REMARKS OF
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SECURITIES AND EXCHANGE COMMISSION

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Mr. Chairman, Ladies and Gentlemen. I am delighted to be here today and to participate in your 51st Annual International Conference. The theme you have selected, "Preparing for the Future," is broad enough to permit examination of many fundamental considerations confronting management these days. I sincerely hope that your discussions will be both informative and of practical use in planning and conducting your business affairs in the future.

I bring to you the greetings of the Commission, along with the reminder that my comments do not necessarily reflect the opinions of the Commission or my fellow Commissioners. In other words, I speak only for myself.

Today, financial writers and other representatives of the public are clamoring for a change in corporate reporting. There is other evidence of uncertainty and turmoil regarding this subject today -- witness the litigation and claims involving accounting matters. Improvements in accounting principles, procedures, practices and financial reporting must be made. The need is urgent.

This is not to deny that considerable progress has been made within the last year or two. Major developments include:

Opinions of the Accounting Principles Board, such as the proposed opinion on business combinations and intangible assets.

The SEC rulings on line of business and product-line reporting.

The recommendations contained in the Wheat Report.

Nevertheless, there still exists a continuing demand for additional clarification and definition of accounting principles. Most of the urging is directed at the accounting profession and the Commission. Quite rightly too, for traditionally these two groups have shouldered the major responsibility for the development of accounting principles.

More recently, others have responded to the demand. Groups such as yours and the Financial Executives Institute have joined the ranks of those working to develop standards. The Financial Analysts Federation has indicated that it, too, is going to increase its efforts in this direction.

Welcome -- for there is much to be accomplished, and additional manpower and resources are needed. Furthermore, when you help to develop accounting principles, you also meet your legal responsibilities as financial officers of publicly held companies. These responsibilities were defined, in part, in 1939 by the Commission _In the Matter of Interstate Hosiery Mills_, when we said:

> The fundamental and primary responsibility for the accuracy of information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting.

As I am sure many of you are aware, the decision in the case of _Escott_ v. _Bar Chris Construction Corporation_ served as a vivid reminder of the responsibility of management for reliable corporate reporting.

In view of these decisions, I have wondered why financial executives and accounting officials waited so long to assume a more active role in the development of accounting principles and financial reporting.

Some months ago I publicly questioned how objective a lawyer could be in advising a client company in which he held an equity interest. Specifically, I wondered what priority would be given the public interest. My point was that lawyers should carefully consider the problems which might arise when their fortunes are, to a certain extent, tied to those of client companies.

I recognize, of course, that it is not practical to demand that an advocate be completely independent of his client. Nor do I consider it practical to suggest that financial and accounting officers should be completely independent of their employers.

Nevertheless, I wonder if accounting officers should not strive to achieve a more independent status within their companies so that financial information could be presented as clearly as possible in accordance with applicable standards. On one hand, management's overriding responsibility is to its stockholders. On the other, being human, managers have a natural desire to present financial matters in such a light as to insure their own continuity. In contrast, more independence for the financial executive would help to insure more consistent reports of the financial condition of his company.

This concept of independence for financial officers is based on more than wishful thinking. It stems from their basic responsibility. As a matter of fact, a former Chairman of the Commission indicated that internal accountants should ask the same question as public accountants. He said:

> Because of his special status and responsibility, the accountant has a unique opportunity to be a leader in raising standards of investor protection. The "financials" provide the key information both in the distribution and trading of securities. ... [T]he accountant should not be satisfied when he has done just enough to answer affirmatively the question, "Will this get past the SEC?" The standards prescribed by law are a bare minimum. The independent, as well as the internal, accountant should be guided by the question, "What do the investors, and the professionals who bear a heavy responsibility in recommending or selling securities, need to know to make an informed decision about this or that issuer?"

I believe the public investor has a right to expect the financial officers to encourage their managements to adopt more responsible accounting methods. I also believe financial executives should not hesitate to exert such efforts. In the last analysis job security must be weighed against potential liability under the Acts administered by the Commission.

In the past the Commission has been a patient and untiring participant in the development of accounting principles. We have resisted the role of heavy handed regulation in our dealings with financial officers. But others within and without the government are not so patient. The pressures of a dynamic economy, a growing number of investors, and modern communication techniques are such that it is not easy for everyone to exercise restraint where corporate reporting is concerned.

It is a well-known fact that management has sole responsibility for such financial data as that included in the "up-front" material in reports to shareholders, in news releases and in interim unaudited financial statements. It is in these areas that internal accountants can help to prevent abuses by taking a more independent stance when preparing and reviewing data.

The importance of doing so cannot be overemphasized. In one instance in 1968, the Commission felt impelled to deny acceleration of the effective date of a registration statement until misleading percentage increases were corrected in sales, net income and earnings per share included in the "up-front" section of a report to shareholders and in advertisements.

The opinion stated that:

> ... it is misleading to make comparisons such as were made in this instance or to invite or draw conclusions as to improvement in a company's operations by comparing pooled figures for a particular year with unpooled figures for the prior year. Comparisons in such case should be made with financial data for the prior period restated on a combined (pooled) basis.

As you know, the Wheat report recommended that the Commission adopt a rule which would bar any inclusion in the text of a report of financial data significantly different than revealed in the financial statements contained in the report or prior reports.

Under the circumstances, it is not surprising that there has been some public discussion over the desirability of having independent public accountants certify more of the contents of a company's published reports. One prominent financial executive recently predicted that within five years certain non-financial figures disclosed in annual reports would be certified. He stated that the certification would be initially limited to data on employment, man hours, floor space, capital expenditures, basic raw materials used, and units of specific product produced or delivered. Apparently he anticipates even further extensions of the attest function after five years. In my opinion, however, if corporate financial executives were independently to answer the question "What do investors need to know to make an informed decision?", just as independent accountants must, there would be no reason to extend the attest function of the auditor.

The fact that recommendations have been made that outsiders attest to data appearing in a company's report is indicative of certain opinions and attitudes towards management. To put it another way, the uncomfortable feeling some managements experience in dealing with the public is due to a "credibility gap" -- real or imagined. I hope you will think long and hard about this.

A great deal of criticism is also directed at management today for resorting to "accounting gimmickry" in reporting business combinations, so as to improve earnings per share data. This problem has two facets:

(1) management has devised and issued a great variety of complex securities (often referred to as "funny money") and

(2) it has applied pooling-of-interests accounting to as many combinations as possible by stretching current criteria for pooling-of-interests accounting to the breaking point.

The APB has dealt with the first problem in recent opinions and is currently working on the second problem, as evidenced by the well-publicized exposure draft of a proposed opinion: "Business Combinations and Intangible Assets." These are very serious problems which, I am sure all will agree, warrant the highest priority by the Board. I wonder, however, if they would have become so serious if financial executives had exercised a greater degree of independence, or influence, if you will.

It is interesting to reflect momentarily on the approach used by the profession and the Commission to resolve the "Case of Reporting Earnings Per Share." As the merger movement accelerated, so did the use of a wide range of complex securities in effecting the combinations. This raised the question of whether complex securities were a device to manufacture earnings per share through gimmickry. It was also difficult to determine the dilutive impact of the securities on the earnings per share data.

In response to these problems we urged the accounting profession to improve the standards for reporting earnings per share data so that the immediate and the potential dilutive impact of all securities would be clearly presented in reports which companies issue to the public. Such an approach is in accordance with the

Commission's long standing policy of encouraging the profession to develop and promote better accounting and financial reporting standards. The Commission itself refrains as much as possible from prescribing detailed regulations on these matters.

The APB, with our cooperation, issued Opinion No. 9 in December 1966 to provide guidance. With the subsequent proliferation of complex securities, it soon became apparent this opinion needed to be broadened and refined. Accordingly, the APB began a reexamination of the problem.

In the meantime, the Commission encountered a number of instances in which the securities issued, while clearly dilutive, were structured in such a way that they escaped being subjected to the opinion. The Commission dealt with this type of problem in June 1968 in a public release (Securities Act Release No. 4910) which stated in part:

> In general, if at the time of issuance of a convertible security in an acquisition, the terms are such as to result in immediate material dilution to pro forma earnings per share, assuming conversion, then that security should be considered a residual security whether or not a majority of its value may be derived from its conversion rights.

Then in May 1969, the APB issued another opinion which superseded the prior opinion regarding the computation of earnings per share. APB Opinion No. 15 provides detailed requirements for the consideration of all securities, including the so-called leverage securities, such as convertible debt, convertible preferred stock, and all stock options and warrants in a primary and secondary calculation of earnings per share, so that a clear presentation of the immediate and potential dilutive impact of these securities is obtained. The Commission requires registrants to adhere to this opinion and considers it a satisfactory solution.

I know many of you believe that only a "Philadelphia lawyer" could possibly interpret Opinion 15. Certainly it's not easy. But to put an end to all the abuses conceived by very resourceful people in the computation of earnings per share, required a comprehensive and necessarily complicated opinion.

The second problem involved in the reporting of business combinations has to do with pooling-of-interests accounting.

The question of whether purchase or pooling-of-interests accounting is properly applicable to a business combination is more difficult to answer today because the standards have been so badly stretched over the years. Companies now use wide discretion in accounting for the combinations on either a purchase or a pooling-of-interests basis. Reports on the results of operations of the combined companies can be affected significantly by the choice of basis.

It was because of the erosion of former standards that the Commission urged the Accounting Principles Board to develop new standards in this important area.

As you know, the exposure draft of the opinion on business combinations and intangible assets subsequently issued by the APB has received the general support of the Commission.

We encouraged the APB to include in this proposed opinion the very restrictive criteria for the use of pooling-of-interests accounting and the requirement for mandatory amortization of goodwill arising in purchase transactions. We believe that if these criteria are adopted, many of the abuses that occur in accounting for business combinations will be curbed.

Merger-minded management has favored the use of pooling accounting because future operations of the acquired companies will bear lower expense charges as compared to the purchase basis because of the lower cost basis of depreciable assets and the absence of goodwill that might have to be amortized.

Limiting pooling transactions to the exchange of common stock will reduce the use of leveraged securities in business combinations and thereby one method of creating "instant earnings." We have seen a number of cases where convertible preferred stock with a dividend rate lower than the earnings per share applicable to the common stock of the acquiring company was issued in poolings, thus enhancing those earnings per share.

The proscription in the opinion against a plan for the disposition of a major portion of the assets of a pooled company will reduce the possibility of creating "instant earnings" through a sell-off immediately after the pooling of low cost assets, such as real estate and securities, which are not needed in the combined enterprise.

The prohibition against the retroactive "pooling back" of the income of a company acquired shortly after the end of a fiscal year in the financial statements first issued for that fiscal year will mean that a company cannot improve current year earnings in this manner, as permitted under accounting standards now in effect. We have noted some cases where the "shortly after" period has been stretched to several months.

On the other hand, the present requirement for "pooling back" the income for current and prior years of companies pooled in the current year is continued. This is in accordance with the pooling concept that the combining companies should be portrayed as always having been together. It also prevents an unfair presentation of an earnings trend based on a comparison of the earnings of the acquiring company for prior years and the combined company for the current years.

The requirement for mandatory amortization of so-called "goodwill" in purchase transactions will mean that future earnings cannot be inflated by avoidance of a charge for the cost of this goodwill, as is permitted under current standards. This requirement should also counteract a tendency for companies to underestimate the fair value of depreciable assets in the allocation of the total purchase price between the depreciable assets, goodwill and other intangibles, when goodwill is not amortized, thereby further reducing future charges to income.

Many other features of the opinion will serve to tighten up the standards for accounting for business combinations on either the pooling or the purchase basis. A requirement for more detailed disclosures will permit full analysis of the effect of the combination in the current and prior years for the combined companies.

It's no secret that the APB has received a large number of letters of comment on this proposed opinion. Copies of many of these letters were sent to the Commission and it is clear that much serious study has gone into their preparation.

There is strong support from very respectable sources for the position taken in the exposure draft. There is also vigorous opposition, much of it from corporate executives, principally regarding the size criterion for the applicability of pooling accounting, mandatory amortization of intangibles in purchase transactions, and the guides for determining the values to be assigned to specific assets in allocating the cost in a purchase transaction.

The arguments pro and con can only be judged on the basis of one paramount consideration -- what will best serve the public interest?

The proposed opinion on business combinations deals with only one of a number of current problems. The APB has initiated additional studies in areas where alternative accounting practices exist -- such as intercorporate investments, inventories, depreciation, research and development costs -- to name a few. These studies may result in further changes in accounting and financial reporting requirements. Even the current exposure draft of the proposed opinion on accounting changes is being studied further with the view toward a possible change in position and re-exposure.

The SEC also, is trying to bring about improvements in the quality and timeliness of financial reports filed with it. We have extended our requirements for line-of-business and product-line reporting by diversified companies. We have proposed the same requirement for the annual report form. We have also proposed to change several of our requirements on the basis of the Wheat Report recommendations. These recommendations are now under consideration by the Commission.

As far as accounting principles are concerned, the Commission has always believed that the profession should set the standards and that all others should voluntarily comply with them.

This is not a universal opinion. As Leonard Savoie, Executive Vice President of the AICPA, recently stated:

> While the Institute speaks for the profession, there is no way we can force our clients to do anything unless ... the SEC chooses to be the policeman.

I hope we do not reach the point where government intervention is required. I believe that the Institute has in the past formulated principles which are persuasive on their merits. Coersion has not been necessary. It should not be necessary in the future. It won't be if the APB, the SEC and financial executives such as yourselves contribute jointly to the solution of problems which jeopardize the public interest.

The words of John W. Gardner bear repeating at this point. He said:

> But there is in us as Americans something better than selfishness, something better than the lazy, comfortable inclination to blame others.
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> There is in us, if our leaders will ask for it, the courage and stamina to face our problems honestly, to admit that we ourselves are partly to blame for them, and to identify paths of constructive action.

I say that it is in your self-interest to respond to the words of Mr. Gardner, for the basic issue at stake is nothing less than investor confidence.

Investor confidence is important to you. If it is impaired, savings will be channeled away from the securities markets. If fewer dollars are invested in the securities of your company, you will not have the financing you need to grow, and to provide the products and services that an educated society will require in the future. If such funds are not available to American industry, the real growth in our economy will be slowed substantially, and our people will be deprived of the opportunity not only to maintain their standard of living, but to improve it. This is why it is in your own interest to help insure that accounting principles and needed reforms in corporate reporting are instituted, and that the credibility gap is bridged so that investor confidence is not shaken.

The Securities and Exchange Commission has often been characterized in terms that are unflattering. But, on balance, I believe that our reputation is best described by a recent writer who said:

> The Securities and Exchange Commission is known as a considerate agency of government, the guardian angel of widows and orphans and the polite policeman of those in the securities business. It is happily endowed with a competent staff which has traditionally displayed a benign understanding of the difficulties of compliance with all the niceties of federal securities regulation.

In all fairness, I must also tell you that he then went on for three pages to list our weaknesses.

No governmental agency can expect to be loved by all of the people, all of the time -- particularly an agency such as ours, which has such broad responsibilities. It is much more important that people, such as yourselves, understand the reason for our being and something of the problems we face.

I hope my remarks have contributed toward this end.