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THE FASB CONCEPTUAL FRAMEWORK PROJECT: A SILENT REVOLUTION

An Address by

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As many in this room are undoubtedly aware, there are signs around us that accountants may be standing today on the threshhold of dramatic change. For many years, there has been a widespread tendency to regard accounting as an arcane subject with little readily discernible importance outside the confines of corporate board rooms or the halls of the Internal Revenue Service. That era of relative obscurity and misunderstanding is, I believe, coming rapidly to an end. The problems and changing expectations confronting accountants were well-aired during the extensive public hearings examining the profession recently held before a Senate subcommittee chaired by Lee Metcalf. Congressman John Moss has indicated that he may continue this process of public examination. The picture which those involved will draw of the profession is not yet clear. At one extreme, the Metcalf subcommittee staff report in several places links the present structure of the profession and its standard-setting mechanisms to "revelations of wrongdoing by publicly-owned corporations" and "[u]nexpected failures of major corporations" and suggests that, in many ways, the profession should come under close federal control and direction. This recommendation is one in which I personally do not join and which, I believe, can be avoided by positive and meaningful initiative within the profession itself. In any event, however, in response to both internal and external questions and criticisms, accountants are now in the midst of a re-examination and restructuring which will almost certainly result in a profession which, 5 years from now, is governed and practiced in a fashion different from that familiar to accountants today.

One of the important -- possibly the most important -- of these new changes facing the profession is also the least overtly dramatic -- the FASB's conceptual framework project. I suppose that in the minds of many people -- including even some businessmen and government leaders -- the idea of an exercise aimed at defining the nature and function of accounting embodies the type of abstract theorizing best left to those who are not actually responsible for meeting a payroll or guiding the national economy. I know that most of you here understand that this view is far from accurate and that the conventions and assumptions underlying financial reporting have consequences which are at once subtle and profound in their impact on our economy and our society. I would, however, like to spend a few minutes this evening outlining some of the important implications which I see inherent in the conceptual framework project. I want particularly to focus on one example of an area in which accounting principles can have far-reaching consequences for our economic future -- the interrelationship between accounting and inflation and the effects of each on capital formation. From the viewpoint of the vitality of our economy, the interplay between those factors should be kept firmly in mind as the conceptual framework project progresses.

My point, simply stated, is this: The conceptual framework project must address squarely the need for financial reporting to mirror economic reality. This does not mean that accounting based on historical costs must be discarded nor does it mean that the new methodology necessary to bring financial reporting closer to an economic picture of business operations should be agreed upon as part of the conceptual framework. On the contrary, I visualize the process of developing the reporting techniques necessary to implement the goals of the conceptual framework statement as an evolutionary process which may span many years. I do believe, however, that, if the project does not result in a framework within which financial reporting can come to grips with economic realities, then the project will bear a very heavy burden of self-justification.

Financial Reporting and Economic Reality

The increasingly close public and political scrutiny which is being directed at the accounting profession is, I suppose, only an element in a much broader re-examination of the role of business in our society. During the past 10 or 15 years, the public has come to demand more and more that business discharge obligations which might, in some sense, be thought of as social rather than purely economic -- the protection of the air, water, and the other facets of the natural environment; the promotion of occupational safety; the implementation of the national policy of equality of employment opportunity; and similar objectives might fall in this category. In the long run, of course, it may be difficult or impossible meaningfully to separate the economic components of each from the social components. In any event, these new factors are now as real a part of the equation of business responsibility as are the more traditional goals of providing employment and a source of livelihood for our workforce and of producing the goods and services necessary to satisfy a rising level of expectations with respect to the standard of living.

Thus, as a society, we are placing increased demands on our private enterprise system in striving to reach national objectives as important and as diverse as full employment, energy independence, and environmental protection. The problem of marshalling sufficient capital in order that business may discharge its role in accomplishing these goals is a serious one. Unfortunately, however, the effects of inflation upon the present methods of reporting business performance obscure the increasingly pressing need to bring forth additional capital and, indeed, may lull us — as government policy-makers, as decision-makers in private business, and as individual citizens — into a belief that corporations are generating more than adequate funds to satisfy our demands for capital.

This problem is an important and serious one, and, in my judgment, one which hignlights the economic and behaviorial impacts flowing from the principles on which our accounting system rests. I do not mean to suggest that consideration of the need to stimulate capital formation leads me to the conclusion that historical cost should be discarded in favor of conversion to an accounting system premised purely on current-cost assumptions. On the contrary, I have some very serious reservations about the kinds of judgmental or subjective decisions which would be injected into financial reporting by such a system. And current-cost basis accounting would undoubtedly produce its own distortions -- distortions which might well be more severe and damaging than those which flow from historical accounting. I do believe, however, that a review of the interplay between financial reporting, inflation, and capital formation strongly suggests that the conventions and assumptions underlying accounting must leave room for -- and indeed must demand -- disclosure of the impact of inflation. To ignore these economy wide consequences of financial reporting would seriously handicap business's ability to deal with our economic future.

In my view, we are, as a nation, facing a crisis in business's ability to earn the profits necessary to generate capital needed for accomplishing the national goals I have outlined. I have addressed the economic dimensions of this capital formation crisis on other occasions and will only summarize them now. Without necessarily adapting either his conclusions or his methodology in their entirety, I find very thought-provoking the approach to this problem which appears in economist George Terborgh's study prepared under the auspices of the Machinery and Allied Products Institute. Terborgh's analysis deals statistically with corporate profits, the impact of inflation on those profits, and the ability of earnings to generate the new capital required by industry Take as an example the year 1976. That year saw the highest corporate earnings in history -- reported after-tax profits of $77 billion. Terborgh performed two adjustments in order to convert those earnings to a figure which, he believes, more closely represents the real purchasing power generated from business operations. First, he recomputed earnings based on current-cost, double-declining balance depreciation. The objective of this step was to charge against earnings a figure which, in Terborgh's view, more accurately reflects both the manner in which capital equipment is consumed and the cost, in inflated, current dollars, of replacing it. Second, Terborgh endeavored to convert inventory consumption charges, as reflected in the cost of goods sold, from historical to current costs. Net of these adjustments, 1976 aftertax profits shrank to $43 billion, only a little more than half the $77 billion figure reported.

Terborgh also directed his attention to the share of its profits which business retains after dividends as a source of capital for re-investment. He found that annual retained earnings, adjusted as described above and converted to constant 1972 dollars, fell from $27 billion in 1965 to $7.9 billion in 1976, a drop of around 70%. Terborgh's analysis produces a $13.3 billion dollar <u>deficit</u> after dividends for 1974 alone. His study also suggests that, while there were net additions to adjusted retained earnings in 1975 and 1976, those additions were insufficient to offset the 1974 deficit. Thus, over the most recent 3-year period for which figures are available -- 1974 to 1976 -- business has, in effect, apparently paid its dividends out of capital.

The effect of this effort to adjust corporate earnings for inflation is even more startling from the perspective of federal tax policy.

Terborgh points out that, in 1965, the effective tax rate was about 42 percent, whether computed on the basis of reported profits or on profits as he adjusts them to reflect inflation. In 1974 and 1976, for example, the effective rate on reported earnings — that is earnings computed on the basis of traditional accounting assumptions — was still essentially the same 42%. However, if actual tax liability is compared to pre-tax profits adjusted, as described above, for inflation-based under-depreciation and inventory gains, a much different picture emerges: In 1976, the effective tax was 56%, while in 1974 it was a shocking 80%. Thus, Terborgh's approach suggests that inflation, and the failure of the tax system to recognize its distortion of corporate profits have resulted, in effect, in tax increases which have gyrated as high as nearly 100% over the apparent effective rate during the last decade. These increases have, as I have observed in other speeches, been accomplished without Congressional action of any sort and, consequently, with no opportunity for debate over the effects on capital formation — a debate which would certainly occur if a legislative doubling of the corporate tax rate were proposed. Indeed, these figures make a case for the proposition that discussion of adjustments in the legal rate of taxation is almost meaningless if it is not premised on a recognition of the impact of inflation.

Terborgh draws these conclusions from his study:

> "[T]he present situation is bad not only for business, but for the nation as a whole. Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is vital that they be large enough not

> only to motivate the expansion of productive investment, but to finance a substantial part of it. * * * [T]he Alice-in-Wonderland accounting of costs and profits that now passes for orthodoxy is a problem not only for business management, but for the accounting profession, the regulatory agencies of the government, and, not least, for the tax authorities. It is high time for concerted action by all concerned."

<u>The Impact of Financial Reporting</u>

This kind of analysis suggests at least two things. First, rather than earning disturbingly high profits as is often assumed, American business as a whole is not accumulating and retaining the resources required to meet the challenges facing it. In short, corporate profits are not high enough. Second, the financial reporting system through which investors, businessmen, government policymakers, and the general public view business profits obscures the dimensions of this crisis.

In relating his work to the conceptual framework project, I will draw once again from Terborgh's own statistics. His figures show that, in 1965, before inflation acquired its present momentum, after-tax profits, as reported according to conventional accounting methods, and after-tax profits net of the adjustments I have described, were virtually identical. In 1974, on the other hand, if Terborgh's assumptions are adopted, inflation-adjusted profits were one-sixth of reported profits; in 1976 they were about 56%. This, I think, suggests -- not that accounting based solely on historical costs is illogical or unsound --

but simply that the business environment in which it evolved as the sole touchstone has undergone a significant change.

The implications of financial reporting which reflects any divergence from the business realities with which the users of financial information must deal spread throughout our economic system. For example, the undependable nature of reporting earnings — that is, profit figures presented without the benefit of at least some guide to the impact of inflation on those earnings — can subtly affect confidence in the securities markets. To the extent that the investor doubts the relevance of reporting earnings, he will be less confident in his investment judgments and less likely to discern any rational basis for movements in stock prices. Institutional investors may have access to data which permits them to compensate. But, when reported financial data is not a reliable guide to the economic position of the issuer of securities, the small, private investor may be reluctant to participate in the equity market.

Ironically, however, the impact upon securities prices may be the least serious of the consequences. There is a growing body of research suggesting that the stock market is more efficient in reflecting economic realities than had traditionally been assumed. Consider, for example, that the current average price-earnings ratio of the companies composing the Dow Jones industrial average is around 10. A recent study by one investment research organization indicates, however, that, if depreciation based on replacement cost is considered in computing earnings, the aggregate P/E ratio of the Dow rises to almost 34. It might be argued from this that the market, in pricing securities, reflects the magnitude of corporate profits in terms of real purchasing power to a considerable degree. Indeed, a P/E ratio of 34 would suggest that — rather than being depressed -- the stock market is, at present, unrealistically high. Considerations such as these lead me to believe that claims such as that the elimination of a particular choice of accounting methods will impair the ability of those in a given industry to raise capital may well be overstated. Inconsistencies and lack of comparability between similar companies may well confuse investors much more than does the impact on financial statments of curbing some of the existing reporting alternatives. We should continue to gather empirical information about the way in which the market responds to the bottom line on an imcome statement.

In any case, however, the effect of a theory of accounting which looks only to past, rather than current, costs may be greater on businessmen themselves than on investors. Corporate directors and managers, in estimating their capital needs, the internally-generated capital available, and the projected returns from proposed investments, may be relying on an information system which depends on historical costs and ignores the present -- and future -- impacts of inflation. Where the defects in available information are perceived, but more realistic substitutes are not available, decisionmakers may resort to informal judgments, intuition, or guesses in an effort to allow for price-level changes. To the extent, however, that corporate decisions are made on the basis of incomplete information, the riskiness of a venture may not be accurately gauged, and resources may be allocated inefficiently.

Moreover, present financial reporting principles may be having seldom-recognized consequences for the way in which corporate managers are evaluated and rewarded. Even in firms with sophisticated, inflation-oriented, capital budgeting techniques, executive compensation may be tied to the bottom line on the conventional income statement. Thus, for example, there are managers who are being awarded enhanced compensation and promoted up to the executive ladder in return for running an operation which, in real terms, is dissipating its capital. I believe that, if the theoretical under-pinnings of accounting expressly recognized the legitimacy of considering the consequences of variations in the purchasing power of the dollar, the same type of scrutiny would be more likely to focus on the meaning of dollar figures which are used for internal corporate purposes such as performance measurement and management compensation.

Finally, and, in the long run, most importantly, the premises on which financial reporting rests influence the way in which society in general — especially through its elected representatives — views the business community. If published earnings reports lead the public to perceive business profits as inordinate or "obscene," and increasing steadily, the demands will be inevitable that government take action to harness those earnings for the public benefit. And if the economic reality is that American business profits — particularly those of the largest firms, those most able and most responsible for aiding in the attainment of our national objectives — are insufficient to generate the cash flow necessary to replenish, modernize, and expand the assets needed to discharge the responsibilities we expect them to shoulder, then government decisionmaking which is actually destructive of the effectiveness of our economic system is almost unavoidable. Enhancement of this confusion in the public mind — and of its manifestations in the actions of our elected decisionmakers — would perhaps be the most profound and serious consequence of any type of financial reporting which does not allow the flexibility to come to grips with economic realities.

Lessons For The Conceptual Framework Project

With respect to the conceptual framework project presently facing the FASB, the thrust of my comments tonight is to urge that, in developing that conceptual framework, recognition be given to the true costs of business operations. I am not recommending a particular methodology, such as replacement cost, nor am I suggesting that the financial statements themselves must necessarily reflect assets on a current cost basis. I do urge, however, that, within the conceptual framework, there be mandatory disclosure of the impact of inflation on the financial statements. Such disclosure would include the current cost of assets as well as the current cost of using those assets. I do not believe it necessary to discard the historical cost framework for financial reporting. Indeed, as I mentioned at the outset, I feel considerable discomfort over the added judgmental aspects of financial reporting which would be implicit in the abandonment accounting methods based on historical costs. The key, however, is economic reality, and I believe that supplemental disclosure of the impact of inflation on the financial statements is required to mirror that reality. Once the principle that the effects of inflation must be reflected is accepted, the methodology can evolve and develop in the same manner as have other innovations in financial reporting.

The same type of analysis which, in my judgment, requires that the conceptual framework recognize the existence of inflation as a fact of economic life also suggests the need for the model to recognize and support other types of disclosure which are sometimes labeled, perhaps disparagingly, as "soft" information. Areas in which the Commission has already taken public positions include management's discussion and analysis of the summary of operations, forecasting, interim reporting, internal control, and line of business information. These other areas of disclosure -- like replacement cost or other inflation-based methodologies -- provide the user of financial statements with significant information bearing on the financial condition and profitability of the company. The inclusion of such disclosures in financial reports is a trend which the Commission has favored in recent years. The Commission has, for example, required line of business reporting, and the FASB in Statement No. 14 made such disclosure mandatory, effective for this year's financial statements. Similarly, I believe other types of less traditional financial information fall within this same category, and the current FASB conceptual framework project appears to be the logical stepping-stone for consideration of these disclosure requirements.

One final point bears emphasis here. Closely linked with the disclosure of various types of soft information is the issue of whether the auditor should be responsible for performing an independent review of that information. In my judgment, auditors must recognize that they are increasingly expected to review any information of a financial nature issued by management. The Cohen Commission's tentative conclusions reflect the need to expand the auditor's role in this language:

> "* * * [T]he traditional association of independent auditors with annual financial statements is an obsolete, limited concept. The changing business and investment environment requires a more flexible and timely form of association, and the audit function should evolve in that direction.

> We believe that the audit function can and should expand to include information of an accounting and financial nature that management has a responsibility to report if the auditor's competence is relevant to verifying the information and that information is produced by the accounting system."

While I recognize the possible need for the Commission to consider the desirability of safe harbor provisions -- comparable to the one provided in the area of replacement cost data -- if the scope of auditor responsibility expands, I believe that the Cohen Commission's conclusion is sound.

The Roles of the FASB and of the SEC

I have yet to see a government body discharge with great effectiveness responsibility for detailing accounting rules and practices, and I think that many examples could be cited of the problems that are created when government tries to do so. I am firmly convinced that the private sector -- the accounting profession -- is in a much better position to maintain and assume this responsibility than is any governmental body.

The conceptual framework project exemplifies the kind of important and fundamental undertaking which the profession can perform best, and is one of the foremost existing opportunities, I believe, for the accountants to demonstrate to Congress and to the profession's critics its effectiveness and resolve in confronting the important issues facing it. The conceptual framework must be -- as I think the Board recognizes -- much more than merely an attempt to catalogue the premises and assumptions which are implicit in accounting as it exists today. The project must rather be an exercise in leadership -- an effort to create a set of principles which can serve as a goal, a visionary guide, for the profession to work towards as it develops and refines disclosure techniques during the coming decades. For that reason, a meaningful and successful statement of the conceptual framework cannot possibly be produced in an atmosphere of compromise aimed at reconciling present differences over conflicting methodologies. On the contrary, the conceptual framework — if it accomplishes its purposes — will undoubtedly reflect a gap between present accounting methods and the precepts reflected in the framework. The process of filling that gap will be a separate task to which accountants can turn after the framework, the profession's constitution, has been established.

For these reasons, it is vital that the private sector, and in particular the FASB, provide the leadership necessary to the conceptual framework project so that the fruits of that work can provide an accounting and reporting model for a disclosure system that will serve the profession and the business community regardless of the changes in the economic climate which our society may experience in the future. I cannot emphasize enough the importance of this project in helping to improve our reporting system and, accordingly, the need that exists for strong leadership in directing the project to completion.

The Commission's role, on the other hand, is one of oversight — the prodding, guidance, and review necessary to insure that the profession meets these challenges in a manner which harmonizes with our responsibilities under the federal securities laws. Accordingly, the Commission will take an active interest in the timeliness and direction of the conceptual framework project during the coming months. With respect specifically to the issue of inflation impact, the Commission recently issued a release requesting comments on implementation problems encountered by companies in providing replacement cost data and announced that it would undertake a major study of the existing rules governing replacement cost next year. The Commission's ultimate decision as to any rule changes resulting from that review may depend, in part upon the direction of the outcome of the conceptual framework project. While I can speak as but one voter on a five-member commission, I believe that those who foresee the end of inflation accounting as a possible outcome of the Commission's review of the replacement cost rules are wholly mistaken. In my judgment, the issue of the need for disclosure of the impact of inflation on corporate performance is simply no longer open to serious debate. The question is not whether it should be disclosed, but how.

Conclusion

In his recent article in the Harvard Business Review on inflation accounting, Thomas D. Flynn captured what may be the essence of much of the hostility to replacement cost and other inflation-based accounting techniques. He observed:

> "U.S. businessmen are somewhat like football players who have learned to do very well indeed under the existing rules. To change the dimensions of the playing field significantly would introduce uncertainty and make most players apprehensive of how they personally would fare on the radically new field. By and large, American businessmen have been satisfied with the financial system under which they have grown up. They do not wish to have newfangled ideas introduced unless they can clearly perceive the practical advantages of such changes."

The same attitude may well be common among those segments of the accounting profession which view inflation accounting less than enthusiastically. As I have tried, however, to point out this evening, the assumptions which have undergird our system of financial reporting must be selected with a view to aiding investors, business managers, politicans, and the general public to evaluate realistically the performance and capabilities of private enterprise, especially in an era in which annual inflation of 6% or more is the norm. This is not a theoretical or abstract problem. It impacts directly on the capital formation process and on society's attitudes toward the effectiveness of the private enterprise system.

In the conceptual framework project, I believe that the FASB has the opportunity to take steps which could go far in alleviating these problems while, at the same time, demonstrating the commitment and innovation which will be necessary to preserve the accounting profession as an essentially private, self-governing institution. Methodology is, of course, open to debate. I would urge only that those responsible for the development of the conceptual framework focus squarely on the important, economy-wide implications of their work as they continue with this important and far-reaching project.