Accounting Principle Changes Which Will Impact Future Financing Needs

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I will discuss new developments which may effect financial statements and how these may impact an enterprise's ability to raise capital. There are new developments which may result in many changes to financial statements and financial statement disclosures. Everyone is waiting to get into the picture and many changes have been proposed. For a moment let me address the question of change per se and human behavior related to change.

By and large, people do not like change, especially rapid change. That is just a human characteristic. In our everyday life at home, we resist change. I like to find my shirts laundered in a particular way and I like to find them in a particular place. My wife took a little vacation and while she was away I found that I didn't like the manner in which the elderly lady caring for my children did my shirts. Also, in my own household, it has taken me a long time to adapt to the fact that our three boys have, by my standards, long hair. In fact, their hair style is very similar to that of my daughter's.

I can analogize from there to almost any situation. President Elect Carter plans many changes in Washington. Congress recently changed the Internal Revenue Code, and some of the changes in that bill may alter to a considerable degree events in the marketplace. Mexico recently floated the Peso - that change is having considerable negative effects on the retailers in border communities but is supposed to positively effect dual plant sites along the border and tourism. The Arab oil embargo, now almost forgotten, changed dramatically the course of our everyday life and certainly has effected the distribution system of oil and gas. The list is endless, so let me move into the more specific changes of the accounting world. Financial statements involve an interplay between measurement and disclosure: Disclosure dependent on measurement, and measurement dependent upon disclosure. It is not just disclosure changes that are causing concern. The business community is quite concerned about the disclosure changes that resulted from measurement changes. They do not like to be told that what was profit yesterday is not today because of changes in measurement techniques.

Disclosure is much in the discussion forefront among accounting philosophers today. The annual report of Safeway Stores, issued on the Golden Anniversary of their founding, contained a facsimile of their first report - from 1926. The change in the information that campany provided suggests the evolution of fifty years.

The 1926 report contained a balance sheet and a letter from the President, in which he discussed the organization of the Corporation and sales and net earnings for the first six months - two pages in all. This would hardly meet the requirements of quarterly disclosure in 1976.

In sharp contrast, the current report contains complete financial statements, three pages of footnotes, and five pages of statistical summaries and analysis. This report brings into clear focus the profound changes that have occurred in disclosure over these five decades. In my view, these changes will continue and the trend toward more frequent and expanded disclosure will accelerate. The business community has a tremendous education project. It sometimes is difficult to explain to a banker that the business is the same - it just doesn't look the same.

What are some of the changes in measurement and disclosure that can effect your financial statements? Let's review current FASB activities.

A. Oil and gas accounting - This may not directly impact your financial statements but it most certainly effects the energy companies, their accounting and possibly their ability to raise capital and develop energy sources. There isn't a company or individual not affected by what happens to energy. If the private sector doesn't solve oil and gas accounting, then Congress will legislate a solution. Once they accomplish that there will probably not be an element of the private sector that may not be susceptible to congressional legislation of accounting principles.

B. Leases - We should have a final statement before year-end from the FASB on lease accounting. This statement has been in the works over two years involving two exposure drafts and a great out cry. This statement singularly of present FASB activities, probably affects the financial statements of those in the audience today. The bottom line result of this statement will be the capitalization of most of the property and equipment leases that we know of today. Why is this important - well, today these same leases do not appear on balance sheets as assets or liabilities, the charge to earnings is a level straight line charge equal to the monthly payment to the lessor. Capitalization means the property or equipment will appear as an asset on the balance sheet as a property right to be depreciated in a consistent fashion with other assets. The lease obligation discounted to its present value appears as a liability. The result is to treat the obligation similar to any other borrowing. This doesn't seem too bad but it really can impact the financial statements because the combined charged to earnings of the depreciation of the property right with the assumed finance cost built into the lease will exceed the straight line lease payment that is charged to earnings during the first half of the lease obligation. This is not good news to any industry or company that typically operates on a very low margin. Additionally, this new debt obligation dramatically alters debt equity ratios that bankers typically place great importance in. The business enterprise will probably not be any different than it was before capitalization. However, the capitalization may reduce earnings, impact borrowing capacity and alter ratios such as debt equity, return on equity and return on assets. This may take some explanation to the user of financial statements. I would like to point out though that leases are merely a form of financing and they represent significant obligations and commitments of an enterprise. Accordingly, why shouldn't the real picture be shown?

C. I think you should be aware of the direction the FASB is taking and the direction its predecessor, the Accounting Principles Board attempted to take.

I shall not dwell on the experiences of the Accounting Principles Board but I think it is important to note the problem with Opinion No. 2, that dealing with the investment credit. The Board first said it should be amortized. Then after a great outcry and congressional intervention they said, "Do whatever you want - just disclose what you're doing." It is probably unnecessary to remind you of the experience of the APB with Opinions 16 and 17, dealing with business combinations and purchased intangibles; or of that Board's experience with its opinions on leases. In each case in which constraints were imposed on measurement, a violent reaction was encountered from those who favored alternatives.

The experience of the FASB has been identical. Statement No. 5 restricted the accrual of certain loss contingencies. There was a strong reaction to this standard, for many had been using reserves of this nature - reserves such as self-insurance reserves - to smooth income; to present a picture of trended earnings.

The Board had a similar experience with Statement No. 12, that on marketable equity securities. To some extent, it subjected corporate earnings to some of the vicissitudes of the stock market: That is, market declines and recoveries, conditions beyond the control of management, were impounded in earnings.

The reaction to those two statements, however, was modest compared to what the Board is experiencing in connection with Statement No. 8, the statement dealing with foreign currency translation. Prior to the adoption of that statement, many companies had been deferring and amortizing the net gains and losses from currency translation; the statement required that they be reflected in income currently. The result has been an outcry from managements who find that earnings are vascillating with fluctuations in exchange rates. They are disturbed by the fact that they cannot smother these effects, and therefore, cannot control periodic earnings.

The implications of these three standards are the same: In each case the standard has, to some degree, restricted the ability of managements to dampen fluctuations and to level or to trend enterprise earnings.

The problem arises from the perception of some as to the nature of earnings: That earnings are not the product of changes in balance sheet values over a period, but rather are an idealization of operations and conditions during the period. The perceptions of managements of the earnings are frustrated by factors over which they have no control.

Our present accounting model is and can be faulted in many respects. But, if I had to single out its major fault, it is the failure to provide comparable information. Many make the assumption that financial statements of similar enterprises ought to be comparable.

The absence of uniform standards and the availability of alternative acceptable accounting principles and measurement techniques provides for the situation we find ourselves in; that being there is virtually no comparability between firms and often little comparability within the same firm. Thus, a dichotomy between flexibility and uniformity.

Because of this situation, I would like to bring out for discussion the current proposals before the Congress. In September, the House committee on oversight and investigation made several recommendations after reviewing the SEC. The subcommittee generally gave good marks to the SEC and was critical of the White House administration and the Office of Management and Budget for curbing the SEC's spending. However, the subcommittee was critical of the SEC for abdicating the accounting principle setting to the private sector. The subcommittee recommended, among other things:

1. Independent accountants and auditors should become neutral corporate financial reporters. Thus, to the maximum extent practicable, the SEC should prescribe by rule a framework of uniform accounting principles. In instances where uniformity is not practicable, the SEC should require the independent auditor to attest that the accounting principles selected by management represent financial data most fairly. The SEC should also prescribe supplemental data to permit a translation from one set of assumptions to another, thereby permitting comparability among companies in a particular industry.

2. Internal Controls - The SEC should act promptly to promulgate rules necessary to assure that:

a. publicly-owned corporations adopt and enforce codes of business conduct that conform to the laws of all countries in which a corporation operates, and that are disclosed publicly to shareholders through filings with the SEC.

b. procedures which allow corporations to develop off-the-book accounts are eliminated.

c. uniform financial controls are applied throughout every department and operating division of the consolidated corporation;

d. communication is strengthened among in-house accountants and auditors and the appropriate levels of management;

e. falsification of books and records is penalized;

f. independent auditors attest to the quality of internal controls and the quality of enforcement of those controls in the annual report.

3. Board of Directors - The SEC should promulgate rules necessary to assure that:

a. a director of publicly owned corporation receives compensation and independent staff sufficient to perform responsibly his board duties;

b. a majority of the board is independent of senior management and operating executives and from any other conflicts of interest;

c. the board reviews and approves the corporation's code of business conduct and system of internal controls;

d. the board's auditing and nominating committees are comprised of a majority of independent directors;

e. the board's auditing committee has available to it independent expert advisors; and

f. the board has the authority to hire and fire the independent accountant, legal counsel, the general counsel, and senior operating executives.

4. Auditing Standards - a. The SEC should prescribe by rule auditing standards to be followed by independent accountants who certify financial reports filed with the SEC.

Most people outside the public accounting profession are not particularly excited by this commotion, and they seem to have little interest in the matter. But their lack of interest and participation may well come home to haunt them.

In my opinion, the outcome of this matter potentially has far-reaching implications. I do not know how far, but possibly as far as determining whether accounting and auditing standards will continue to be set in the private sector or whether that function will devolve onto the Federal government. If this is the case, I assure you that it will dramatically affect your ability to meet future financing needs in a negative way.

I look back to history and I see that changes are accomplished basically in two ways - by revolution or evolution. Change by evolution has been described as incremental change, namely, that change that is possible within the existing political environment. Unless I have misjudged the situation badly, I foresee no revolutionary changes in accounting and reporting. I do see, however, a lot of evolutionary or incremental changes. I also see that because of our tremendously increased speed of communication that the pace of change will accelerate. And I also see us experimenting more and more with different expressions of financial information to communicate more fully to those who need the information. It is important that we not allow the government to dictate this information for we do not need any more FPC and FEA's dictating disclosure and measurement. Psychologically, none of us likes change. But it is not our lot to choose. We are constantly buffetted by the winds of change. We must adapt to change. But, given today's speed of communication, perhaps the important thing we have to cope with is not change itself but the very pace of change.