.

PROFESSOR SOLOMONS: Would these public interest representatives be paid?

MR. CUMMINGS: Yes. We haven't resolved that problem, but we said that perhaps the Institute budget could be fattened

to take care of this ongoing obligation. They might associate themselves with some trade association or some other national group.

PROFESSOR SOLOMONS: But wouldn't that run afoul of your other rule about associating with special interest groups?

MR. CUMMINGS: We don't associate the American Bar Association or the University of Oklahoma with any special parochial interest! (Laughter)

MR. PRYOR: How would you select these public interest people?

MR. CUMMINGS: There are a number of organizations that would be consulted: American Philosophical Association; American Political Science Association; Academy of Political Science; National Institute of Social and Behavioral Science; The American Sociological Association, and American Economics Association. These groups would have to be consulted.

MR. PRYOR: By whom?

MR. CUMMINGS: By a committee of the Institute which would have to screen them and approve them.

CHAIRMAN WHEAT: Mr. Cummings, when you referred to the public interest members being paid, you didn't have in mind that they would serve full-time?

MR. CUMMINGS: No.

CHAIRMAN WHEAT: Just be paid something for the time that they spend, is that right?

MR. CUMMINGS: Yes, I think they will have to remain associated with some kind of organization. Some of them may

now be associated with corporations, and they would have to sever that connection in order to qualify under this proposal.

CHAIRMAN WHEAT: Excuse me. The last time we had a gentleman here we failed to ask if you in the audience had any questions. I'll repair that omission by asking if anyone has a question for Mr. Cummings.

QUESTION: Mr. Cummings, as I understand your remarks, you would be willing and feel it desirable to utilize representatives of the business community, their intellect, their intelligence and their experience in the affairs of the APB. But you wouldn't give them a vote.

Would you elaborate a little on what would disqualify them for voting?

MR. CUMMINGS: It's a difficult thing to say. I tried to illustrate by using the oil and gas industry. If you were to give a vote to a man who was a total coster, for example, the successful well coster is going to be injured. He will feel that his position is not being given an adequate hearing.

We have found that the FEI and other groups are adding great input to the deliberation effort. But it's very difficult to get a firm position because of the diverse positions on various issues.

What I'm saying is that the man sitting on the body who is attached to a corporation is not as free, as independent, and as objective as he might otherwise be. I don't mean in any way to demean the contribution made by those who have been with us over the years, but I just have to believe that as a fact.

QUESTION: What if he disassociated himself from his firm?

MR. CUMMINGS: Then I would have no problem.

CHAIRMAN WHEAT: Thank you, Mr. Cummings, very, very much.

Mr. Norby, we have tried your patience; I'm sure that we have tried the patience of all of you this morning, but you've been very considerate. We apologize and thank you.

We are delighted to have Mr. Norby here. He is Chief Executive of the Financial Analysts Federation. With him is Dr. Frances Stone who is Chairman of the FAF Financial Accounting Policy Committee.

MR. NORBY: Mr. Chairman, we appreciate your adding us to your deliberations. We had deliberations with your committee some months ago, and in the last few days, our Financial Accounting Policy Committee has submitted a position paper.

My purpose today is to elaborate on that statement and to give your committee some of the views of our senior members. Our organization, perhaps, illustrates a point Mr. Cummings just made--it's hard to get monolithic opinions from voluntary groups.

Perhaps the conveyance of some impressions of our members will be valuable to you. We don't want to stress too much any specific mechanics.

First, I would like Dr. Stone to summarize the paper that has been submitted on behalf of our Financial Accounting Policy Committee.

DR. FRANCES STONE: I am only going to take a very short time because we have spelled out some of our ideas in this area, and we have talked with the committee before.

I'd like to emphasize that I think this overall statement of principles which the Trueblood Committee is charged with is very important, and that the combination of the two committees--both the Trueblood and the Wheat Committees--is an excellent thing.

I feel that we've gone a long way in the last few years, and I'm a little surprised, now, to find that I've been involved with this process longer than I thought. It has seemed to me that we're doing a great deal of patching. The analysts, I think, are aiding and abetting in that process.

I would like to see the SEC a lot more directly involved with the setting of accounting principles, or guidelines, because I'd like to see them have the force of law.

That, I think, would be a welcome step forward. Then we'd have no problem about going to the courts on this.

I would like to see a full-time, independent, highly professional board. I would like to see them serve for a limited time. In this way you could select high caliber people with sufficient experience in the field of accounting to make an effective contribution.

I think if you would ask them to serve on a very short-term basis--say nothing less than three years--that you would be able to tap a really large pool of good talent.

I'm going to suggest that the decisions be made on a majority vote, because the two-thirds rule is too restrictive. And I would like to ask for a much quicker reaction to poor accounting practices.

I think the long period of time some practices have been used before they've been cited, works to the detriment of financial users.

I would like to suggest that there be some kind of tax or dues on all of the members, and all of industry as well, so that we have sufficient funds for research. Not only should the group have its own research staff, but it should call on all of the other disciplines. They should have the money and authority to call on other groups as well.

I'm going to stop right there.

MR. NORBY: We had a conference a couple of weeks ago and we took the occasion to discuss this subject with our Board of Directors. I wanted to reflect some of their views, which some of you may have already heard privately.

I think it can be said that our members have generally expressed conservative views on this whole problem of establishing accounting principles, which I see can be divided into two parts. The first would be who is going to have the responsibility, and secondly how will they be organized.

Concerning the question of who will have the responsibility, I think our members have consistently held the view that professional accountants should establish

accounting principles. There is a particular fear of Government responsibility for this function, having in mind political pressures, legal roadblocks to progress, and the slow pace that usually characterizes Government bureaus when it comes to change.

This is not to say that Government agencies have not made many contributions to reporting, and that they have not prodded the private sector to action on accounting matters. But we believe that an organization in the private sector will have greater flexibility and show more responsiveness to the needs of investors in business.

When we say professional accountants should have the responsibility, we mean exactly that. Not only do they have professional competence, but we feel that they have the independence.

Numerous comentators in the past few months have suggested that the Financial Analysts Federation or the financial analysts, should have a role in decisions. We are complimented by this but we do not think it appropriate. By the same token, we do not believe organizations representing business management should have a role in decisions, either. Business is the subject of accounting measurement, and therefore should not be a participant in establishing the standards of measurement.

We agree that financial analysts, business management, and any other parties affected by accounting rules should participate in the decisions and should have positions of advocacy. In this way they can make an effective contribution

to the development of accounting principles. But they cannot be both advocates and judges.

I think that the development of public hearings is a very fine forward step in bringing about the participation of many organizations and the interchange of ideas.

This is not to say that if you conclude that other organizations should have a role in decision-making on accounting principles beyond what we have suggested, that our organization would not try to cooperate. We would want to have a part in representing professional investors.

Linked to the determination of responsibility, of course, is the problem of enforcement. The APB and the Securities and Exchange Commission have a relationship, developed through custom and practice. It is this relationship, derived from the SEC's legal powers, that gives implied force to APB opinions.

We think this relationship could be strengthened or made more explicit, as Dr. Stone has implied in her statement. The principle of the self-regulatory agency as related to the Securities and Exchange Commission does provide a model, perhaps. Admittedly, the self-regulatory concept is currently being questioned in the securities business, but I think the circumstances of accounting principles are somewhat different.

I would also suggest that the SEC's authority in accounting matters be primary among Government agencies, so that other regulatory bodies do not require public companies to issue statements that are not consistent with general

principles. The separate ways of several agencies in the past, I think, has been a disservice to investors.

Secondly, voluntary membership organizations have difficult organizational problems. They are not really equipped to respond quickly to increasing demands, nor are fast decisions usually feasible. We believe the APB in recent years has made extraordinary progress in the pace of its opinion issuing, relative to the inherent organizational limitation.

Yet the problems do seem to be multiplying and greater speed is demanded from all quarters. Thus, reformation of the organizational structure is a very important subject.

Our committee has recommended full-time membership of professional accountants for limited terms. We recognize that the present volunteer members of the APB are devoting practically full-time to the task. But from an organizational point of view, the full-time, fully-compensated member would appear to have two advantages--first, greater continuity of effort; and second, complete independence.

In saying this we do not mean to imply in any way that present members have not been faithful to their mission on the APB. But independent stature, would give the APB increased credibility in many quarters, I believe.

As I have indicated, in our organization, as in others, there is a diversity of viewpoint. Many of our directors prefer the present voluntary membership of the APB. This preference is based on the idea that voluntary members through their firms,

will be closer to the current practical problems and their decisions would gain more acceptance than decisions made by an independent group which might become, let us say, too academic.

They believe the establishment of accounting principles is a pragmatic, quasi-legislative process, and that it is not necessarily bad if members are close to the pressures of practical problems.

Mr. DeFliese's statement seems to be in that same general direction.

Within our group, we also have different views as to the composition of the full-time, independent board. I should mention the excellent paper by Mr. Ellis at the recent Northwestern University Symposium. Mr. Ellis is a member of our Financial Accounting Policy Committee. He proposed a broader group than professional accountants, but nonetheless would require independence. No member, he said, would retain any employer or a vocational tie.

The purpose would be to bring to bear on the total problem of reporting, a wider range of viewpoints. I think in the key requirement for independence, he was not at great variance from the other viewpoints expressed among our members.

I'd like to state my own view, based on observation of voluntary organizations over a number of years. I tend to favor full-time, compensated board membership. I believe this is the only way the APB is going to be able to keep pace in the next few years. I believe these board members can be

selected in a way that will ensure continued responsiveness to practical problems.

The criticisms of the APB seem to rise in part from the desire for speedier action. When we have our problems identified, we'd all like a quick solution. However, there are many parties of interest, and their acceptance of final opinions rest on their opportunity to present recommendations and listen to arguments.

This takes time, and it will be difficult to speed up the process no matter how the APB is organized. These other parties of interest are also voluntary organizations, in many cases. Accounting is not their primary objective or concern, although it is very important.

Speaking for the Financial Analysts Federation, we recognize that we must expand our capability to provide input to the APB, because it is desirable to settle accounting issues more rapidly. Nonetheless, I have to say that our ability to provide this input is going to be in the nature of evolutionary expansion.

Consequently, I believe we reflect the proponderent opinion of our organization, that we're suspicious of some of the grand, sweeping reorganizations in the accounting principles process that have been proposed. An evolutionary change and improvement, building on what has already been developed by the AICPA and other organizations, seems to be a more practical approach to us. In that connection I will state that our committee's position is consistent with that approach.

Thank you.

CHAIRMAN WHEAT: Thank you very much, Dr. Stone and Mr. Norby. Let me probe for just a minute your comment about the full-time professional board. A number of people have commented to us that if you wanted the most qualified, most experienced, vigorous, professional accountants, it would be extremely difficult to get them on a full-time basis. They would have to leave their firms, and the ladder of success, if you wish, that they're on; they would have to move their families, which is quite a significant thing to do. If they were employed as professors and were going to be away as long as three years, they would have to give up tenure.

Lawyers frequently move in and out of Government. It's no great problem. But it's extremely difficult for an accountant near the top of his firm to leave for a period of three years, and have any assurance as to where he's going to fit when he returns.

It's a contrast, apparently, between the two professions. Accordingly, the question has been raised as to whether it would be desirable to take the risk that, in order to get five or seven full-time professionals, one would have to take men who are substantially less experienced and had substantially less prestige than present APB members.

How do you react to that?

DR. STONE: I think that one of the things that could be done is to make service on the board as prestigious as service on the Council of Economic Advisors. I think that it could be done. In this way, someone who is at the top of his firm could feel that he could leave that firm; the firm would regard this as a favorable step and keep room for him over a three-year period.

It really isn't that long a time to be gone from a firm. If a firm has plans for the future, they usually don't come to fruition in three years. They have five-year plans or ten-year plans.

I think that problem could be coped with. It's an image problem, I think, more than anything else.

CHAIRMAN WHEAT: One of the gentleman who appeared at these hearings stressed the desirability of substantial continuity and experience in this process. Members of the Board today serve for two terms, gaining experience and judgment in that process.

He referred to it as possibly the last ten years of a man's career, because he was looking to people over fifty. How do you react to that?

DR. STONE: Since I'm going to reach that age sooner or later myself (Laughter), I guess I had better react properly!

CHAIRMAN WHEAT: I was assuming that we'd get the youthful viewpoint from you! (Laughter)

DR. STONE: Actually, I was supposed to be presenting the radical viewpoint, and Bill the conservative viewpoint.

Age is really no barrier, one way or the other. What I am looking for, really, is the maintenance of an open mind and that is true of any age. If you get somebody who's thirty who has decided that all the decisions have been made and wants to maintain the status quo, he's of no use.

If you have somebody who's fifty and has lived through the changes and is extremely flexible, I'm all for him. I don't think age really matters.

MR. NORBY: I would concur that the full-time position on a board of this type would be quite prestigious in the accounting profession. I think it would be possible to attract the best people.

Length of tenure might be a problem; this is an organizational and management kind of thing that would have to have more detailed study. Possibly one solution or one compromise might be to make the term longer and have seven members, each serving seven-year staggered terms.

It was interesting, though, that a lot of our Board members felt that the shorter term would keep the member closer to reality, so to speak. Whether this is a real risk of a longer term, I don't know. I'm a little doubtful, myself.

MR. PRYOR: Bill, did you favor a small board? You didn't say that in your first testimony, but you just mentioned seven.

MR. NORBY: I don't think we have a firm position on the precise size of the board. It seems to me that

the implication of a full-time, fully-compensated board would probably be a smaller body.

PROFESSOR SOLOMONS: It's true to say, isn't it, that your Board of Directors was unanimous in recommending a full-time board? I was really quite surprised that they would come out with that view.

MR. NORBY: I want to make it clear that our Policy Committee tended to favor the full-time board, and that is also my position. Our Board of Directors strongly favored the voluntary board.

MR. PRYOR: How knowledgeable would you say the Directors are, as a whole, about the whole problem of how accounting standards ought to be set?

MR. NORBY: I would say they are not extremely conversant with the details, but I think that they represent an impression in the financial community that is worth taking account of; that's the way I want to put it in the record.

I think you have to be concerned with the net result of how things appear to people.

MR. SMITH: Mr. Norby, would you reread the part of your testimony that discusses industry representation? There was a point I didn't get.

MR. NORBY: Well--

MR. SMITH: It was where, I think, you were saying that you didn't favor them and expressed an opinion on this.

MR. NORBY: I said first of all that various parties

had suggested that financial analysts have a role, but we did not think it appropriate. By the same token we did not believe organizations representing business management should have a role in the decision either. We felt that business was a study of accounting measurement, and, therefore, should not be a participant in the establishing of standards of measurement.

MR. SMITH: That's the phrase. You're not saying that business should not have a voice in the laws that govern them. What is it that makes you think that industry should not have a voice in setting standards?

MR. NORBY: Business through accounting and corporate reporting is giving a report of its stewardship; it's being held accountable for its performance. Therefore, others should establish the measurement of that stewardship.

I would like to say that on this point we would have virtually unanimous views throughout the Federation.

DR. STONE: I want to reinforce what Bill has just said. I don't think that there is a place on this permanent group for a business member. Nor do I think that the FAF should be represented as a permanent member. I think we should give input; I think business should give input, but that the decisions should be made by the professional group.

MR. NORBY: Thank you very much.

CHAIRMAN WHEAT: Wait just a moment, Mr. Norby; let's ask if anybody from the audience has questions.

Mr. Defliese has a question.

MR. DEFLIESE: I'd like to know whether the proposal for a full-time board was dependent upon the availability of speed in operations, or was it the appearance of independence?

MR. NORBY: I would say that the general viewpoint would lean toward the appearance of independence.

MR. DEFLIESE: That seems to conflict, then, with the thought that a person could return to the firm from whence he came.

MR. NORBY: Well, if he came back to the firm where he had a prior relationship, there would be no conflict.

CHAIRMAN WHEAT: At this point, despite the fact that it's late, and I'm sure you're all hungry, I would like to ask if there is anybody in the audience that has a question to raise with us, or has a comment that he wants to make which would be beneficial to us.

I hope that you would keep it relatively short, but nevertheless we're very much interested.

Let's ask the lady down here who hasn't spoken, yet.

MISS GERTRUDE MULCAHY: I'm Gertrude Mulcahy of the Canadian Institute of Chartered Accountants.

CHAIRMAN WHEAT: Oh, I beg your pardon! We heard from you yesterday.

MISS MULCAHY: I had a number of questions that I wanted to raise, but they have been answered this morning.

There is one thing that has been mentioned quite

frequently by many of the speakers, and that is the need for more research to support the work of the APB.

As a foreigner looking at what happens in the United States, I never cease to be amazed by the amount of research that seems to be done. But it seems to be in a spirit⁺ of competition, rather than in the spirit of getting together. I look at AAA, NAA, and FEI; each one tries to outdo the other. Maybe I'm wrong.

It seems to me that when your committee looks at this, you should not ignore the work done by other organizations.

CHAIRMAN WHEAT: Thank you, Miss Mulcahy.

QUESTION: My name is Luke Patrick. I want to commend the committee for doing a fine job during the two days of looking into this matter. We've heard a little bit about independence, but there's one phase of independence that I don't believe is a matter of the record.

In the interest of serving the appearance of due process being reported here at this hearing, I want to look into that a little bit and see if maybe some members of the committee or some of the witnesses might have some clarification for me on this point.

We think of independence in terms of certification or attestation, and we're thinking about an unsavory relationship or a savory relationship between the independent accountant, who is going to attest and certify, and the firm whose reports and business he is going to attest to.

But the Accounting Principles Board is not in the area of certification or attestation, but in the area of enunciating

accounting principles by which business reports its transactions. So what I think we're really talking about, and the thing that's important, here, is a conflict of interest.

It seems to be accepted by most of the speakers that the independent accountants, by being made independent would not have a conflict of interest.

I want to point out that independent accountants owe their very existence to the fees they get from their clients. There have also been records of numerous multimillion dollar lawsuits against accountants for their certifications and I'm sympathetic to their position in this thing. I'm not critical of them in any way whatever.

But I say that in the area of enunciating and establishing accounting principles that independent accountants are not disinterested. They do have imbedded interests in the problem; they do have perhaps even conflicts of interest as between their interest in the accounting principles established and the interests of business or the financial community.

My question is, is this something that is given due consideration by the committee that we're meeting with here today, and will it be given due consideration?

CHAIRMAN WHEAT: I can assure you, Mr. Patrick, that it will be given due consideration. We appreciate your statement and we recognize the significance of what you say.

Is there anyone else?

Thank you all, again. I guess we're closed.
We'll have a hearing record if anybody wants to have a
look at it.

(The meeting adjourned at one thirty-five
o'clock.)

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Pages 281 to 499 not used.
Part B starts with Page 500.

