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Marvin L. Stone

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PUBLIC CONFIDENCE IN PRIVATE ENTERPRISE -- LET'S KEEP IT

An Address

by

Marvin L. Stone, President

American Institute of Certified Public Accountants

Before

The Economic Club of Detroit

March 11, 1968

When I think of the investing public, I'm thinking about my Aunt Hattie. Since Uncle Charley died, Aunt Hattie has managed to get along pretty well, what with Social Security and the yield from the modest estate he left.

When Aunt Hattie collected on Uncle Charley's insurance, she instinctively put the money in a savings account, since Uncle Charley never had much faith in the stock market. But about a year after Uncle Charley died, Aunt Hattie began wondering if she was managing her capital wisely. Her bridge foursome talked constantly of capital gains, stock splits, and hot tips. To hear them, anybody who didn't get into the stock market just didn't care about money. Her son the doctor, too, seized every opportunity to quote from Medical Economics on the importance of hedging against inflation. Finally, Aunt Hattie decided to invest a few thousand dollars in the stock market, wondering all the while how she would explain her folly to Uncle Charley -- may he rest in peace -- when they met again. Even if it doesn't work out, she thought to herself, I'll at least know what all my friends are so excited about -- I'll be able to talk about stock splits and capital gains, too.

Her son's broker suggested to Aunt Hattie that she buy only blue chips. Her son later explained that term to Aunt Hattie, since it conjured up much different connotations in her mind than had been intended by the broker.

The broker also used a lot of other investment jargon like price-earnings multiple, downside risk, convertible, conglomerate. Aunt Hattie's son, the doctor, nodded knowingly during all this, adding a little jargon of his own -- straight from the latest

Kiplinger Newsletter. The broker, quoting from an analysis out of his New York office, recommended that Aunt Hattie buy stock in that well-know conglomerate, Amalgamated Treadmill & Tambourine and so it came to pass that she bought 100 shares of -- well, let's call it A.T.& T for short.

About a week after she had paid for her stock, Aunt Hattie received a letter of welcome from the President of A.T.& T. Even though it looked like a form letter, Aunt Hattie thought it was "real friendly" of him to write. She has, of course, received quarterly statements and annual reports as well, all of which she reads with great interest. I can attest to that interest, because I receive a 'phone call every time Aunt Hattie runs across financial data she doesn't understand.

So it was that my Aunt Hattie joined some 22,000,000 people who own shares in American business. The means by which such shares can be made even more attractive to the 22,000,000, and to the other millions as well, is what I'd like to talk about this afternoon.

The capital needed by American business is furnished by the public. Public confidence is essential if the capital pool is to expand rather than dry up. Confidence is a delicate flower which, to flourish, needs to be fed continuously with useful and reliable information. The undernourished capital markets in other parts of the world illustrate my point. Much less information is made available to investors in most other countries than is given to U. S. investors. That fact accounts, in no small measure, for the limited capital pool available elsewhere compared with that available in this country.

I said that the public should be given useful and reliable information. For many years, and particularly since the passage of the Securities Act of 1933, the investing public has had reasonable confidence in the reliability of published financial statements. It is the other attribute -- that of usefulness -- which is lacking in much of the published information.

There have been great advances in corporate financial reporting over the past 20 years, and most American companies have been doing a good job of providing information to the investing public. But new conditions and complexities in business require continued improvement if financial reporting is to achieve greater usefulness to the public.

An investor not only must know how his company is doing, but he should be in a position to compare his company's operations with those of other companies in the same industry or even in different industries. Comparability is obviously a tall order. In fact, true comparability is an impossibility. However, I believe it is a fair statement that much greater comparability can be achieved than is now the case.

In its efforts to bring about greater comparability -- greater uniformity -- the accounting profession finds itself caught between the financial analyst who seeks a utopia of complete comparability and managements who want complete flexibility in the presentation of their financial data.

Traditionally, management has felt an obligation only to its present stockholders not to potential stockholders. Management has resisted any limitations on its free choice of accounting methods on the premise -- a mistaken one -- that greater comparability of financial data is not its cause. I submit that management has a greater stake in the cause of comparability than anyone else, because greater comparability increases usefulness which is in turn an essential ingredient in public confidence.

Many corporations seek to enlarge their share of the capital pool by new security "packaging" techniques (e.g., convertibles), by stock splits (to keep stocks popularly priced) and even by institutional advertising. Perhaps a little effort should be directed toward enlarging the pool, to make more capital available for everyone.

I am convinced that furnishing investors with more comparable data will build public confidence and understanding -- will enlarge the capital pool. Greater comparability means elimination of unwarranted differences in financial reporting, so that like things will look alike and different things will look different.

Since Aunt Hattie became a shareholder, she has become an avid reader of the financial page of the Denver Post. She turns to the stock quotes even before reading Dear Abby. While she doesn't understand everything she reads, Aunt Hattie is getting more sophisticated every day. And since many of the articles talk about accounting methods and their effect on earnings, I am often called upon to explain the import of these articles to Aunt Hattie.

I'm sure you are as aware as Aunt Hattie of the attention given to accounting matters in the financial press during the last few years.

Articles have appeared pointing out, for example, that one company charged its pension costs on a pay-as-you-go basis while another used an accrual method, with markedly different impacts on reported earnings.

Criticism has been voiced of the way different companies handled extraordinary gains and losses -- or of the way the same company might have included an unusual gain in operating income last year but charged an unusual loss this year to retained earnings.

Business writers called their readers' attention to the different effect on earnings when acquisitions were treated as pooling of interest rather than as purchases. They noted, with more than a slight tone of "What goes on here?" that some oil companies expensed dry-hole costs and some capitalized them -- that some high technology companies handled R & D costs one way, and others differently.

Inevitably the accounting profession was included in the criticism. Journalists complained that there were so many alternative accounting methods that a management, by choosing among them, could show its profits at any point within a very wide range. One editor fumed, and I quote: "Generally accepted accounting principles mean damn little." Some writers hinted darkly that auditors were not so independent as they professed to be but docilely went along with whatever their clients wanted to do.

While all this was worrying the press, a Congressional subcommittee held some hearings at which questions were put to the then chairman of the Securities and Exchange Commission. One question was, and I quote: "Is it true that the Commission now accepts financial statements from various companies following alternative accounting practices with materially different results for similar transactions, and the certifying statement that all of these practices are in accordance with generally accepted accounting principles?"

The chairman replied that in some areas there were, indeed, more than one accepted accounting principle. The Congressman then asked that a list of these areas be supplied. This was done in due course, and the list included the following:

Valuation of inventories; depreciation and depletion; income tax allocation; pensions; research and development costs; and three or four more.

Now as many of you know, the accounting profession is constantly reviewing the accounting principles which it regards as acceptable for use by companies in preparing financial reports. And long before the criticism arose which I have described, feeling had been growing in the profession that its efforts to weed out superfluous or outmoded principles were not keeping up with the changes in a dynamic economy. So, as far back as 1959, the task of codifying generally accepted accounting principles and of cutting back unwarranted differences in accounting practices was assigned to an arm of the American Institute of Certified Public Accountants known as the Accounting Principles Board.

But I must point out that accounting principles are intellectual concepts. They are not subject to the kinds of proof that are applied to laws of physical science. So legitimate differences of opinion within the profession itself are virtually inevitable. Some CPAs feel strongly that there should be one -- and only one -- acceptable principle to apply to a fairly broad set of circumstances. Others maintain that business involves so many diversities that some latitude in accounting principles is necessary in order to portray the facts most accurately. There is general agreement, however, that transactions which are actually alike should be accounted for in like manner.

There is also general agreement that absolute unformity in corporate accounting -- that is, a set of rules to be applied to business across-the-boards -- might produce results more misleading to investors than otherwise. At the same time, it is recognized that at least a greater degree of uniformity is a reasonable goal, and that unnecessary obstacles to the comparison of one company's earnings with those of another ought to be removed.

The work of the Accounting Principles Board has brought about notable progress toward correcting the practices that have been criticized in corporate accounting, and the results are beginning to be seen in the reports to shareholders issued by almost every publicly held company. The Board has issued pronouncements -- known as Opinions -- on a number of very important subjects.

In December, 1966, it issued its landmark Opinion 9 setting forth when an item of gain or loss should be considered extraordinary, when it should be charged or credited to retained earnings, and when, instead, it should be charged or credited to current income.

The divergent manner in which General Motors and Standard Oil of New Jersey reported their 1962 sale of the Ethyl Corporation exemplifies a type of reporting inconsistency which will be eliminated by applying the criteria in Opinion No. 9. General Motors reported its $101,000,000 gain as extraordinary income, while Standard Oil transferred its $75,000,000 gain directly to retained earnings. Had Standard Oil reported the gain in its 1962 income statement, earnings would have been increased by 35¢ per share. On the other hand, had General Motors chosen Standard Oil's reporting method, its earnings would have decreased by 27¢ per share. Reports issued last year by Crowell Collier and Macmillan, Inc., First National Stores, Inc., I.T. and T. Corporation, and Pan American World Airways, Inc., clearly show the illuminating effects of Opinion No. 9.

The increased use of convertible securities provides an excellent example of the ever-changing conditions to which the APB must address itself. Unless the potential dilution of earnings is reflected in a company's report, current earnings-per-share figures are meaningless. The Board, reacting to this new trend in corporate financing, recommends in Opinion No. 9 that supplementary pro forma computations of earnings-per-share be reported, giving effect to the potential issuance of common stock (1) upon conversion of senior stock or debt, (2) upon exercise of stock options and warrants, and (3) upon the issuance of common shares for little or no consideration as is often the case in satisfaction of contracts of acquisition. Financial writers have shown an increasing awareness of this requirement.

As a result, so has my Aunt Hattie. Not to be outdone by the others in her bridge foursome -- which as you might have expected is now an investment club -- Hattie dropped her subscription to the Ladies Home Journal in favor of the Wall Street Journal. She quotes from it constantly. Last December she showed me a Wall Street Journal analysis of the Rapid American Corporation, backbone of the Meshulam Riklis Empire, which forecast an increase in reported earnings during the year ended January 31, 1968 -- $2.50 per share compared to $2.22 per share in the prior year. However, when the pro forma dilution is computed, estimated earnings for the current year would <u>decrease</u> rather than increase -- $1.65 per share compared with $1.86 last year. Aunt Hattie couldn't have been more tickled if she had found a new cookie recipe. By the way, reports issued last year by Bell and Howell, Collins Radio, McGraw-Hill, Crowell Collier, Macmillan, and Pan American World Airways, contained examples of pro forma earnings computations giving effect to contingent dilutions.

APB Opinion 9 also requires that earnings-per-share computations take into account not only common stock but all other <u>residual</u> securities. The latter term refers to securities which have participating dividend rights with common stock or which clearly derive a major portion of their value from conversion rights or common stock characteristics.

Example: During March, 1966, Litton Industries issued some 4,000,000 shares of preferred stock in exchange for a like number of common shares. The preferred shares are convertible into common stock at a rate which gives effect to stock dividends paid on common shares. Clearly, these preferred shares are residual securities. Even before the Board had issued its opinion, the SEC required Litton to include these new preferred shares in the earnings-per-share computation. Were it not for this requirement, Litton's reported earnings-per-share would have risen from $2.25 to $2.71 -- an increase of more than 20% -- just because of its reshuffled capital structure.

Until the Accounting Principles Board issued its Opinion 10, many companies showed their interest in unconsolidated subsidiaries simply on the basis of the original cost of the investment. Opinion 10 requires that the investment in an unconsolidated domestic subsidiary be adjusted for its owner's share of accumulated undistributed earnings and losses since acquisition. The Opinion also requires that the subsidiary's earnings or losses be reported on the parent's income statement, normally as a separate item. Stockholder reports issued last year by Crown Cork & Seal, Kaiser Aluminum, Sun Oil, and West Virginia Pulp & Paper all reflected the improved treatment prescribed in this Opinion.

Accounting for sale-leaseback arrangements, and for leases which closely resemble purchases, has been vastly improved since the issuance of Opinion 5. Opinion 8 brought greater order into accounting for pension costs. And I could give numerous additional examples of reporting practices which have been improved because of APB pronouncements.

The painstaking and arduous work of the Accounting Principles Board, however, has not invariably been received with hurrahs and hosannas. In fact, I should suppose that members of the Board sometimes feel in the position of a woman, in some of the Middle Eastern countries, who is caught in adultery. In some of those regions, as you may know, the offender is buried upright in the ground, to her neck, and the neighbors gather around and peg rocks at her head.

Let me cite as example the question of how the investment tax credit should be handled in a company's financial statements. The Accounting Principles Board has tackled this problem three times since 1962 -- and has had rocks thrown at its head each time.

As you all know, the investment tax credit is a provision enacted by Congress to reduce by a certain percentage the taxes of any company that purchases productive assets. The provision is the same for all companies in all industries so there is no theoretical justification for handling the tax credit in different ways. Yet two ways are now commonly used. One takes the full amount of the credit in the year in which the reduction of tax occurs -- the so-called flow-through method. The other method spreads the credit over the life of the asset which has created the credit in the first place.

Ever since Congress adopted the tax measure providing the credit, sincere accounting theoreticians have debated which way is the better. Theoretically, either way can be justified. The rub is that <u>two different ways</u> can't be justified.

In 1962 the Board decided that the credit should be spread over the life of the related asset. Apart from theoretical considerations, it was felt this would avoid sharp (and possibly misleading) fluctuations in earnings as between years in which capital investments were made and years when they were not.

Objection to this decision came both from a considerable number of businessmen and a considerable number of CPAs. The SEC took the position that, because of the questions surrounding the matter, both methods would remain acceptable to the Commission. Faced with this attitude of SEC, the Accounting Principles Board in 1964 revised its earlier Opinion with a new one which still expressed preference for spreading but recognized the flow-through method as still acceptable.

When the Accounting Principles Board in 1966 began to develop an Opinion on income-tax allocation, it again had to face the investment tax credit question. Two-thirds of the Board's members voted for the spreading method and elimination of flow-through, and this was the position taken in a draft Opinion that was circulated for comment to some 7,000 individuals and groups in business, government, and the accounting profession.

Again there was a shower of rocks. Campaigns were organized by trade groups to bring pressure on the Accounting Principles Board. More than a thousand letters were received by the Board, most of them objecting to its proposed Opinion, and as a consequence the portion of the Opinion dealing with the investment credit was withheld from the final ruling to permit further study.

That is where we stand now. But to me it seems clear that the question must be resolved -- two different methods of accounting for the tax credit cannot be permitted to continue. And I am personally convinced that if the accounting profession and the business community cannot agree on the method, the SEC will feel obliged to settle the matter by edict.

Thus far, the SEC has maintained an enlightened attitude toward the prescription of accounting rules. Rule-making has been left largely to the accounting profession, even though the SEC has the power to specify detailed accounting rules. The SEC has issued specific rules only when the accounting profession has moved too slowly.

But let's not push our luck. Government regulation seldom remains confined to its initial objective. Overall social and economic objectives soon override the original reasons for regulation. Portrayal of business facts is difficult enough when left to accountants who seek only to present data fairly. Think what chaos could ensue if politicians seeking to manipulate the economy -- as is now done through changes in taxing and monetary policies -- were able to prescribe mandatory accounting rules. Reported earnings could be manipulated simply by government edict.

The mission of the Accounting Principles Board is sometimes a thankless one. If it proposes an Opinion that would establish Practice A as against alternative Practice B, companies using B (fearing the loss of a real or fancied advantage, or simply because of natural resistance to change) protest vehemently. But contrariwise, if the Board sought to establish Practice B and eliminate A, objection would come from other quarters.

Thus we CPAs have occasionally riled business managements of late, and I think it is a pretty good prediction that we will rile them in the future. This is not because the accounting profession wants to irritate businessmen -- after all, they are our clients.

But an independent auditor has a different set of responsibilities from those of a company management.

The overriding responsibility of management is, of course, to its stockholders -- with responsibilities too to employees, customers, and the general public. A management, however, naturally wants to put its best foot forward. High-level executives -- motivated by pride in personal accomplishment, by their reputations among their peers, and perhaps by stock options -- like to show earnings curves rising steeply and steadily.

The auditor's responsibility -- to a company's stockholders, to the broad investing public, and to credit grantors and regulatory agencies -- is to examine the management's financial statements and give a candid opinion on whether they report the company's earnings and the state of its financial health accurately and with disclosure of all material facts. Any certified public accountant worth the name is motivated, first and foremost, by considerations of professional integrity.

I should emphasize, though, that CPAs are not hidebound theorists, obsessed with their own concerns, and splitting hairs in an ivory tower. They are keenly conscious of the demands and problems that managements face. Their aim is to devise and gain adherence to accounting practices that are firmly based in rationality and are as useful to society as it is humanly possible to make them.

I do not want to leave you with an impression that the accounting profession feels it is opposed and set upon by corporate managements. For quite the contrary is the case. Most chief executives and top financial officers realize that rationalizing the whole body of corporate accounting practices will serve the best long-range interests of their organizations. And they are therefore entirely willing to accept the adjustments that a tightening of accounting rules may make necessary in their particular companies during a transition period. The Board Chairman of one of the biggest companies in the country just recently sent a letter to the American Institute which said in part:

"I am glad to see that the Accounting Principles Board is making progress in the search for, and acceptance of, sound accounting principles. . .I believe the Board is right in basing tax expense on book income. . .What is badly needed in solving accounting's problems is the willingness to step up to hard decisions on matters of controversy."

My thesis today is simply this:

During the past decade or so, important changes have taken place in business: -- the growth in pension plans, for instance; a wave of mergers; the rise of the so-called "conglomerates"; a widening use of convertible securities for financing, and a number of other developments. Over the same time, rank-and-file investors like my Aunt Hattie have become more numerous and more interested participants in the economic scene.

Combined, these circumstances heavily underscore the need for business information that is as useful to the public as it can be. In a free and open society, the public sooner or later demands that its interests be served and protected; and if the private sector does not do this itself, the people will press the government to get the job done.

The accounting profession strongly believes the job can be done best -- not just for itself or for the business community but for our society as a whole -- by the private sector. The profession firmly intends to do its share. In addition, business management has a big part to play. I am certain that complementary effort by business management and the accounting profession can continue to provide the quantity and quality of communication that will not only keep, but will build still further, the public's confidence in private enterprise. Together, we might even sell a few shares to the millions of Uncle Charleys who still own no interest in American business.