NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

FOR RELEASE: 1:30 P.M. EST THURSDAY, MAY 31, 1979

FINANCIAL REPORTING IN A CHANGING ECONOMIC ENVIRONMENT

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FASB Conference on Financial
Reporting and Changing Prices
New York, New York

May 31, 1979

I appreciate the opportunity to participate in this conference. That having been said, however, I would like to take the liberty of revising your agenda somewhat. While the official discussion topic today is inflation and changing prices, in my judgment the real agenda for the conference should be the need for, and the ability of, the profession and the corporate community to address, in a timely, meaningful, and effective manner, the problems of financial reporting in a changing economic environment. That issue is neither so abstract nor academic as it may sound. There is an enormous and growing perception and credibility gap between financial reporting and economic reality. The impact of inflation on traditional accounting conventions is one important symptom of that gap -- it is, however, the underlying ailment and not merely the symptoms which demand our attention.

For that reason, my theme this afternoon transcends the issue of inflation accounting. Simply stated, it is that we are at a critical period in assessing the ability of the private sector to move responsibly in addressing the financial reporting issues that confront us today. We need to assure that we have constructive and effective processes through which changes in accounting principles will occur promptly as the needs arise and as the product of both informed experimentation and the best thinking available. That task will require the FASB to continue its efforts to provide leadership -- not merely consensus building -- and will require that the members of the accounting profession and the corporate community encourage the board to provide that leadership, support the Board's decisions -- even when a particular decision has an adverse impact on the financial results of a particular company -- and join more actively in the process of innovation and experimentation which provides the raw material for meaningful decision-making. In my view, the future vitality of the private standard setting process hangs in the balance.

Fostering the FASB's leadership role during a period of economic uncertainty and change will not be as easy as it may sound in principle. In both the accounting profession and the corporate community, potent forces exist which oppose any serious rethinking of traditional accounting conventions -- even at the expense of the relevancy of the financial data which those conventions yield. For example, the argument most frequently voiced against disclosure of more relevant data is that it would sacrifice the existing objectively verifiable basis for primary financial statements. This notion of recognizing only so-called "hard" data is deeply engrained in both accountants and accounting literature. Auditors particularly champion this view out of a concern, I suppose, that the data with which they associate themselves be limited to that which is susceptible to objective measurements. The very real risks of monetary liability which have become a daily fact of life in the auditing profession make this attitude quite understandable. Yet, dogmatic adherence to this concept prevents effective consideration and response to the resulting disclosure inadequacies in a changing economic climate. When the consequence of adherence to the familiar threatens to be that issuers and accountants are producing a product which is useless to the users of financial information, a fundamental reconsideration is obviously in order.

Those within the accounting profession who resist change are not without allies in the corporate sector. Any accounting principle that, in attempting to reflect the economic substance of events and transactions, leads to increased volatility and less predictability of earnings performance is typically opposed in the corporate community. While managements couch their concerns in terms of the evils of uncertainty and unreliability, their basic motivation may be that new approaches would not put as favorable a face on corporate financial results and would make it more difficult to maintain an orderly and predictable pattern of earnings growth.

The academic community also has done little to discharge its role of analyzing and criticizing its brethren in the practicing community. By contrast, in many other professions, the impetus for experimentation, change, and development originates on campus.

Finally, the Commission is not without blame. Until recently, the agency has made its own contribution to maintaining the status quo by its long-established insistence that only "hard" historic-based information be part of formal public disclosure and by more subtle attitudes which discourage experimentation with novel accounting and disclosure techniques. An aggressive enforcement posture has, I suspect, also served to reinforce corporate and professional conservatism.

All of these conditions suggest powerful drags restraining change and favoring the status quo -- including even a constituency which advocates communicating information that is substantially at odds with economic reality. These conditions also suggest that the private sector process may be inadequate to the task of self-correction. If that process is to endure and be effective, experimentation and leadership are essential -- but "followership" which is not subordinated to self-interest is necessary as well. While the private sector has demonstrated the ability -- often slow and reluctant -- to be responsive on accounting matters, it has done so largely in reaction to external prodding. In my judgment, it is essential that this pattern change.

In the balance of my remarks this afternoon, I would like to relate this need for more aggressive leadership within the profession -- and more enlightened "followership" in the profession and the corporate community -- to the current priorities of the FASB. The logical starting point is the most basic task confronting the Board -- the Conceptual Framework Project.

Conceptual Framework Project

The utility of financial disclosure is obviously no better than the accounting principles on which it is based, and the Board has recognized this fact in structuring its Conceptual Framework Project. The Project to be successful, must lead to the creation of a set of principles which can serve to guide the profession as it seeks to develop and refine disclosure principles and methodology which will serve the needs of users of financial information in a constantly changing economic environment. It is a safe prediction that, during the coming decades, the economic, political, and technological changes in the world -- and their impact on the nature and methods of American business -- will be enormous. The accounting profession must have a conceptual framework adequate to guide future developments. It also is a safe prediction that such a framework will never be the product of consensus.

The FASB has made important progress with its Conceptual Framework Project to date. Further, timely action is essential. Let me illustrate what I consider to be the basic obstacle to that progress. Until very recently, the focus of financial disclosure has been much too heavily on what I would call the "all or nothing" approach. That is, information not perceived as being part of traditional, historical cost financial statements generally has been regarded as wholly outside the discipline of accounting. The result has been that such information has received inadequate attention, regardless of its utility, from either the practicing or academic sides of the profession. And, correspondingly, disclosures called for by users, which are "financial" in nature -- such as segment information and foreign currency translation -- have been forced into the mold of the financial statements, even where the information involved does not fall squarely within traditional financial statement concepts.

The Board's recognition that the accountant's domain can extend to information outside the four corners of the balance sheet or income statement may alleviate many of the anomalies and misunderstandings which the "all-or-nothing" approach has engendered. The broader area of financial reporting provides an appropriate frame of reference within which to grapple with conceptual problems. And, the FASB's recognition that the financial statements are only one element in the complex of financial disclosure is an essential exercise in leadership. Such an approach provides management with the opportunity to distinguish between objectively measurable results typically presented in financial statements and other information which may be equally meaningful to users, but less precise. Further, this expanded perspective also should encourage the auditor to lend the credibility of his independent expertise to useful, but nontraditional, data of this nature.

I said a moment ago that the "all-or-nothing" syndrome was a basic issue. There is, however, a second, related issue. We need also to rethink the objectives of individual financial statements. For example, the objective of the present income statement is difficult to define. It does not reflect merely results of an entity's day-to-day operations. On the other hand, it is obviously something less than a comprehensive picture of changes in the shareholders' equity in the venture -- that is, the current, real dollar gain or loss which the entity has experienced. The point is that our rethinking may have to begin with the concept of net income itself, and whether that concept, as we know it today, has outlived its usefulness.

While I am not suggesting that we abandon our current historical cost model -- for much can be done through supplemental data -- a logical next step in expanding upon the objectives of financial reporting would be to define the objectives of individual financial statements. For example, should the primary financial statements reflect only transactions with outside parties, with the balance of the information concerning earnings reflected outside the basic financial statements? Should a financial reporting system provide a statement showing management's view of a company's current earning power or should it simply provide sufficient information for a user to make such an evaluation himself? Where do foreign currency translations, accounting for the effects of changing prices, or reserve recognition accounting fit into the model being developed?

One possible approach might be to provide for a two-part income statement that reflects both operations and adjustments thereto to determine "real income" in a broader sense. Such an approach might provide for foreign currency translation and effects of changing prices in the latter part of the statement. Another obvious alternative might be to reflect these types of items directly in a statement of equity. Other approaches might include the presentation of a fourth statement to disclose such items or supplemental disclosure of the appropriate information.

It is my conviction that many of the problems we experience with issues such as FAS Nos. 5 and 8, accounting for interest costs, and lease accounting, stem from the absence of the kind of definitional understanding that a conceptual framework would provide.

The current state of affairs in financial reporting of oil and gas companies is a reflection of the dynamics I have been describing. I am confident that the efforts to develop reserve recognition accounting would benefit from the existence of a conceptual framework. Indeed, the existence of a conceptual framework might have provided the type of guidance that would have stimulated experimentation and thinking in this area, as a result of which we might be in a different place today than we are. The Commission, in the process of developing the concept of reserve recognition accounting, will, of necessity, have to deal with conceptual framework-type issues if they have not, by then, been resolved.

Also to be considered in the context of the Conceptual Framework Project are the potential benefits of auditor association with additional financial information. The inevitable future expansion of accounting standards into the broader area of financial reporting will necessitate redefinition of the appropriate level of auditor association with supplemental information.

I am not suggesting today specific answers to these questions. However, I do want to emphasize the need to address the underlying issues within the overall consideration of the conceptual framework.

Accounting for Inflation and Changing Prices

I do not intend by my discussion of the conceptual framework to suggest that other important efforts, such as accounting for inflation and changing prices, should await further development of that effort. As I have said on numerous previous occasions, accounting for the effects of inflation and changing prices is one of the most important issues facing the FASB, the profession, the business community, and, indeed, the general public. If you wish to test the validity of that assertion, you need only consider the continuing debate concerning whether corporate profits are -- during a time when efforts to curb inflation occupy center stage -- unduly high.

A little background may help to put the issue in perspective. The decade of the 1970s has been characterized by rates of inflation far above historical norms, at times exceeding 10 percent annually. For many companies and industries, specific price changes have been even steeper. Although there has been much discussion of the limitations of the historical cost accounting model in such a period of rising prices, specific attempts to deal with the problem have been few and coolly received. Yet it has become increasingly clear that some method of reflecting the effects of changing prices is essential.

In 1978, U.S. nonfinancial corporations reported record earnings of $167.1 billion before taxes and $98.6 billion after. Studies have shown, however, that if profits were adjusted for depreciation recomputed based on the current-cost, double declining balance method and for inventory consumption charges, 1978 after-tax profits of nonfinancial companies would shrink to some $56.5 billion -- only about 60 percent of the figure reported. The economic reality of an inflationary environment is that much of American business is not generating and retaining sufficient funds to replace existing capacity and to maintain the present level of operations -- let alone expand and invest in improved productivity.

Some businesses are actually paying dividends out of capital. A recent New York Times article pointed out that corporate dividends are rising more rapidly than the rate of inflation. While such news may be encouraging to some, it seems to me to add another dimension to the problem. The tendency is for corporate dividend rates to be set at a percentage of after-tax income; for individual investors to anticipate increases in dividends as earnings grow; and for equities today to sell on a yield basis. Unfortunately, all of these conditions create pressures for increases in dividends beyond what makes good economic sense in the context of the long-term interests and capital requirements of many American corporations.

Conflicting reports, of record profits on the one hand and inadequate earnings to maintain and expand capacity on the other, serve only to confuse the public and political leaders. Further, they raise questions about the integrity of financial reporting. The Administration's recent attack on corporate profits has been described as a reminder to corporate managers of "the price business pays for reporting inflated profits." A recent _Business Week_ article summed up the situation by stating that "fully one-third of the earnings that companies reported for 1978 were an illusion--gains created by inflation and out of date accounting methods." Unfortunately, however, daily press reports of record earnings fail to communicate the effects of changing prices in a meaningful way, and thus the confusion and conflicting claims are likely to continue -- with corporations complaining that profits are too low, while the public, labor unions, and some parts of the government respond that profits are excessive. In such a conflict, business, serving up the weapons for its own destruction, is clearly and predictably the loser.

The accounting profession and the business community are running out of time in which to develop meaningful solutions to this problem. It should be a source of embarrassment to both, as it is to me, that after a decade during which inflation has been recognized as a serious problem, greater progress has not been made in explaining its effect on corporate income. The reluctance to experiment with new ideas and to accept the need for new approaches must be overcome if the credibility of financial reporting is to be maintained.

The FASB's recent exposure draft on "Financial Reporting and Changing Prices" offers significant potential for meaningful progress. I therefore am most disappointed with the tenor of many of the responses to the FASB proposal. They are primarily negative and self-serving -- the same criticisms I have heard for years. They also seem calculated to ensure that the status quo will be maintained and that the problem will remain unsolved. While it is not certain that all the data to be provided will be useful -- and it can be confusing -- the FASB action is an essential step if progress is to be made in dealing with the effects of inflation and changing prices on the relevancy of financial information.

Several commentators urge the FASB not to require any particular information and to allow for more experimentation. I wonder, however, why one should believe that experimentation in lieu of imposing requirements would be more productive today than it has been over the past decade. Conversely, what is there that would prevent experimentation beyond the parameters of requirements that reflect the best thinking and the state of the art today? I see nothing that should prevent a reporting company from supplementing required disclosure in order to better reflect the impact of inflation and changing prices on the corporation if the objective really is a more fair presentation. Perhaps, as suggested by the AICPA Task Force on Conceptual Framework for Accounting and Reporting, both methods should be required. Perhaps reporting companies should be encouraged to augment those disclosures with constructive quantitative and qualitative analysis which would improve the ability of the users of the information to assess the impact of inflation and changing prices on the corporation and make relevant comparisons.

Such a response would, for example, have been a much more constructive reaction to the requirements of ASR 190 than the disclaimers concerning this disclosure that appeared in many annual reports. Unfortunately, too many companies failed to disclose replacement cost information in their annual reports to shareholders, arguing instead that it did not present a fair picture of the company's financial condition. It would have been far more constructive for them to have disclosed it in their annual reports and used the opportunity to augment the required information with whatever additional information or analysis they believed would help provide a fairer picture.

Unfortunately, critics of the FASB exposure draft have tended to focus on the problems the proposed methods would present for them, rather than on the needs of users and the public at large to understand the effects of inflation and on the more profound long-term corporate self-interest served by closing the credibility gap.

A fundamental fact in developing an accounting approach to the problem of changing prices is that the general rate of inflation is not necessarily the same as the impact of price changes on a particular company or industry. Prices change for a variety of reasons other than inflation. If the objective is to measure only the general impact of inflation on business entities, then a general purchasing power or constant dollar approach might suffice. Many accountants and economists have considered inflation accounting only from this perspective. But most users of financial information have questioned whether the data generated by such an approach has sufficient practical utility. It may not, and often does not, adequately portray specific price effects on companies or industries. Therefore, it does not assist investors in assessing or projecting future cash flows or dividend-paying capacity -- important objectives of financial reporting as set forth in the FASB's Statement of Financial Accounting Concepts No. 1.

The FASB exposure draft offers "guidelines" by which companies would choose between the current cost and the historical cost/constant dollar approaches. There appear to be considerable differences in how readers have interpreted the degree of choice that these guidelines provide. Some have argued that the general emphasis throughout the proposed

Statement is that the reporting requirements be flexible in order that experimentation be encouraged. This would suggest that companies would be allowed to report historical cost/ constant dollar information even though the guidelines would appear to specify the current cost approach and even though other companies in similar circumstances might report current cost information. If this degree of latitude does exist in applying the guidelines, then I believe that the Board should consider narrowing it. Unfortunately, too many companies might choose to report only constant dollar adjusted information, simply because it is easier to prepare or the results look better, even though such information does not adequately reflect the effect of changing prices on the enterprise. For any company having a significant investment in inventories and property, plant and equipment, it is difficult to see how the constant dollar approach would constitute meaningful reporting over any period of time.

The concept of presenting a five-year comparative summary of selected financial data is an interesting and progressive aspect of the FASB proposal. Such a summary would provide useful information to investors and others concerning the impact of changing prices on a company's results of operations and financial position over time.

The Commission and its staff will be following the Board's deliberations on the proposed Statement with great interest. We need to make substantial progress and make it now. The Commission deferred last year and determined to delay re-examination and expansion of the requirements of ASR 190 so as not to conflict with the Board's consideration of these issues. While the Commission will consider amending or rescinding ASR 190, if an acceptable final Statement is adopted, we would not look positively at the loss of another year. To assume the initiative on this all-important project, we expect that, much as in a relay race, the receiver of the baton will be moving at a rate of speed at least comparable to that of the passer. We are not closed-minded as to approach, and we recognize that we may need to consider safe harbors to encourage experimentation, but we are not flexible as to the need for progress.

Conclusion

If the initiative for standard setting is to remain in the private sector, then the profession and the corporate community must encourage and support the FASB in assuming initiative and leadership in the establishment of standards and be committed to accepting the judgment of the FASB in establishing standards -- whether or not they have a positive or negative effect on the reporting company and whether or not they fully agree. No standard worth its salt will make all companies look better; and no important standard can possibly be designed without having some adverse effect and without, in all likelihood, requiring modification at a later date.

We are all "experts" in matters of accounting. It is too easy to be critical of the FASB. It also is too easy to pay lip service to the concept of private sector leadership -- only to see the concept fail at implementation and its supporting coalition fall apart when individual views do not prevail or self-interest is adversely affected. We are today addressing not only the next phase in the development of accounting principles for inflation and changing prices, but also the future of private sector standard setting. If you care to preserve it as much as we at the Commission do, it must be demonstrated by your affirmative actions, not by inaction on the part of the Commission.