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Accounting Principles and Financial Analysts

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An address by Thomas D. Flynn, President,
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ACCOUNTING PRINCIPLES AND FINANCIAL ANALYSTS

Ladies and Gentlemen -

Last October the American Institute of Certified Public Accountants was delighted to have Mr. William Norby, the immediate past president of your national organization, take part in our annual meeting. In his address Mr. Norby said: "There is much to be gained by both financial analysts and CPAs from the increasing dialogue between the two professions..." I fully subscribe to this view, so I welcome the opportunity to speak to you here today.

A prime subject for a dialogue between our two professions is that of accounting principles -- specifically, of which accounting principles should be generally accepted and which should not. Sometimes this problem is stated as a need to eliminate, or at least reduce, the number of alternative accounting principles presently in use in the preparation of financial statements. While granting that this is part of the task, the accounting profession conceives it in broader terms -- as involving not only the elimination of less desirable principles, but also the significant modification of existing principles and the development of new principles not now in use.

Effort to improve accounting principles is continuous within the profession. In this effort it must always be kept in mind that accounting principles should be socially useful. And since our society is made up of many segments, the question arises -- "Useful to what groups?"

One of the main groups, of course, is the people who manage business enterprises, since accounting is indispensable to the management of almost any business larger than the corner drug store.

Another chief group is the investing public. There are some 18,000,000 individual stockholders in this country who receive company financial reports. These stockholders and their families -- plus the beneficiaries of life insurance and pension funds, whose savings are also largely invested in corporate securities -- constitute a substantial part of the American public.

As you are well aware, there has been criticism of corporate financial statements in recent years on the ground that they embody such a diversity of accounting principles as to make it difficult, if not impossible, to compare one company with another.

Much of this criticism is more vociferous than justified. For instance, extreme cases may be cited as illustration of differences in financial statements caused by the use of different accounting principles, and the impression is left that these examples are quite typical. We may be told of the difficulty of comparing the net incomes of oil companies because some of them write off intangible development costs while others capitalize these costs. While this particular criticism had some pertinence a few years ago, there are today, among the oil companies listed on the New York Stock Exchange, only a handful which do not capitalize intangible development costs.

Similarly, we hear of the difficulties of comparison between companies because of different methods of inventory valuations -- such as LIFO, FIFO, and average cost. Yet over the past several years while prices have been relatively stable, net incomes of listed companies have been little affected by differences in inventory methods.

Another criticism is that balance sheets should state fixed assets at current -- or so-called economic values -- rather than at cost. This proposal is made particularly with reference to companies in the extractive industries, whose assets may consist in large measure of minerals underground. This criticism -- at least as sometimes presented -- is misleading on two counts. In the first place, it has nothing whatever to do with reducing the number of alternative accounting principles for the simple reason that valuation-at-cost is the <u>only</u> principle now used in these situations. If the economic-value principle were added, it would <u>increase</u> the number of alternatives rather than the other way around. More importantly, the criticism tends to be voiced in a way which implies that economic values are not used, because of almost wilful refusal on the part of the accounting profession and corporate managements. This implies also that there is a method for doing so readily at hand. This is just not so. The reason that the economic-value principle is not applied is that nobody has yet been able to find a method for doing so which would not be subject to abuse and have many more shortcomings than valuation-at-cost.

I am quite prepared to support research into the possibility of the use of economic values for fixed assets where appropriate. But let us not delude ourselves that a solution to this problem is just around the corner.

We are all aware, in the natural sciences, of the importance of stating a problem as objectively and accurately as possible. I believe it is just as important to do so in the <u>social</u> sciences -- and this includes public accounting and financial analysis. We should get our problem in proper focus.

We should, for example, recognize that in the last generation or two there has been remarkable progress in the development of accounting principles and in the form and extent of financial information furnished to stockholders. The excellent brochure published three years ago by the Corporate Information Committee of your National Federation makes this point clearly.

A number of forces have contributed to the improvement: the accounting profession -- public, private, and academic; corporate managements; security analysts; bankers; the stock exchanges, and stockholders themselves. A major force has, of course, been the SEC. Thirty to forty years ago, many companies did not disclose net sales, depreciation, and transactions in the capital and earned surplus accounts. Information on foreign operations was usually meager or non-existent. Stock dividends from affiliated companies were not infrequently recorded at market values, thereby inflating net income. Write-up of fixed assets on the basis of optimistic appraisals was common. Charges were made to capital surplus which were more appropriately assignable to net income or retained earnings. Companies sometimes included in net income profits made from dealing in their own securities. These practices have now been substantially eliminated.

The whole tone and level of financial reporting has been raised. In consequence, the American stockholder is the best informed stockholder in the world today. In fact, he and his investment advisers have available to them such a tremendous mass of corporate information that how to make it more compact and manageable is itself a problem.

Does this mean that we have gone as far as we can go -- that there is no room for further progress? Of course not. There are a number of important accounting principles which must be studied further and improved upon. As you may know, the Accounting Principles Board is actively studying such problems as business combinations, pension costs, foreign operations, research and developments and allocations of federal income taxes. I firmly believe that the public accounting profession, through the Accounting Principles Board and with the cooperation of other business and financial groups, can make substantial additional progress in improving the usefulness of accounting principles. I am equally certain that <u>sound</u> progress is not so simple to accomplish as is sometimes thought.

Some persons, for example, apparently feel that if complete uniformity of accounting principles were given the highest priority, the debate over alternatives would lose its force and solutions to all sorts of problems could be rapidly reached. Quite recently, a prominent business economist told me that he did not care <u>which</u> accounting principles were selected and <u>agreed</u> upon by the profession, so long as they were <u>uniform</u> for all business and were consistently applied over a long period.

The vast majority of CPAs and corporate management are united in their opposition to this approach. Even those accountants who speak most fervently against the present degree of diversity will not themselves give up a principle which they regard as superior in order to achieve uniformity.

The reason why CPAs and management are united on this point is because they know that sound accounting principles are important, and are indispensable to the proper measurement of business events and phenomena.

American business exhibits a tremendous variety of forms, arrangements, and kinds of transactions. It would be as impossible to describe these accurately with a narrow, incomplete set of accounting principles as it would be to use the vocabulary and mathematical concepts employed in your work to describe a problem in nuclear physics, or vice versa. We must not, merely to satisfy a craving for simplicity, render accounting unsuited to describing real, living business organisms. Greater consistency, yes; rigid uniformity, no.

When we come to the matter of greater consistency, some people think that CPAs should assume the lion's share of responsibility -- or possibly <u>exclusive</u> responsibility --

in establishing it. Others are of the opinion that CPA's are presumptuous in the degree of responsibility they already undertake. Some think that auditors are too complacent vis-a-vis their clients, too ready to yield their own convictions lest they lose business. These people believe that the withholding of a so-called "clean" opinion should be used as a means of enforcing compliance with a narrow set of accounting principles. Others feel that accountants already are too stiff-necked in insisting on having their own way.

I have recently had a most illuminating demonstration of the wide variety of view on these subjects. It came about in this way -- the executive director of our Institute wrote an article titled "Management's Stake in Accounting Principles," and I thought it would be a good idea to send reprints to the chief executives of some major companies. The gist of the article was that although corporate reports have greatly improved, questions have arisen as to whether progress is being made fast enough. It went on to say that managements have the responsibility for deciding what accounting practices best reflect the position of their companies, but that they should bear in mind that consistency in reporting among companies in the same industry would be helpful to investors.

The article also described efforts of the Institute's Accounting Principles Board to narrow areas of difference in reporting; and in sending the reprints, I asked for any comments the recipients might have as to how corporations could advance this aim.

The volume of response has been amazing. I have had well over a hundred letters, and they are still coming in. Moreover, the majority, by far, are not merely courteous acknowledgments. Many go to two and three pages. Without my foreseeing it, the result has been a sort of informal opinion-survey which, while not strictly scientific, is nonetheless revealing.

Because the companies represented are those whose securities you analyze, I'm sure you will find a sampling of the comments interesting.

For example, with respect to the degree of influence that the accounting profession should attempt to exert, one vice president wrote: "We believe accounting principles can achieve greater acceptance if the Institute will assume active leadership. We advocate a strong position by the Accounting Principles Board." But an executive vice president in the glass industry said: "To be real frank, we find too often that the decisions of your committees are influenced by theoretical, professorial-type thinking and reflect too little a practical common-sense business viewpoint."

A president in the metals industry opened his reply to my letter with the statement: "The rate of progress in developing and selecting accounting principles unquestionably is too slow." Another man says: "Progress has been and is being made, and I am all for it. But I do not like the Institute's present attempt to force a faster rate of change."

The controller of a steel company put it like this: "Condemnation of the accounting profession which is so prevalent today is, in my opinion, somewhat out of order. If one considers the rapid gains that the profession has made, it appears to me they should be complimented rather than condemned. This does not mean we are not subject to some criticism or that we should not try to improve."

Concerning comparability and uniformity, a president of a chemical company declared: "The value to business in having a high degree of comparability in annual reports is great. With increasing stockholders, a more informed public and more governmental interests, it is more than ever necessary to have a common set of accounting principles, consistently applied as the base for financial reporting."

On the other hand, the president of an aircraft company is dubious about the emphasis on uniformity. He says: "I am not so sanguine in the belief that less divergency and more uniformity will be a panacea to our problem. Instead, I believe that our divergent practices evidence our efforts to adapt accounting to our rapidly changing economy."

The president of an important company has still another approach to this subject. He says: "The greatest need is not so much for greater uniformity as for fuller disclosure. The aim might be more toward encouraging companies to explain in annual reports how certain controversial accounting matters are treated, as against the monumental task of establishing and enforcing rigid industry standards."

On the subject of cooperative effort, the president of a large oil company expresses a thought which recurs in a good many of the letters. He writes: "I feel that one of the more effective ways for management and the accounting profession to work together on these problems is through industry-wide studies such as that being conducted by the American Petroleum Institute."

Notwithstanding the conflicting viewpoints in the letters I have quoted, there is a strong consensus in the correspondence: first, that a problem does exist, and second, that management has a definite responsibility to participate in its solution. Most executives seem to feel that the AICPA should take the lead -- although a few have reservations on this. But all agree that management should take a more active part. It is frequently suggested that the Financial Executives Institute provides the best channel for cooperative effort. Other suggestions are that the AICPA work through industry groups to achieve greater consistency in accounting principles among companies in the same industries; or that industry have greater representation on the Accounting Principles Board itself; or that seminars on specific problems be held through the country to develop agreement on controversial questions.

There are references to financial analysts which will interest you. For example, the chairman of a large oil company wrote: "Refinement of accounting principles must be coupled with an educational program directed particularly to large, sophisticated stockholders and the financial analysts on whom they rely. Such a program would lead to a better understanding of accounting principles, the reasoning underlying them and their advantages and limitations. It should also lead to a realization that substantial progress is being made in eliminating diversity of accounting principles."

You analysts know that many factors besides financial statements must be weighed in judging the worth of a stock -- factors such as the quality of management, current and potential competition, general economic prospects, and so on. You know, too, that these factors are subjective and difficult of precise appraisal.

The small to medium investor, however, would quite naturally like to have some rule-of-thumb which he could apply to all companies without taking the time to scrutinze underlying data. So he tends to base judgments on what appears to be the solid, precise figure of net income per share. But it is just not possible to encompass all the complexities and variables of a business, particularly one of any size, in a single figure, especially for a single year, and for this reason CPAs have for some time been pointing out the limitations inherent in an unsophisticated use of earnings-per-share.

For example, a company might last year have had an important and profitable government contract but have no comparable contracts this year. Or a company might greatly expand or curtail advertising expenditures with significantly varying effects on net income in the current and following period.

Perhaps research and development is the best example of the danger in mechanically comparing net income per share. Generally speaking, substantially all listed companies charge off general research and development costs as incurred because of the difficulty of finding rational bases for allocating such costs to future periods. If one company in an industry charges off high expenditures to develop, say, color television, and another company in the same industry undertakes no general research at all, can we, without qualitative evaluation, compare their earnings per share?

Modern accounting attempts to match costs with related revenues. This necessarily involves assumptions that such costs will in fact produce revenues, and when they will be received. Such assumptions as to the future will rarely prove precise in the light of subsequent events. But this approach yields far more useful earnings information over a period of years than any other yet discovered.

It is remarkable in fact that, through accounting refinements, it has been possible to pack so much meaning into this single earnings-per-share figure. But let us always be aware of its limitations. We can make it better and improve its comparability, but we should be careful not to encourage the investing public to use it uncritically as a guide to the future.

I should like to point out that any limitations of the earnings-per-share figure apply even more to cash-flow-per-share. Your own Federation recognized these limitations in a policy statement on funds analysis which was adopted in April of last year.

You analysts, more than any other group, are the users -- the consumers -- of financial statements. It follows that you are in an almost unique position to judge the usefulness of these statements from the viewpoint of the investor.

It seems to me, therefore, that as a group you should inquire deeply into the reasoning which supports the acceptance or rejection of a given accounting principle. You may wish to concentrate chiefly on those accounting principles which are of particular usefulness in security analysis. This effort will, I feel sure, require greater expenditure of time and money than has been expended in the past for this purpose by either your national Federation or its various individual associations.

I believe you would be well advised to employ full-time staff to assist your members in this effort. Your national Federation and our Institute have already appointed cooperative committees, through which opinions of your members can be channeled to the Accounting Principles Board.

But individual personal opinions on complex technical questions are not always helpful. And analysis in depth of controversial accounting issues is a heavy burden for volunteers who must give priority to their own jobs. What we would like most to get from you is a consensus of a representative group of analysts, based on thorough consideration of the research studies published by our accounting research division. These studies precede by two or three years any action by the APB on the problem being researched. Your views should be available, with supporting reasoning, when the Board begins to consider the available evidence -- not after it has already reached tentative conclusions. But to keep up with the steady stream of research studies, I think you will need full-time paid help.

I would summarize all this as follows:

First, the investor in securities of American companies has available to him a greater volume of financial and related data than any other investor.

Second, this condition represents marked progress, particularly during the past three decades. Many groups and institutions, including your profession, have contributed to the progress.

Third, as at all times and in all fields, there is room for further advances. As far as accounting principles are concerned, these advances will come about not by building a Procrustean bed but by refinement of existing practices and seeking better ones. They will not come overnight nor by fiat but, as the research director of the Accounting Principles Board has said, by "calm, steady and persistent progress based on good research and common sense."

Fourth, economic growth and the continued broadening of participation in that growth -- with all that these things mean in terms of material benefits for the individual under conditions of freedom -- depend importantly on an informed investing public. I am personally determined to do everything I can to see that the American investor has access to all the information needed for intelligent decisions. My colleagues in accounting share this resolve. We earnestly invite the help of security analysts and all other appropriate groups to this end.

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