

GENERAL THOUGHTS ON THE ACCOUNTING
ENVIRONMENT AND SPECIFIC THOUGHTS
ON ACCOUNTING FOR LEASE FINANCING

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It is certainly a pleasure to be here today to address a group of financial and accounting executives in two vitally important industries. Before I start, I am directed by the Securities and Exchange Commission (SEC) to advise you that as a matter of policy the SEC takes no responsibility for the statements of individual members of its staff and accordingly what I say is my own view and does not necessarily represent that of the Commission or my colleagues on the staff.

In my talk today, I intend to spend a little time talking about the accounting environment in general, because of clearly significant changes taking place. The bulk of my time will be devoted to the problem of lease accounting and then in passing I will touch upon some aspects of the problem of allowance for Funds Used During Construction.

The Accounting Environment

Looking at the accounting environment in general, it is quite apparent that significant changes are brewing. In the first place, they are most evident in the area of setting accounting principles where a new body is now in existence: The Financial Accounting Standards Board (FASB). We at SEC are very confident that it will improve the standards of accounting measurement in a significant fashion. We believe this because we think it is institutionally more appropriately structured for dealing with problems facing it than was the Old Accounting Principles Board (APB).

The APB was originally designed by a committee that was convinced that research would produce Truth and that the only thing that would be needed after accounting research was done was a body to simply anoint the truth that had become apparent. Therefore, they established a part-time large body which would come together occasionally to perform this anointive task. In the 15 years since 1958 when the APB was created, it has become apparent that while research may be the hope of the future in fuel generation and energy shortage, it does not seem to have the same prospect in the area of financial accounting measurement. Accordingly, it was necessary to develop a body which will be more appropriately structured to perform the required quasi-legislative function than was the part-time APB. The over-all record of the APB was a

reasonably good one, but it seems likely that a smaller full-time body directly in control of its research holds promise for more success. The new Board, however, is not going to find that the difficult problems confronting the APB will become less difficult when it looks at them. In the final analysis, I suspect the success of the new Board will be determined by the willingness of this body to face the tough strategic decisions that have to be made. There are a number of areas which deal with financial measurement where people are deeply involved, because their pocketbooks are deeply involved; and there is nothing more emotional than money. So that it seems very likely that as the new Board gets underway, those that find themselves ill at ease with its initial exposure drafts will probably bring the same kind of pressure to bear as they brought against the APB. And I don't think the fact that the members of the FASB are not current practitioners of accounting is going to shield them from this pressure to any great extent. Nevertheless, I am optimistic that they will be able to move expeditiously. It is apparent that expeditious action is needed as well as sound action, because at the present time we are in a position where doubts and questions have been raised about the adequacy of our measurement systems. And it is important that they be put to rest in a very short period of time. It is certainly the intent of SEC and the accounting staff of the SEC to work with the new Board as we have worked with the APB. I have characterized our relationship as one of mutual nonsurprise where we both must advise the other of how we are thinking and what we are doing. The SEC does not view itself as being in a position of absolute authority and the FASB as working for it. We think that authority exists for both parties and in this particular situation the responsibilities of both parties are better served if we work together. If we find ourselves in an adversary posture, we will be involved in a situation which in game theory is called a negative sum game - - one in which there is a negative total payoff. We both know this. And therefore it seems very likely that we will be working effectively with the Board. The first steps have already been taken. The Board has met with SEC. The SEC staff has established relationships with various members of the Board, various subcommittees, and we are optimistic that this relationship will work effectively and will improve standards of accounting measurement.

In addition to changes in the world of accounting principles or measurement principles, one can also perceive changing patterns of disclosure. Disclosure, of course, is different from measurement. Measurement principles are the criteria which should be used in the process of corporate scorekeeping. Disclosure deals with the question of how much information should be given to the public in a variety of areas. The SEC has traditionally taken a leadership position in the area of disclosure and expects to continue to do so. The various proposals that have been put out in the last six to nine months indicate a willingness and desire on the part of SEC to lead in this area.

It is worth speaking a bit about the general philosophy which the SEC is, I think, implicitly expressing in a number of its proposed rules and pronouncements on the subject of financial disclosure. In the first place, one concept that is being developed is that of "data of public record" as opposed to disclosure in every document sent to stockholders. At the present time, as most of you are aware, there is a rather acute inside information problem that exists. This is because it is considered to be unfair and probably illegal under Rule 10(b)(5) for people with inside information to buy and sell in the securities markets. This creates major difficulties for any principal employee or officer or director buying or selling shares of his corporation because almost by the definition of his job, he has inside information. The SEC is not anxious to take officers, directors and principal employees out of the market place for the stock of their companies. I think we all believe, almost a matter of faith, that it is very useful to have officers, employees and directors participate in the ownership of the enterprises which they manage. This means that they must have the opportunity to buy and sell at reasonable points in time. The appropriate answer, therefore, seems to be that all material investment information should in one fashion or another be made data of public record. This probably means that a great deal more information has to be filled and put into the public record than has historically been the case. In addition, an increasingly sophisticated analytical community is developing the ability to deal intelligently with greater volumes of data. It is clear that a number of our proposals at the present time go to this type of disclosure.

One of the problems that comes up with increasing disclosure is the problem of hidden facts. If you have an absolute mass of data available, there is every likelihood that the average investor - - indeed, in many cases, the sophisticated investor - - may be overwhelmed. Anyone who has read through a complicated proxy statement - - and I'd say that number is in the order of magnitude of one one-hundredth of one percent of those who receive complicated proxy statements-- will soon find out what the hidden facts doctrine at law means. After you have read the first fourteen pages of a financial statement with notes and other things there is a certain element of discouragement that tends to set in. Accordingly, there are clearly problems to the idea of more and more disclosure, for the average investor and even for the sophisticated analyst. Therefore, it seems that the only answer to the fact that on the one hand there needs to be more information as a matter of public record, and on the other, that the average investor has to be satisfactorily served, is a significant improvement in the quality of summarization of data that is presented. The corporation is going to have to assume greater responsibility in deciding how data should be summarized and interpreted. Our "Quality of Earnings" proposal, for example, indicates that we believe that management has a responsibility not only to disclose but to analyze as well, to point out those things which are most important in understanding the results of corporate activity.

In summary, it seems apparent that we are moving into an approach which will call for the filing of a lot of data, available to all, but not routinely sent to all. And then there will be an improved system of summarization with increasing responsibility on corporate managements for meaningful analysis of the data which are being presented. This is a package which has not yet been fully developed or articulated by SEC, but it seems to me that this is the direction in which we are moving. It is no longer an adequate answer in my judgment to say anything that should be made public is important enough to be shown to everybody, and thus it should be included in the annual report. The annual report presumably is oriented primarily to the average investor and the man who wants substantially more information should be able to get it, but he should be able to get it in a fashion other than simply getting the annual report that is sent to everybody.

In addition to changing patterns of disclosure, we are also seeing changing patterns of responsibility in financial reporting. In the first place, the aggregate amount of responsibility is increasing. There is more responsibility now than there used to be in terms of providing adequate, meaningful data. Beyond the aggregate increase in the amount of responsibility there has also been some shifting, and I think that has been in the direction of a more than proportionate increase in the responsibility of auditors as opposed to management for financial reports. In the first place, court cases and various SEC actions indicate the auditor has a responsibility beyond simply saying: Have the financial statements met a particular formula which has been established by some authoritative body? It is apparent that the courts, SEC and the analytical community are all saying that the auditors in the first place have a joint responsibility for financial statements, not simply a secondary responsibility, and in the second place that their judgments are going to be tested against a guideline that says: Do they make sense within the framework of economic activities being reported upon? This means that the financial statements have to be fair as well as in conformity with generally accepted accounting principles. This is a difficult responsibility to bear because it is sometimes hard to find what fair is. And if there is one thing that I have learned in a year at SEC, it is that there are dramatically different points of view as to what constitutes “fairness” and how a particular set of facts can be looked at. These different points of view are good faith points of view in most (but not all) circumstances. Therefore, it seems apparent that the FASB, SEC and others are going to have to begin to develop some guidelines for fairness that auditors can use, but not rules, because there are no rules which can be established that will guarantee fairness of presentation. Where you set up rules, then you require people to make analogies to factual situations to apply those rules, and the result may be a false analogy, a problem.

In addition to a responsibility that financial statements make sense, it also appears that auditors are increasingly being pushed into association with more than simply the financial statements of their clients. They are being associated to a greater extent with all public financial reporting which their client is undertaking. I believe that even today most auditors now

recognize some responsibility to read the various sections of the annual report in which financial data are included, to be certain that the data are consistent with the financial statements and that the president's letter does not paint a creative picture which is inconsistent with the statistics in the financial statements. Even beyond this there are a number of areas of supplemental disclosure which auditors obviously are having to take a look at. Line-of-business disclosure is not part of the principal financial statements, but I don't believe that many auditors are sitting back and saying: Well, we don't have to concern ourselves about that, because, after all, we don't give an opinion on it. If they are taking this position, they are likely to find it an inappropriate one in various factual circumstances where they may not enjoy the results. It is apparent that auditors are going to have to extend their traditional view of their responsibilities.

Another area where auditors perhaps should devote some time is reviewing press releases in which annual results are reported to the public. One of the areas of deficiency which we have found in the past few years is the way in which the press release describes the financial results of the business. I am not speaking about the majority of press releases but of that minority which do not reflect the results in a fashion consistent with the financial statements. As financial reporting experts, it seems logical that auditors should be involved the review of press releases before they go out to the press to be certain that technical requirements of financial reporting are met and that the impression which they give is not inconsistent with accounting reality.

The area of interim reports is another area in which auditor responsibility seems likely to increase. At the present time auditors do not have any direct responsibility for interim reports. I do not anticipate you are going to see audited interim reports in the near future at least, but it does seem to me likely that the auditors of all corporations are going to have to perform something like the review function that they now perform in a number of corporations, in dealing with interim results. I think this is going to be a matter of necessity from the point of view of outside directors as well as from the point of view of regulatory agencies and stockholders. The responsibilities of outside directors are reaching the point where they cannot simply sit back and automatically accept the interim reports of management for which they have responsibility

without at least asking professionals to take a prepublication look at them; the criteria for such a review still have to be worked out. The American Institute of Certified Public Accountants' Auditing Standards Executive Committee must obviously work to try to develop standards which are on the one hand handleable from the economic point of view, while at the same time reflecting the public need in this regard. The Commission has taken a first step toward requiring auditor association with certain interim results by requiring that an auditor publicly report on the validity of the accounting methods involved any time a material unusual charge or credit to income is made.

Lease Accounting

I would like to turn next to the specific topic of lease accounting on which I was advertised to speak, so that you will not feel that any Truth in Labeling problems exist. This is a topic of considerable importance in accounting theory and obviously one which impacts very heavily upon the utility industry in general since leases have been used increasingly in this industry over a period of time.

The first statement that I would like to make in regard to leasing is that I am not against it. The SEC is not against it. We have no brief for trying to reduce the amount of leasing in the economy. We believe that leases are a useful financing device. The legal arrangements implicit or explicit in their use may add flexibility to a financing package. They may enable a shifting of tax obligations in such a fashion as to reduce overall cost of financing. They may perform a number of other functions. In addition, the sharing of ownership risks, which exists in some leases, may permit alternative mixes of risk and return among investors with different preferences, and hence enable people to tap a more extensive financing market. So we believe leases have a very significant role to play and we are not attempting to reduce or eliminate the use of leases in any sense.

Equally important, however, we do not think that leases should be made attractive beyond their true economic advantages simply because they are not properly accounted for. A part of the huge growth of leasing in recent years can be attributed to a lower capital cost

resulting from factors of this sort. In the first place some people are fooled because financing is not shown on the face of the financial statements. Poor footnote disclosure has not permitted even the sophisticated investor to make accurate economic evaluations of the capital structure of firms. And in addition, leasing has had the impact of increasing reported income in the early years of a project by straight-lining interest which is not in conformity with generally accepted accounting principles. To the extent that leasing's growth is a function of these factors, we believe it constitutes an inefficient capital raising technique in the broad sense in terms of its impact on capital markets. We believe this is not desirable, even though these advantages may be very real for the individual firm. If the amount of capital available in the capital market is limited, it does not seem desirable that artificial biases be inserted in the capital allocation process through accounting aberrations.

Perhaps we should look and see why accounting has, to a very significant extent, failed in its attempt to describe lease transactions in a realistic fashion. In the first place we have to look at the basic accounting model. The fundamental model was originally designed for and still is best applied to the simple trading enterprise. It describes the operations of a corner grocery store very well. The real world, however, is complex, and therefore a very simple trading model cannot describe it in its full complexity. There are two possible answers to this. Either the model must be changed and increased in its complexity or else the real world must be analogized to the hypothetical simple world of the model.

Occasionally accountants have used the first approach of making the model more complex. APB Opinion No. 15 on the subject of earnings per share is an example of this approach. And that did provide employment for more accountants, so I wouldn't say it is necessarily bad. But in the more common case, the real world is analogized to the simple world of the accounting model. When we analogize we tend to do so by relating complex transactions to the simple transaction which is most familiar to us. In the case of leasing, I guess the phenomenon that most touches our lives is the rent we pay when we rent an apartment or rent living space or office space, or whatever. Accordingly, we say: "Well, that's where leases tough

our lives and therefore leases must just be like renting space as we do it in our own life.” This is a clear case of the wrong analogy. Anyone who has worked through a typical leveraged lease deal will surely recognize that we have moved far from the renting that affects our daily lives. And yet the accountant does not move much beyond. His idea is to say that if it is a lease payment it is rent, and rent is rent.

The APB’s answer - - ABP Opinion 5 - - drawn up in a time when leasing was far less prevalent, did not deal with the problem effectively. This was not the result of lack of spirit on the part of the APB; in fact, if you read that opinion one way you can find it is a very strong opinion. It is said that a large proportion of the more than two-thirds majority that voted for this opinion believed they were voting for a strong opinion, whereas another part of the majority was aware that they had built in a large loophole (in the concept of building up equity) which could be exploited to obtain a result quite inconsistent with the overall theory of APB Opinion 5. It is therefore not surprising that the overall principles of APB Opinion 5 have eroded through a series of interpretations hanging mostly on the question of whether or not a stream of payments builds up an equity in the property.

At the present time it is apparent that lease accounting is inconsistent with the SEC’s objective of an efficient capital market. Certain suppliers of capital are at an unfair advantage. As a result, other capital suppliers, knowing this unfair advantage, have rushed in trying to exploit an accounting loophole to create lessors where there are no lessors and leases where there are no leases, in order to maintain a reasonable competitive position in the financing world. And this is understandable. If I were in their position I would do it as well.

In addition, investors are not being told the full story. They are therefore allocating funds without adequate reward in some circumstances. If on the basis of realistic economic data investors would require a greater return on capital, it is not desirable to coax them into an investment on the basis of defective measurements. I have heard from Capitol Hill, and from others, the argument that showing the truth would cause higher costs of power, transportation, or what have you. I believe in the first place that it is highly doubtful this is the case. In the second

place I don't believe this is adequate justification either morally or economically for falsehood in financial statements. It is not fair that consumers should profit from the ill-informed investor.

The question then is: What should be done? And here SEC has what might be called a three-part program which we are currently executing. In the first place, we have referred the basic measurement problem to the FASB for expeditious action. We have done this and they have put the item on their first agenda and are working actively on it. In this connection it is clear they have to look first at the balance sheet treatment of leases and leased assets; second, at the problem of straight-lining interest cost as opposed to charging interest on outstanding balances, which is probably the most significant accounting problem, as that hits at the income statement where people feel most strongly involved. Finally, the Board will have to look at the problem of the definition of a lease so that a lease will include items which differ in form but not in substance. It would be foolish to develop a beautiful opinion on leasing which lawyers can circumvent by creation of a few additional words that will convert a lease into a heat supply contract, a take-or-pay agreement or some other similar device. It may be that in developing a comprehensive definition of a lease, the Board will have to consider the entire issue of executory contracts.

The SEC has in prior years expressed a staff view to the APB that in our judgment current accounting for leasing is totally unsatisfactory and some means must be found for reporting on the financial statements assets and liabilities which exist in a very real economic sense. We doubt that the view that we will express to the FASB will be very different from this. However, we do not have definitive judgments how this should be done, what should be done with the interest cost problem, or how the problem should be bounded to include more or less executory contracts. There are many issues on which the SEC staff has taken no position even informally.

The second part of our program is to hold the fort against additional deterioration of APB Opinion 5. In Accounting Series Release 132 we identified one source of deterioration- - lessors without economic substance. We will be further interpreting ASR 132 in the very near future to

deal with the problems of what is substance and perhaps to look at other criteria. At the present time we have a series of guidelines which we are using internally to analyze lease transactions to determine which will qualify for noncapitalization. In order to keep a lease off the balance sheet at the present, the first criterion is that the lessee must agree to nothing beyond a commitment to make lease payments. No guarantees, no acceleration clauses, no other devices which make the stream of lease payments take on the characteristics of debts. In the second place the lessor must have substance. Either it must be a bona fide leasing company with significant capital, a variety of clients, a real operation, or if it is not a bona fide leasing company but an entity created for this purpose, it must have substantial equity capital, where 15 percent is a rule of thumb that has been accepted in normal cases. So the lessee must agree to nothing beyond lease payments and the lessor must have substance. Third, the lessor's capital must be at risk. This can either be done through a guarantee, if the lessor creates a subsidiary to be the actual legal lessor, or by putting its own capital at risk. If the lease deal is 100 percent financed without risk, the lessor is merely a conduit between the lessee and the lender and the "lease" would not therefore qualify for lease treatment on the financial statements.

As I indicated, we view these guidelines as primarily a holding action and we hope that the FASB will move expeditiously to consider this problem so as to remove uncertainties which exist today. In the meantime, the staff does not intend to spend its efforts on additional interpretations beyond the general guidelines it has developed. Registrants and their independent accountants will have to make judgments about individual transactions.

The third part of our program is to improve disclosure rules for leases at the present time. The APB as you know had an exposure draft opinion outstanding which was going to require substantial additional disclosure of the effect of leases on financial statements, including the present value of lease commitments. We thought this was a good step; we were sorry to see it dropped. It seems likely that in the near future the SEC will propose a similar requirement, as an amendment to Regulation S-X. The principal omission in the APB exposure draft was disclosure of the impact on income of treating financial leases as a lease rather than as debt and our

proposal may include some requirements along these lines.¹ We are very hopeful that by the time 1973 accounts are prepared, disclosure will be significantly improved. And by the time 1974 accounts are out, measurement will be fully consistent with economic reality.

Allowance for Funds Used During Construction

I would like to just touch upon briefly one other area that is of particular interest to you gentlemen, although there is by no means time to talk about it extensively. This is the area of Allowance for Funds Used During Construction (AFC). Here I want merely to indicate our present thinking as to what constitutes necessary disclosure in this area and why we think that way.

At the present time we are asking utilities to disclose in a note to their income statement the amount of AFC that represents return on equity and the percentage of net income that that represents. We recognize in so doing that there are imperfections in measurement techniques used to determine how much of an overall allowance does represent return on equity. We are confident that you gentlemen, the Federal Power Commission (FPC), and your accountants will be able to overcome these measurement problems with appropriate incentives and we expect that you will do so. FPC is, of course, at the present time considering additional guidelines in this area through rule making.

The basic reason why we are asking this is a simple one. Basically, capitalizing a return on equity is inconsistent with the accounting model as it is generally used in industry. We account for equity as a residual; to credit a return on equity invested to current income is anticipating income in the traditional accounting sense. In other words, when one says that by the act of investing his equity capital he earns a return which should be reflected in income as invested, he is anticipating the return and this is not consistent with the conventional accounting model which does not permit the anticipation of income. The accountant would normally say

¹ See Securities Act Release No. 5401 for this proposal which calls for the disclosure discussed. Subsequently, the APB issued an opinion which represented a dilution of its previous proposal discussed above.

that income is only earned when revenues flow from the assets created by the investment of capital. To say that utility accounting for return on equity funds invested is inconsistent with the traditional accounting model does not say it is not reasonable in the economic sense. When you add rate base you add economic value and it may well be that the certainty in rate making is sufficient to justify the recognition of such value in financial statements.

I have also heard arguments justifying this utility accounting on the basis of the stability of earnings it creates. It is said that by accruing a return on equity a utility can report a more realistic stable pattern of earnings. This, however, is a bootstrap argument because the accounting device creates the stable earnings rather than reflecting operating stability.

I should reassure you that in the AFC area we are not trying to change accounting practice. We are not planning to eliminate AFC or amend it significantly. We are not trying to downgrade it in terms of the quality of earnings, because we think the utility industry is different, and that there are legitimate justifications for accounting in this fashion. We do believe, however, that the investor is entitled to know the dimensions of this significant difference between the conventional accounting model and the accounting model used in this industry. And this is the rationale for our requirements that there be disclosure of both the amount of allowance for equity funds used and the proportion that such amount represents of reported net income.

Conclusion

In conclusion, I think it is fair to say that we recognize that the utility industry has unique and difficult problems at the present time. These are both operational problems and problems in the accounting area. We believe that accounting should not hide nor should it unreasonably accentuate operational problems. SEC cannot allow investors to be attracted to utility investments because financial statements do not tell the full story. But we are sympathetic to the problems of the utility industry, and we want your inputs- -we welcome them, either through the organizations represented here or through individual companies, and interested individuals. In the final analysis, our goal is congruent with yours- -an efficient capital market in which resources will be attracted to meet the needs of society.