University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public Accountants (AICPA) Historical Collection

1968

Meeting Consumer Needs

Leonard M. Savoie

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides

Part of the Accounting Commons

Recommended Citation

Savoie, Leonard M., "Meeting Consumer Needs" (1968). *Guides, Handbooks and Manuals*. 1317.
https://egrove.olemiss.edu/aicpa_guides/1317

This Book is brought to you for free and open access by the American Institute of Certified Public Accountants (AICPA) Historical Collection at eGrove. It has been accepted for inclusion in Guides, Handbooks and Manuals by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

MEETING CONSUMER NEEDS

by
Leonard M. Savoie

before a joint meeting of the

Washington Society of CPAs
Financial Executives Institute
Mortgage Bankers Association

Hyatt House Hotel
Seattle, Washington
September 19, 1968

MEETING CONSUMER NEEDS

This is the era of the consumer. Everywhere one turns he sees action designed to protect consumers. Federal legislation, regulatory rulings, court cases and consumer groups all are bringing more attention to the growing demands and rising expectations of consumers.

Business, which is greatly affected by changes in recognition of consumer interests, very often has strongly opposed attempts to provide greater consumer protection. The opposition of business is predictable, vociferous -- and often ineffective. For in spite of it, we have seen on the broad consumer front major actions in such areas as automobile safety, truth-in lending and fair advertising.

We have also seen major changes in the interests of some very special consumers -- consumers of financial information. Here the "consumer" is a creditor or an investor -- and extending the concept further, a potential investor. And business had better be alert to this consumer's needs, for they are growing rapidly and with an insistence that cannot be ignored.

In the last few months, important court decisions and regulatory actions have come in rapid-fire order, with serious consequences for all who are concerned with financial information. Terms such as "conflict of interests", "insiders information", "full disclosure" and "due diligence" have all taken on new meaning.

The decision by a Federal court of appeals in the Texas Gulf Sulphur case breaks new ground on the use of information by insiders before making it public. The decision in Escott vs. Bar Chris Construction Corporation brings to securities offerings new meaning to due diligence by officers, outside directors, underwriters and accountants.

The SEC's administrative proceeding against Merrill Lynch, Pierce, Fenner & Smith -- the nation's largest securities firm -- charging violation of anti-fraud provisions of Federal securities laws has rocked Wall Street. Allegedly, the firm disclosed to large institutional investors non-public information about declining earnings of a company, causing these investors to sell the stock, while small customers who were buying or holding that stock were not given the same information. Some observers think this is the first blow in a drive to force separation of securities underwriting and brokerage, because of alleged conflict of interests.

Meanwhile, the Federal Trade Commission has launched a major investigation of conglomerates to determine whether possible anti-competitive effects of conglomerate mergers are against the public interest. And the House Committee on Banking and Currency is weighing the significance of a 2,000-page staff report

that reveals the concentration of ownership of securities through trust departments of banks, and the service of bank officers as directors of some of the same corporations.

These sensational developments in this era of the consumer should warn all concerned with corporation finance to pay heed to the growing demands and rising expectations of the consumer of financial information -- as aided and abetted by various governmental actions.

Some of the cases cited have a direct bearing on the accounting profession. In the era of the consumer, there are specific lessons for the accountant.

In some ways the CPA in the public practice of accounting is in a stronger position than many in the financial community to supply the new consumer demands. For public accounting was founded on the need to provide confidence in the reliability of financial statements. In filling that need the profession has established accounting and auditing standards for guidance of its members and has provided a code of ethics which among other things requires a member to adhere to these standards and also to be personally and financially independent of his clients.

Although these conditions enhance the status of the public accountant, his very assumption of a position of public trust entitles the consuming public to expect

more from him than from others. While the accounting profession has made great progress in fulfilling its professional responsibilities, there is evidence that it, too, along with other segments of the financial community, is having a hard time keeping pace with the demands of consumers. Court decisions and SEC rulings are emerging so rapidly that the accounting profession must accelerate the creation of standards where none exist or where new conditions require changes. Otherwise, others will perform that function.

The accounting profession grew up as an intergral part of the private enterprise system in the United States -- it could not have developed in the same way without the relative freedom of aggregation of capital by the private sector. The accounting profession has in turn greatly facilitated the progress of private enterprise by adding confidence in corporate financial information.

But private enterprise in the U.S. today is not what it was in, say, 1900. Today there is a strong public interest in business, for there are some 24,000,000 investors in business, not to mention bankers and other credit grantors who also have specific information needs. More and more the accounting profession is recognizing that these investors and creditors are its clients. Third party responsibility is looming larger than ever before.

Early in this century, the accounting pro-

fession began to establish standards for guidance of its members. Actions along this line have increased at a rapid rate, but today it appears that these efforts may not have kept pace with investor needs.

This situation exists partly because of changes in tax laws, changes in methods of financing, and changes in structure and operations of business organizations. It may also be partly because the accounting profession was slow in relating these changes to consumer needs in financial reporting. For example, accountants were slow to recognize the need of investors for greater comparability of financial statements of different companies. For several decades, the accounting profession assumed that consistency of application of an accepted accounting principle by a company from year to year was the important thing, even if alternative accepted principles were used by other companies in the same industry. Now, however, the Accounting Principles Board of the American Institute of CPAs has a major effort under way to improve accounting principles and to limit alternative principles to those justified by differences in circumstances.

Some business men -- and even some accountants, I might add -- still have only a meager understanding of how accounting principles are established and how their authority arises. The basic responsibility for financial statements, and for the underlying accounting methods,

rests with corporate management. Independent auditors have a separate responsibility to third parties -- bankers, stockholders, the general public -- in expressing a professional opinion on the fairness of presentation of these statements. While the American Institute has led in the development of accounting principles, its pronouncements have direct authority only over its members. But years of cooperation between the stock exchanges, the SEC and the American Institute have given greater indirect authority to these pronouncements. Although the CPA has only his opinion on financial statements as a means of expressing dissatisfaction with accounting principles of his client, this becomes a powerful weapon. For the SEC and the stock exchanges nearly always refuse to accept an auditor's opinion which contains an objection to accounting principles underlying material items in the financial statements.

The Accounting Principles Board thus occupies a quasi-regulatory position. The Board and its predecessor body in the American Institute have earned this position. But for an organization in the private sector to continue to carry out a public function, it must continue to deserve its position. The Accounting Principles Board will continue to deserve this position as long as it meets the consumer needs.

Recent progress by the Board has been good, but this is no time to rest on laurels. Every subject tackled by the Board is controversial and strong opposition can be expected from some quarter for any position taken. Accounting principles do not derive from physical laws; they cannot always follow consistent logic and they must often reflect pragmatic -- sometimes even arbitrary -- decisions.

In arriving at its Opinions, the Board follows careful deliberative procedures to make sure that all aspects of a problem area are duly considered. Whenever practical, a research study in depth precedes Board preparation of an Opinion. Consultations are held with responsible business groups and government agencies. Tentative positions are exposed widely for further comment. Finally, after redrafting to give appropriate effect to comments received, the Board votes on the matter, and if the Opinion receives an affirmative vote by two-thirds of the 18 members, it is issued to the profession.

In the last two years, the Board has issued several Opinions of importance. One clarifies pension accounting principles and narrows practices while still permitting a rather wide latitude in methods. It prohibits pay-as-you-go and terminal funding methods and states that accounting for pension costs should not be discretionary. All of its specific technical require-

ments are intended to spread pension cost over appropriate periods by systematic and rational methods.

Another Opinion deals with accounting for income taxes. It calls for taxes to be provided in income statements in the same period that related income is reported, regardless of whether taxes are actually paid at that time. This Opinion encountered considerable opposition from business as well as from some accountants, even though the basic concept of income tax allocation was already well established. Much of the opposition was directed at a proposal to limit accounting for the investment credit to a single method -- a proposal which was withdrawn for further consideration in response to strong objections.

It is becoming increasingly difficult to see how investor needs can be satisfied if more than one method of accounting for the investment credit is permitted. Although there are far more important accounting principles to be resolved than this one, it is one that should be settled in the near future. Board efforts at solution in 1962 and in 1967 were each unsuccessful. Failures of this kind pose a serious threat to the continued establishment of accounting principles by the private sector. I should think that business men genuinely interested in private enterprise would support the Board in its attempts at a solution. For investor needs must be served. Some day accountants will find

it impossible to report that the financial statements of two clients are both presented fairly when, with no difference in circumstances, one takes an investment credit into income in the year granted and the other spreads it to income over the life of the property giving rise to the credit. If all companies follow the same rules, it will be fair to all.

In other areas, the Board has been responsive to consumer needs in timely fashion. Nearly two years ago the Board issued its Opinion 9 on reporting the results of operations and earnings per share. This pronouncement has assured the reporting of all elements of income in determining net income. No longer is it possible to bury unusual losses in retained earnings.

But an even more significant part of that Opinion dealt with earnings per share. The Board strongly recommended that earnings per share be disclosed in the income statement, thus making it subject to the auditor's opinion. For years accountants had been telling each other -- and any one else who would listen -- that investors should not rely on a single figure of earnings per share but should review complete financial statements. It really is dangerous to make investment decisions on the basis of a single figure. However, there was no stopping the practice of applying a times-earnings ratio to earnings per share to arrive at a market price. Finally, the accounting profession

saw that the investor demand for an earnings per share figure could not be avoided, and set about to help refine it. Previously, earnings per share appeared only in the unaudited portion of annual reports and was not necessarily computed according to standards set by the accounting profession.

In addition to the primary computation of earnings per share, Opinion 9 calls for a fully diluted computation showing reduced earnings per share that would result if convertible preferred stock or debentures were converted into common stock. It also introduced a residual security concept which requires treatment as common stock in the primary earnings per share figure for participating and convertible securities where the major portion of their value arises from common stock characteristics.

The Accounting Principles Board was in the right place at the right time with its Opinion 9, for a wave of complicated securities was beginning to emerge. Some were so imaginatively conceived that earnings per share computed by a traditional method could often be enhanced simply by the issuance of the security -- and there would really be no change in substance because the security was virtually the same as common stock. Experience with Opinion 9 has revealed a need to expand

and clarify the meaning of residual securities. The Board is now doing that, and has circulated for comment another proposed Opinion. This one will change the Board's previous strong recommendation to a statement that earnings per share should be reported on income statements, both a primary figure with residual securities, if any, treated as if converted to common stock, and a fully diluted figure giving effect to all potential dilution.. The Board is just in the nick of time -- or maybe even a bit late -- in bringing out its comprehensive interpretive Opinion on earnings per share, for in June, 1968, the SEC issued a release dealing with two aspects of residual securities. Final consideration of this Opinion is on the APB agenda for its January 29-31, 1969 meeting.

In Opinion 9, the Board provided an exception to its application by commercial banks, pending completion of a study by another committee of the Institute. In March of 1968, after years of working with industry representatives and regulatory agencies, the committee issued its guide, entitled Audits of Banks, containing a format for an income statement. In June, the Board issued an exposure draft of an Opinion that would remove the exemption of commercial banks from Opinion 9.

Here again the Board is considering the needs of investors. Banks do not present a figure for "net

income." The figure most often used as a substitute for net income is labeled "net operating earnings." But net operating earnings do not reflect a provision for loan losses and gains and losses on sales of securities. Bank income statements follow a reporting format required for reporting to bank regulatory agencies, who are concerned mainly with solvency and protection of depositors. But even for this purpose, no one can justify the omission of a loan loss provision from net operating earnings. A preferential income tax treatment complicates computation of a reasonable provision for loan losses, but it does not make it impossible. Loan losses are operating expenses of banks, just as they are operating expenses of all businesses that grant credit. Thus, the operating results of an entire industry are overstated. Investors in bank stocks need a fair presentation of income and the Accounting Principles Board is trying to fill that need -- in the face of formidable opposition. Final action on this proposal is also expected in January 1969.

The major problem area confronting the Accounting Principles Board in 1969 is business combinations -- the whole complex of problems associated with pooling of interests, purchase accounting and goodwill. Accounting for business combinations is unsatisfactory now and the Institute's old pronouncement on the subject provides little guidance.

The current wave of business acquisitions and mergers could not have taken place without tax laws permitting tax-free exchanges and the almost complete freedom of management to choose between purchase accounting and pooling-of-interests accounting. The AICPA's Accounting Research Division has recently released a major research study on accounting for business combinations and goodwill. Although press coverage of the research study was not planned and there was no press release or press conference, the financial news coverage was extensive. This fact confirms the high interest in the study and the topic. A subcommittee of the Accounting Principles Board is developing points for consideration and discussion in preparation for drafting an APB Opinion. I would not hazard a guess as to whether the Board's ultimate solution will follow recommendations of the study or not. They are:

(1) Most business combinations should be accounted for the same as other purchases; pooling of interests accounting is therefore usually inappropriate.

(2) Total value of consideration given in a business combination should be accounted for in recording a purchase transaction.

(3) Separable resources and property rights acquired should be recorded at a fair value at date of purchase, with difference between value of consideration

given and fair value being assigned to purchased goodwill.

(4) Amount assigned to purchased goodwill should be accounted for as a reduction of stockholders' equity, preferably an immediate direct write-off to capital surplus or retained earnings.

This proposed solution or any other solution that is more restrictive than our present loose guidelines will surely spark heavy opposition -- particularly from merger-minded companies. In fact, it is interesting to note the "defensiveness" of companies engaged heavily in mergers and acquisitions. In one ad of an investment service, the implication was made that all efforts to study and understand this movement are part of a new game called "Kick the Konglomerate." More recently, two executives of a leading conglomerate corporation fired heavy salvos at government attempts to investigate and regulate the activities of the broadly diversified companies. One charged that government agencies, in their investigations into the conglomerates, were engaged in "business McCarthyism or witch-hunting."

Quite apart from how they get that way by acquisitions, conglomerates will soon have to disclose a

breakdown of their sales and earnings by major product-line segments, according to a proposed rule of the SEC. This proposal follows a major research study prepared by Dr. Robert Mautz and sponsored by the Financial Executives Research Foundation. The study recommended disclosure of sales and contribution to income by each segment of a company operating in industries with significantly different rates of profitability, diverse degrees of risk, or varying opportunities for growth. So far the SEC proposal calls for information to be reported only in unaudited parts of registration statements. In September 1967, the Accounting Principles Board issued an interim statement recommending voluntary disclosure of revenues and profits by separable segments of diversified companies. Now the Board is giving consideration to what specific disclosures, if any, should be required in financial statements.

The accounting profession has its work cut out in satisfying consumer demands for its unique product. And its product will have to be changed; the old product is not good enough for today's consumer. Clearly, more disclosure and greater comparability of financial information are high among consumer demands. In attempting to fulfill these demands, the accounting profession needs the cooperation and understanding of

business -- particularly financial executives, who are the people in business best equipped to provide both cooperation and understanding.

There are signs that cooperation is improving. The Financial Executives Institute has a committee on corporate financial reporting which has commenced an active program of study and comment on proposed APB Opinions. They have formed counterpart subcommittees parallel to APB subcommittees on each subject, so that careful deliberation can be undertaken by them early in the development of an APB Opinion. The idea is to communicate their views and findings to the Board early in the process before conclusions have been reached.

In addition, a small group from the FEI has met with the planning subcommittee of the APB to discuss mutual objectives, and a follow-up meeting is being planned.

The Accounting Principles Board has sought closer relations with other responsible groups. Among the most important is the Financial Analysts Federation. No organization comes closer to speaking for investors than the FAF. In fact, their views are sorely needed by the Board to provide balance and perspective, and they have been generous in providing their comments.

A most promising development in communication among interested groups was a Symposium on Corporate

Financial Reporting, held in New Jersey during early November. It was jointly sponsored by the American Institute of CPAs, Financial Analysts Federation, Financial Executives Institute, and Robert Morris Associates. The 90 participants were about equally divided among the four groups. This symposium brought together for the first time, I believe, top level producers and users of financial information for the purpose of exploring needs and responsibilities for financial reporting and ways of improving it.

The meeting was a closed session -- limited to the participating groups -- designed to bring out free and frank discussion of problems and conflicting views. Four distinguished professors led the discussions, which were based on papers and critiques distributed well in advance of the symposium. The papers and a summary of the discussions will be edited, published, and given wide publicity in the near future.

The participants concluded that the meeting was of great benefit to all and that further communication among the groups should follow. We believe this is just the beginning of a new era in development of accounting principles as part of the self-discipline inherent in our economic system.

Without accelerated progress, the function of setting accounting principles will not remain in the pri-

vate sector. This would be a great loss to private enterprise and to society in general. For the insistent demands of the consumer should be filled in a manner that nurtures and preserves the system that has given him so much. That can best be done by a continuance of a maximum of activities in the private sector.