

SECURITIES AND EXCHANGE COMMISSION
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HOLD FOR RELEASE 6:00 P.M., TUESDAY, MARCH 18, 1975

“KEEP YOUR EYE ON THE DONUT”

AN ADDRESS BY

A. A. SOMMER, JR., COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION

NATIONAL ASSOCIATION OF
ACCOUNTANTS

NEW YORK CITY

MARCH 18, 1975

“KEEP YOUR EYE ON THE DONUT”

A. A. SOMMER, JR.*

COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION

THERE USED TO BE, AND PERHAPS THERE STILL IS, IN THE MAYFLOWER DONUT SHOPS, A PLAQUE THAT READS SOMETHING LIKE THIS: “AS THROUGH LIFE YOU STROLL, MY FRIEND, KEEP YOUR EYE UPON THE DONUT AND NOT UPON THE HOLE”. THAT ADMONITION, IT STRIKES ME, HAS PECULIAR RELEVANCE TO ALL OF US TODAY WHO ARE LIVING IN A TIME THAT CAN ONLY BE DESCRIBED AS ONE OF HYPER-CHANGE. ALAN TOFFLER IN HIS BOOK, “FUTURE SHOCK” STATED THAT ONE OF THE PRIME CHARACTERISTICS OF THE TIME IN WHICH WE LIVE IS THE ACCELERATING PACE OF CHANGE. WHERE IN TIMES PAST SIGNIFICANT CHANGES IN OUR MORES AND WAYS OF LIFE WOULD OCCUR OVER A PERIOD OF GENERATIONS, NOW THEY ARE COMPRESSED INTO DECADES OR LESS. IN THE MIDST OF ALL THIS CHANGE, WITH PRESSURE UPON ALL OF US IN OUR PROFESSIONS, OUR HOME LIVES, OUR GOVERNMENT FOR MORE AND MORE DEPARTURES FROM THE PAST, IT IS EXTREMELY EASY TO LOSE A SENSE OF RELEVANCE AND PROPORTION AND TO BECOME COMPLETELY ABSORBED WITH THE HOLE IN THE DONUT AND FORGET THE DONUT ITSELF.

YOUR ACTIVITIES, AS YOU WELL KNOW, ARE NOT FREE FROM THE PRESSURE FOR CHANGE IN OUR SOCIETY. TONIGHT I WOULD LIKE TO TALK ABOUT WHAT IS DONUT AND WHAT IS HOLE WITH RESPECT TO FINANCIAL REPORTING.

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I THINK THE DONUT IS FAIRLY EASY TO IDENTIFY. THE TRUEBLOOD COMMITTEE IDENTIFIED THE BASIC OBJECTIVE OF FINANCIAL REPORTING:
“...TO PROVIDE INFORMATION USEFUL FOR MAKING ECONOMIC DECISIONS.”

I MAY SHOCK YOU WHEN I SAY TO YOU THAT IN A SENSE THE “HOLE”, AS CONTRASTED WITH THIS DONUT, CONSISTS OF SUCH THINGS AS GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, THE TRADITIONAL TWO -- NOW INCREASING TO THREE -- PARAGRAPH SHORT FORM OPINION, THE HALLOWED

FORMAT OF FINANCIAL STATEMENTS. THE DANGER I SEE IN FINANCIAL REPORTING IS THAT ALL OF US WILL BE CONCERNED WITH THESE HOLES TO SUCH AN EXTENT THAT WE LOSE ADEQUATE AND CONTINUING AWARENESS OF THE DONUT.

THE PAST I THINK PROVIDES US WITH A NUMBER OF EXAMPLES OF HOW THIS CAN HAPPEN. NOT MANY YEARS AGO, INVESTORS WERE RELYING UPON THE FINANCIAL STATEMENTS OF FRANCHISE COMPANIES IN THE BLIND BELIEF THAT THESE STATEMENTS DESERVED RELIANCE, WERE A FAIR DEPICTION OF THE ECONOMIC REALITIES OF THE ISSUER AND CONSTITUTED A SOUND BASIS FOR INVESTMENT JUDGMENT. THE SAME CAN BE SAID OF THE FINANCIAL STATEMENTS OF LAND DEVELOPMENT COMPANIES. AFTER ALL, THE FRONT-ENDING OF INCOME IN THOSE CASES WAS THOROUGHLY IN KEEPING WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, OR TO USE THE PHRASE WHICH OCCURRED USUALLY WITHOUT QUALIFICATION IN THE OPINIONS OF THE AUDITORS, THE STATEMENTS “FAIRLY PRESENTED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES” THE FINANCIAL POSITION OF THE COMPANY AND THE RESULTS OF ITS OPERATIONS. I WILL HAVE A FEW WORDS TO SAY ABOUT FAIRNESS OF PRESENTATION SHORTLY, BUT I DOUBT WHETHER MANY IN THIS AUDIENCE WOULD DISPUTE MY ASSERTION THAT BY NO STRETCH OF THE IMAGINATION COULD MOST OF THOSE STATEMENTS BE SAID

TO BE FAIR PRESENTATIONS OF THE RESULTS OF OPERATIONS, EVEN THOUGH THE STATEMENTS MAY HAVE BEEN PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES.

IT IS PERHAPS UNCHIVALROUS OF ME TO REMIND US OF THE ABUSES THAT ATTENDED POOLING AND PURCHASE ACCOUNTING DURING THE HALCYON DAYS PRIOR TO APB 16 AND 17 -- ALTHOUGH I HASTEN TO ADD, AGAIN AS I WILL INDICATE IN A MOMENT, IN MY ESTIMATION THESE HAVE NOT BEEN AND SHOULD NOT BE THE FINAL WORD WITH RESPECT TO THOSE MATTERS. BY DINT OF A GENERALLY ACCEPTED ACCOUNTING PRINCIPLE COMPANIES WERE ABLE TO SUBMERGE MANY MILLIONS OF DOLLARS OF COST, AND HAVE IT REEMERGE AS PROFIT. RULES FOR DETERMINING WHEN A POOLING OCCURRED, ONCE RIGOROUS AND DEMANDING, GRADUALLY ERODED AS THE BALONEY WAS SLICED ONE THIN PIECE AT A TIME. THE RESULT WAS NOT ONLY UNWARRANTED RELIANCE BY INVESTORS UPON FINANCIAL STATEMENTS THAT ONCE AGAIN ENJOYED THE IMPRIMATUR OF "GENERALLY ACCEPTED ACCOUNTING PRINCIPLES", DESPITE SERIOUS QUESTIONS CONCERNING FAIR PRESENTATION, BUT PUBLIC CONFIDENCE IN THE INTEGRITY OF THE FINANCIAL REPORTING PROCESS WAS SERIOUSLY UNDERMINED, WHICH LED TO THE EXTENDED AND SOMETIMES ACRIMONIOUS DEBATE OVER THE PROPER ACCOUNTING FOR BUSINESS COMBINATIONS THAT IN LARGE MEASURE ACCOUNTED FOR THE DOWNFALL OF THE ACCOUNTING PRINCIPLES BOARD AND ITS REPLACEMENT BY THE FINANCIAL ACCOUNTING STANDARDS BOARD.

ANOTHER INSTANCE IN WHICH SIGHT WAS LOST OF THE OBJECTIVE OF FINANCIAL REPORTING WAS LEASE ACCOUNTING. INCREASINGLY COMPANIES AVAILED THEMSELVES OF THE STRICTURES AND INFLEXIBILITIES OF THE CONVENTIONAL RULES OF REPORTING AND BURIED OBLIGATIONS AND CHARGES AGAINST FUTURE EARNINGS IN SO-CALLED "OFF-BALANCE SHEET FINANCING."

UNFORTUNATELY, WHILE MANY LESSONS HAVE BEEN LEARNED, THERE STILL EXIST PRACTICES AND OPPORTUNITIES FOR ABUSE THAT REFLECT THE FACT THAT WE HAVE NOT

YET COMPLETELY RESOLVED THE PROBLEM OF FORM OVER SUBSTANCE, HOLE OVER DONUT. I WOULD LIKE TO CITE A FEW THAT ARE STILL UPON US. FIRST, POOLING AND PURCHASE. DO ANY OF US REALLY BELIEVE THAT APB 16 AND 17 ARE THE FINAL RESOLUTION TO THIS PROBLEM? THERE STILL EXIST OPPORTUNITIES UNDER APB 16 FOR COMPANIES TO SUBMERGE COSTS AND RE-CREATE THEM AS PROFITS. THERE EXISTS THE OPPORTUNITY FOR COSTS THAT SHOULD BE ATTRIBUTED TO TANGIBLE PROPERTY AND IDENTIFIABLE INTANGIBLES TO FIND THEIR WAY INTO GOOD WILL WITH LONGER AMORTIZATION AND CONSEQUENT OPPORTUNITY FOR MAXIMIZATION OF PROFIT. I AM PLEASED THAT THE FINANCIAL ACCOUNTING STANDARDS BOARD HAS SEEN FIT TO UNDERTAKE NOT SIMPLY A COSMETIC EXAMINATION OF APB 16 AND 17, BUT A THOROUGHLY CONCEPTUAL ANALYSIS OF THE WHOLE PROBLEM. AS A CONSEQUENCE OF THE FACT THAT WE ARE LIVING IN TIMES WHEN STOCK PRICES ARE INORDINATELY DEPRESSED, THE PASSION FOR ACQUISITIONS IN EXCHANGE FOR EQUITY IS CONSIDERABLY ABATED; THIS MAKES THE PRESENT A GOOD TIME TO EXAMINE THIS PROBLEM FREE OF THE HEAT AND THE PRESSURES THAT IN MY ESTIMATION SERIOUSLY IMPEDED THE WORK OF THE ACCOUNTING PRINCIPLES BOARD WHEN IT DEALT WITH THIS PROBLEM. AT THAT TIME THE ACQUISITION FEVER WAS NEAR ITS PEAK AND A GREAT NUMBER OF BUSINESSES AND THEIR AUDITORS HAD A SUBSTANTIAL STAKE IN PRESERVING AT LEAST PORTIONS OF THE OLD PRACTICES. SUCH A TIME IS HARDLY CONDUCIVE TO THE SORT OF CAREFUL, THOUGHTFUL CONSIDERATION SUCH A COMPLEX PROBLEM DESERVES.

ANOTHER CASE IN WHICH THE EYE SEEMED, AT LEAST FOR A MOMENT, TO HAVE FOCUSED ON THE HOLE AND NOT UPON THE DONUT IS THAT OF THE EARLY EXTINGUISHMENT OF DEBT. AS YOU KNOW, APB 26 UNEQUIVOCALLY ESTABLISHED THAT EARLY EXTINGUISHMENT OF DEBT, REGARDLESS OF THE NATURE OF THE CONSIDERATION USED TO ACCOMPLISH IT, RESULTED IN REPORTABLE INCOME AND APB 30 MADE SUCH INCOME ORDINARY INCOME RATHER THAN EXTRAORDINARY. THE INSTINCTS OF THE APB IN ADOPTING APB OPINION #30 WERE SOUND: IT WAS OBVIOUSLY A CONSERVATIVE

EFFORT TO PRECLUDE COMPANIES FROM USING THE EXTRAORDINARY CLASSIFICATION AS A MEANS OF SWEEPING EXPENSES OUT OF ORDINARY INCOME DETERMINATION. HOWEVER, IT RECENTLY CAME TO THE COMMISSION'S ATTENTION THAT THE CLEVER COMBINATION OF THESE ACCOUNTING PRINCIPLES COULD RESULT IN A SUBSTANTIAL AND POTENTIALLY VERY MISLEADING INFLATION OF A COMPANY'S ORDINARY INCOME. WHAT WAS ONE TO SAY WHEN CONFRONTED, AS THE COMMISSION WAS RECENTLY, WITH A SUBSTANTIAL ISSUER WHICH, BECAUSE OF THE DEPRESSED PRICES OF ITS DEBT ISSUES SOLD AT A TIME WHEN INTEREST RATES WERE SUBSTANTIALLY LOWER THAN THEY ARE NOW, THROUGH THE EXTINGUISHMENT OF THIS DEBT BY EXCHANGE FOR HIGHER YIELD DEBT, MIGHT BE COMPELLED BY GENERALLY ACCEPTED ACCOUNTING PRINCIPLES TO REPORT ORDINARY INCOME VASTLY IN EXCESS OF ANYTHING REPORTED IN THE PAST, WITH EXTINGUISHMENT ACCOUNTING FOR OVER 90% OF ITS TOTAL ORDINARY INCOME? UNQUESTIONABLY THOSE FINANCIAL STATEMENTS WOULD BE PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, SINCE THEY WOULD COMPLY EXACTLY WITH APB 26 AND 30. AS WE ALL KNOW, APB OPINIONS CONSTITUTE ALL BUT CONCLUSIVE AUTHORITATIVE SUPPORT FOR THE PRINCIPLES ENUNCIATED IN THEM. YOU MAY SAY THAT RULE 203 OF THE CODE OF ETHICS PROVIDES A SAFETY VALVE FOR THIS KIND OF SITUATION AND THE AUDITOR CAN ESCAPE ANY QUEASINESS HE MAY EXPERIENCE IN EXPRESSING OPINIONS ON SUCH FINANCIAL STATEMENTS BY RENDERING A RULE 203 OPINION. HOWEVER, AS YOU WELL KNOW, THE PROBLEM IS NOT THAT SIMPLE. IT APPEARS RATHER CLEARLY THAT THE AUTHORS OF RULE 203 DID NOT HAVE IN MIND JUSTIFYING DEPARTURES FROM ACCOUNTING PRINCIPLES BOARD OPINIONS SIMPLY BECAUSE OF THE MATERIALITY OF THE AMOUNTS INVOLVED OR BECAUSE OF SITUATIONS THAT WERE FORESEEN AT THE TIME OF THE ADOPTION OF THE APB OPINION. THUS IN THIS INSTANCE ALL HERE MIGHT VERY WELL QUESTION THE PROPRIETY OF EXPRESSING AN OPINION THAT THE STATEMENTS WERE PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES IF APB #30 WAS IGNORED IN THEIR PREPARATION.

I WOULD SUGGEST THAT THIS KIND OF APPLICATION OF APB 26 AND APB 30, WHICH WOULD PERMIT MANAGEMENT TO CONTROL VAST AMOUNTS OF INCOME, DRAWING IT, AS IT WERE, OUT OF INVENTORY WHENEVER IT WISHED BY ISSUING PAPER WITH A HIGHER INTEREST COUPON, WOULD NOT BE CONDUCTIVE TO SOUND FINANCIAL REPORTING. IN MY ESTIMATION, THIS PRACTICE HAD WITHIN IT THE SEEDS OF GROSS EMBARRASSMENT TO THE ACCOUNTING PROFESSION, THE FASB AND THE SEC AND SOMETHING HAD TO BE DONE ABOUT IT. IT SEEMED TO ME RIDICULOUS FOR ALL OF US TO STAND BY AND ALLOW THIS PRACTICE TO ENDURE AND GROW SIMPLY BECAUSE APB OPINIONS MANDATED IT. LIKE THE PRONOUNCEMENTS OF ANY OFFICIAL BODY APB OPINIONS REFLECT MAINLY THE CONCERNS OF THE MOMENT AND NO AMOUNT OF GOOD WILL AND PROFESSIONAL COMPETENCE CAN FORESEE THE MANNER IN WHICH THEY MAY RESULT IN DISTORTIONS AND MISLEADING INFORMATION. WHEN APB OPINIONS NOS. 26 AND 30 WERE FORMULATED I WOULD SUSPECT LITTLE ATTENTION WAS GIVEN TO THE PROBLEM THAT WOULD OCCUR WHEN SHORT TERM MONEY HIT 12 PLUS PERCENT AND LONG TERM DEBT COMMANDED TWO DIGIT RATES. TO BE LOCKED INTO MODES OF PRESENTATION SIMPLY BECAUSE OF DECISIONS MADE IN A DIFFERENT ECONOMIC ENVIRONMENT SEEMS TO ME ABSURD. FORTUNATELY THE FINANCIAL STANDARDS ACCOUNTING BOARD HAS FELT THE SAME WAY. THEY HAVE UTILIZED THE PROVISIONS OF THEIR CONSTITUTION AND BY-LAWS THAT PERMIT PROMPT ACTION IN THE FACE OF A DEVELOPING ABUSE AND HAVE PUT OUT FOR COMMENT, ON A SHORT STRING, A MODIFICATION OF APB OPINION NO. 30 THAT WOULD RELEGATE MATERIAL AMOUNTS OF INCOME ATTRIBUTABLE TO EARLY EXTINGUISHMENT OF DEBT TO THE EXTRAORDINARY CATEGORY. I DO NOT FEEL THAT THIS OPENS THE DOOR TO THE REINTRODUCTION OF THE ABUSES THAT LED TO APB NO. 30 TO BEGIN WITH. THE STRINGENT REQUIREMENTS OF THAT OPINION REMAIN, TO MY MIND, INTACT; THEY ARE PROPOSED TO BE MODIFIED ONLY BECAUSE IT HAS BEEN FOUND THAT THEY PROVIDED, AS HAS HAPPENED WITH OTHER STRICT AND MECHANICAL REQUIREMENTS, AN OCCASION FOR MISLEADING REPORTING. I COMMEND THE FASB FOR THE ACTION THEY HAVE TAKEN. I

HAVE OFTEN EXPRESSED CONCERN THAT THERE BE A PRESENCE THAT COULD REACT PROMPTLY WHEN ABUSES OF THE REPORTING PROCESS APPEARED AND HAVE SUGGESTED THAT PERHAPS THE SEC HAD THAT ABILITY. I AM NOW PREPARED TO SAY THAT THE FASB CAN, WHEN IT WISHES, PERFORM THE "EARLY WARNING" CHORE. IT HAS SHOWN ITS ABILITY TO MOVE QUICKLY AND DECISIVELY.

ANOTHER INSTANCE IN WHICH TRADITION AND CUSTOM HAVE PREVENTED US FROM SATISFACTORILY ATTENDING TO THE DONUT RATHER THAN THE HOLE IS THE WHOLE PROBLEM OF HISTORICAL COST. AGAIN THE ADHERENCE OF THE ACCOUNTING PROFESSION TO HISTORICAL COST HAD ITS ORIGINS IN COMMENDABLE CONSERVATISM. BY REQUIRING THAT THE ENTIRE SYSTEM BE TIED TO ACTUAL TRANSACTIONS, A GOOD DEAL OF SUBJECTIVISM WAS REMOVED FROM THE ACCOUNTING PROCESS AND VERIFICATIONS WHICH ARE AN ESSENTIAL PART OF THE AUDITING PROCEDURE WERE MADE FAR MORE EXACT AND EASY. HOWEVER, AS A RESULT OF OUR EXPERIENCE WITH DOUBLE DIGIT INFLATION RATES, WE REALIZE THAT EVEN SO SANCTIFIED A PRACTICE AS HISTORICAL COST ACCOUNTING HAS ITS LIMITATIONS AS A VEHICLE FOR FULL DISCLOSURE, HENCE WE HAVE HAD IN RECENT YEARS A GROWING DEMAND IN MANY CIRCLES FOR AT LEAST A LIMITED DEPARTMENT FROM THOSE PRINCIPLES IN THE INTEREST OF MORE MEANINGFUL DISCLOSURE TO INVESTORS.

AS A CONSEQUENCE OF THIS DEDICATION TO HISTORIC COSTS WE ARE CONFRONTED WITH A SITUATION IN WHICH MANY CORPORATIONS HAVE REPORTED EARNINGS A MAJOR PART OF WHICH ARE MADE UP OF THE CONSEQUENCES OF INFLATION; INVENTORIES ARE FREQUENTLY UNDERSTATED IN VALUE ON BALANCE SHEETS; AND FREQUENTLY REAL INCOME IS BURIED UNDER MISLEADINGLY EUPHORIC FIGURES. AS A RESULT OF THIS REPLACEMENT RESERVES ARE SERIOUSLY UNDERSTATED AND CURRENT INCOME IS NOT BEARING AN APPROPRIATE SHARE OF COST. TO SOME EXTENT, THE MARKET HAS RECOGNIZED THIS. WHILE THIS IS SURELY NOT THE ENTIRE ANSWER TO THE DEPRESSED STATE OF THE MARKET, MANY COMMENTATORS ARE OF THE OPINION THAT IN SIGNIFICANT MEASURE THE CURRENT LOW EARNINGS MULTIPLES ARE A REFLECTION OF THE FACT THAT

THE MARKET RECOGNIZES THE INFLATED NATURE OF CORPORATE EARNINGS AND IS APPLYING A SOMEWHAT MORE REASONABLE PRICE EARNINGS RATIO TO THE REAL, NON-INFLATED EARNINGS OF THE ENTERPRISES.

IT IS EVIDENT THAT THIS ADHERENCE TO AN ANCIENT AND REVERED ACCOUNTING CONVENTION, HISTORICAL COST, IS HAVING ENORMOUS CONSEQUENCES THROUGH ECONOMY OF THE COUNTRY. IT IS DELUDING CORPORATE EXECUTIVES AND INVESTORS ALIKE WITH RESPECT TO THE AMOUNT OF CAPITAL WHICH WILL BE NECESSARY TO REPLACE OUR PLANT. IT CREATES IN THE MINDS OF MANY DISTORTED NOTIONS OF THE PROFITABILITY OF AMERICAN BUSINESS, WITH THE RESULT THAT TAX POLICIES ARE SOMETIMES BASED UPON GROSS MISAPPREHENSIONS OF CORPORATE WEALTH. I WOULD ASK YOU: IS HISTORICAL COST A PART OF THE DONUT OR A PART OF THE HOLE?

OF COURSE, AS IS TRUE OF MOST OTHER MATTERS AND PROBLEMS AFFLICTING THE PEOPLE RESPONSIBLE FOR FINANCIAL REPORTING, SUCH AN APPROACH IS NOT WITHOUT ITS DISSENTERS. IN ENGLAND THE INSTITUTE OF CHARTERED ACCOUNTANTS HAS BEEN GIVING SERIOUS CONSIDERATION TO THE SUPPLEMENTATION OF HISTORICAL ACCOUNTING WITH PRICE LEVEL ACCOUNTING. THIS LED ONE CHIEF EXECUTIVE OFFICER TO THIS WARM RESPONSE:

“PAGES 30 AND 31 ARE INCLUDED TO GIVE EFFECT TO THE RECOMMENDATIONS OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES BUT FOR NO OTHER REASON. THE RESULTS OF USING THE RETAIL PRICE INDEX TO ADJUST A WIDELY VARYING RANGE OF REVENUE AND CAPITAL ITEMS IN DIVERGENT INDUSTRIES IN DIFFERENT PARTS OF THE COUNTRY OVER WIDELY EXTENDED PERIODS OF TIME WILL PROVIDE NO SENSIBLE BASIS OF COMPARATIVE PERFORMANCE. IF ANY FORM OF INFLATION ACCOUNTING WILL DO ANYTHING BUT ENCOURAGE INFLATION, WHICH IS OPEN TO DOUBT, IT WOULD HAVE TO BE MORE SOUNDLY BASED THAN THE PRESENT PROPOSALS. THE POSSIBILITY OF THIS, AFTER SEVERAL MILLENNIUMS OF INFLATION, IS REMOTE. THERE WOULD BE MERIT IN A REALISTIC APPROACH TO THE PROBLEM BY PROVIDING DEPRECIATION ON RELATIVELY SHORT-LIFE ASSETS (PERHAPS TEN YEARS WOULD BE A SENSIBLE TERM) AT REPLACEMENT COST PROVIDED THIS SYSTEM WAS FOLLOWED TO ITS LOGICAL CONCLUSION AND TAX RELIEF

GRANTED ON THE TRUE REPLACEMENT COST. ANY INVESTMENT ANALYST WHO FORMS A VIEW OF WEDGWOOD FROM PAGES 30 AND 31 WILL ALMOST CERTAINLY ARRIVE AT A MISLEADING VERDICT.”

ANOTHER DRAMATIC INSTANCE IN WHICH FORM HAS TOO LONG PREVAILED OVER SUBSTANCE IS THE CUSTOMARY SHORT FORM OPINION. BACK IN THE THIRTIES, THE REDUCTION OF THE DIVERSITIES OF CERTIFICATES OR OPINIONS BY ACCOUNTANTS AND THE ADOPTION OF STANDARD NOMENCLATURES SUCH AS “GENERALLY ACCEPTED ACCOUNTING PRACTICES” WERE CONSIDERED TO BE TRIUMPHS OF A MAJOR ORDER -- AND INDEED GIVEN THE DISORDER OF THOSE TIMES THAT IS NOT AN UNTRUE CHARACTERIZATION. IN THIS DAY, HOWEVER, IT SEEMS TO ME THAT THE TRADITIONAL TWO PARAGRAPH -- NOW EXPANDED IN SOME CASES TO THREE PARAGRAPHS -- OPINION IS A BARRIER TO EFFECTIVE FINANCIAL DISCLOSURE RATHER THAN AN AID. A FORM OF OPINION LESS CONFINED BY RITUAL AND HISTORY COULD ADD IMMEASURABLY TO THE UNDERSTANDING OF INVESTORS. IT IS MY UNDERSTANDING THAT THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS HAS HAD A COMMITTEE WITH THIS SUBJECT UNDER CONSIDERATION FOR SOME TIME. I WOULD SUGGEST THAT IT MAY WELL BE THAT THE DIRECTION IN WHICH THE AUDITOR’S OPINION SHOULD DEVELOP IS SUGGESTED BY THE RECENTLY ADOPTED REQUIREMENT THAT SUMMARIES OF EARNINGS IN FORMS S-1 AND 10-K, THE ANNUAL REPORT TO SHAREHOLDERS AND OTHER DOCUMENTS BE FOLLOWED BY A MANAGEMENT ANALYSIS OF THE SIGNIFICANCE OF MATERIAL CHANGES YEAR-TO-YEAR. IT MAY WELL BE THAT THIS SORT OF ANALYSIS COULD PROPERLY BE THE PROVINCE OF THE AUDITOR AND A PART OF HIS OPINION, OR AT LEAST COVERED BY IT.

I’M NOT SURE, HOWEVER, THAT I AM QUITE PREPARED FOR THE CHATTINESS THAT CHARACTERIZED THE OPINION OF THE AUDITORS OF A LARGE BELGIAN COMPANY. THEY SAID, IN PART:

“WE WOULD LIKE TO JOIN THE BOARD OF DIRECTORS IN THEIR TRIBUTE TO THE MEMORY OF THE LATE MR. THEO LEFEVRE.

IN ACCORDANCE WITH LEGAL AND STATUTORY REQUIREMENTS, WE HAVE THE HONOUR OF REPORTING TO YOU ON THE EXECUTION OF OUR DUTIES AS AUDITORS FOR THE 1973 ACCOUNTING PERIOD.

THROUGHOUT THE WHOLE OF THE PAST FINANCIAL YEAR WE HAVE KEPT OURSELVES REGULARLY INFORMED OF THE COMPANY'S ACTIVITIES, NOTABLY THROUGH PERIODIC CONTACT WITH MEMBERS OF THE MANAGEMENT AND THROUGH READING THE MINUTES OF MEETINGS OF THE BOARD OF DIRECTORS AND OF THE EXECUTIVE COMMITTEE.

THE STATEMENTS SUMMING UP THE COMPANY'S ASSETS AND LIABILITIES, THE SUSPENSE AND THE PROFIT AND LOSS ACCOUNTS, WHICH ARE SUBMITTED TO US QUARTERLY, HAVE BEEN SUBMITTED. WE ARE COMPLETELY SATISFIED WITH THE INFORMATION AND DETAILS SUPPLIED TO US ON REQUEST.

WE HAVE EXAMINED THOROUGHLY THE BALANCE SHEET AND PROFIT AND LOSS ACCOUNT DRAWN UP AT 31ST DECEMBER 1973. IN CONCLUSION, WE ARE OF THE OPINION THAT THE COMPANY ACCOUNTS AS PRESENTED TO YOU REFLECT CORRECTLY THE COMPANY'S POSITION AND THE TRADING RESULTS FOR THE PAST YEAR.

LEGAL AND STATUTORY PROVISIONS HAVE, TO THE BEST OF OUR KNOWLEDGE BEEN PROPERLY OBSERVED. WE CONSIDER THAT THE ASSETS HAVE BEEN CAREFULLY ASSESSED.

WE WISH TO THANK THE DIRECTORS, THE MANAGEMENT AND SERVICES OF THE COMPANY FOR THE DOCUMENTATION PLACED AT OUR DISPOSAL AND THE KIND COOPERATION SHOWN BY ALL."

FINALLY, IT SEEMS TO ME THAT THE VERY FORM OF FINANCIAL STATEMENTS NEEDS A RADICAL REEXAMINATION. THE BASIC STRUCTURE OF OUR FINANCIAL ACCOUNTING SYSTEM DEVELOPED AT A TIME WHEN ENTERPRISES WERE FAR SIMPLER, WHEN THE DATA TO BE ACCOUNTED FOR WAS LESS COMPLEX, WHEN MANY OF THE KINDS OF TRANSACTIONS THAT MUST NOW BE ACCOUNTED FOR WERE UNKNOWN. PERHAPS THE BEST EVIDENCE OF THE INADEQUACIES OF THE CONVENTIONAL FORMAT IS THE FACT THAT THE FOOTNOTES ARE BECOMING INCREASINGLY LONG, COMPLEX AND SIGNIFICANT; THIS MAY SUGGEST THAT IT IS SIMPLY IMPOSSIBLE, GIVEN THE CUSTOMARY SHAPE OF FINANCIAL STATEMENTS. TO FIT THE DATA INTO THEIR RESTRICTED FORMAT. THE COMMISSION HAS SUGGESTED

EXPERIMENTATION WITH NEW FORMS OF FINANCIAL STATEMENTS, ALTHOUGH WE DO NOT CONSTRUE THIS AS A LICENSE TO SEEK OUT THE RIDICULOUS. HOPEFULLY, THE FASB TASK FORCE ON CONCEPTUAL MATTERS, WHICH INCLUDES THE IMPLEMENTATION OF THE TRUEBLOOD COMMITTEE REPORT, WILL ADDRESS ITSELF TO THIS PROBLEM. I WOULD HOPE THAT IT WILL BE ABLE TO RID ITSELF OF THE SHACKLES OF HISTORY AND THE SLAVERY OF THE FAMILIAR AND REACH OUT IN A TRULY IMAGINATIVE AND FARSEEING MANNER.

IN CONNECTION WITH FOOTNOTES, I WOULD ADD ONE PERSONAL NOTE. IT SEEMS TO ME THAT MANY OF THE FOOTNOTES THAT ARE PRESENTLY IN FINANCIAL STATEMENTS ARE WRITTEN TO OBSCURE RATHER THAN ILLUMINATE THE FACTS ABOUT THE ISSUERS. I HAVE FREQUENTLY ENCOUNTERED NOTES THAT WERE ALL BUT IMPENETRABLE, WRITTEN IN TECHNICAL JARGON THAT MIGHT BE EASILY UNDERSTOOD BY OTHER ACCOUNTANTS, BUT WHICH TO THE EYES AND MIND OF ANYONE LESS SOPHISTICATED THAN THAT POSE A FORMIDABLE PROBLEM IN UNDERSTANDING. I WOULD STRONGLY URGE THAT ACCOUNTANTS AND CLIENTS MAKE EVERY EFFORT TO KEEP FOREMOST THE FACT THAT FOOTNOTES, LIKE ALL FINANCIAL DISCLOSURE, ARE INTENDED TO COMMUNICATE TO A BROAD SPECTRUM OF SOPHISTICATIONS. WHILE I WOULD NOT SUGGEST THAT THEY SHOULD BE DESIGNED FOR THE ECONOMICALLY ILLITERATE, I WOULD URGE ON THE OTHER HAND THEY NOT BE COUCHED IN SUCH TERMS THAT ONLY THE INVESTOR AT THE OTHER END OF THE SPECTRUM IS ABLE TO PENETRATE THEIR OBSCURITIES. IT SEEMS TO ME THAT THERE IS A HAPPY MEDIUM WHICH CAN BE ACCOMPLISHED BETWEEN OVERSIMPLIFICATION AND EXCESSIVE COMPLEXITY AND THAT A GOOD DEAL OF WORK NEEDS TO BE DONE IN REACHING THAT MIDDLE GROUND.

WHAT CAN BE DONE TO RIVET ATTENTION ON THE DONUT AND NOT ONE THE HOLE? OBVIOUSLY SOME OF THE REMEDIES ARE SUGGESTED BY MY PREVIOUS REMARKS THEMSELVES. LET ME ELABORATE SOMEWHAT ON THOSE.

THE INCREASED CONCERN WITH THE FAIRNESS OF FINANCIAL STATEMENTS POSES AN OPPORTUNITY TO MOVE AWAY FROM THE RIGIDITIES OF GENERALLY ACCEPTED

ACCOUNTING PRINCIPLES AND OTHER DETERRENDS TO MEANINGFUL FINANCIAL DISCLOSURE. I WELL REALIZE THE CONCERN THAT THE ACCOUNTING PROFESSION HAS WITH RESPECT TO THE INTRODUCTION OF CONCEPTS OF "FAIRNESS" INTO THEIR JUDGMENT PROCESS. HOWEVER, I AM SURE ALL OF YOU RECOGNIZE THAT THE COURTS AND THE COMMISSION ARE IN EFFECT COMMITTING YOU TO THIS KIND OF JUDGMENT. IN UNITED STATES V. SIMON, A CRIMINAL CASE DECIDED SEVERAL YEARS AGO BY THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT, AN OPINION AUTHORED BY JUDGE HENRY C. FRIENDLY, IN THE ESTIMATION OF MANY, THE MOST KNOWLEDGABLE AND SOPHISTICATED FEDERAL JUDGE IN MATTERS OF CORPORATION FINANCE, INDICATED CLEARLY THAT IN MANY CIRCUMSTANCES AN AUDITOR MAY NOT STOP AT A DETERMINATION THAT FINANCIAL STATEMENTS HAVE BEEN PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, BUT THAT HIS PROFESSIONAL ENDEAVOR MUST ALSO ENCOMPASS A DETERMINATION OF FAIRNESS. THE COURT OF APPEALS AFFIRMED THE DECISION OF THE LOWER COURT, INCLUDING PARTICULARLY THE LEGAL PROPRIETY OF THE TRIAL JUDGE'S CHARGE TO THE JURY. IN THAT CHARGE THE JUDGE VERY CLEARLY INDICATED THAT WHILE A DETERMINATION BY AN AUDITOR THAT FINANCIAL STATEMENTS HAVE BEEN PREPARED IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES WENT A LONG WAY TOWARD ESTABLISHING THE PROPRIETY OF THE AUDITORS' CONDUCT, THAT DID NOT CONSTITUTE A COMPLETE DEFENSE AND THE AUDITOR MUST OF NECESSITY GO EVEN FURTHER IN EXAMINING THE STATEMENTS FOR FAIRNESS.

I DO NOT THINK THE COURTS OR THE COMMISSION ARE CALLING UPON THE ACCOUNTING PROFESSION TO MAKE FINE DELINEATIONS WITH RESPECT TO FAIRNESS. RATHER IT SEEMS TO ME THAT WHAT WE ARE SEEKING IS THE SORT OF DETERMINATION OF FAIRNESS THAT WOULD FIND AMONG REASONABLE MEN LITTLE DISAGREEMENT, ALTHOUGH THE OLDER I GET, THE MORE I REALIZE THERE ARE VERY FEW PROPOSITIONS THAT CAN BE

PUT FORWARD THAT WOULD NOT ENCOUNTER DISAGREEMENT IN SOME QUARTER. I DO NOT THINK IT SHOULD HAVE REQUIRED ELABORATE STANDARDS TO ENABLE AUDITORS TO MAKE JUDGMENTS OF FAIRNESS ABOUT THE FINANCIAL STATEMENTS OF MANY FRANCHISORS, LAND DEVELOPERS, ACQUISITIVE CONGLOMERATES, AND OTHER PHENOMENA OF THE RECENT PAST, JUST AS I DO NOT THINK IT POSES A VERY HARSH BURDEN TO EXPECT AUDITORS TO MAKE FAIRNESS JUDGMENTS WHEN VERY SIGNIFICANT AMOUNTS OF ORDINARY INCOME OF A CORPORATION REPRESENT GAIN ON THE EARLY EXTINGUISHMENT OF DEBT. IT MAY WELL BE THAT AN INTERIM SOLUTION TO THIS PROBLEM LIES IN SOME SORT OF EXPANSION OF THE FORMAT OF THE OPINION. AS A DEPARTURE FROM THE RIGIDITIES OF THE PRESENT PHRASEOLOGY, SUCH OPINIONS MIGHT VERY WELL HIGHLIGHT QUESTIONS OF FAIRNESS IN THE PRESENTATION AND IT MAY WELL BE THAT EVEN THOUGH AN AUDITOR IS NOT WILLING TO EXPRESS AN OPINION WITH REGARD TO FAIRNESS, AT LEAST THE OPINION MIGHT BE USED AS A MEANS OF SUGGESTING THAT INVESTORS AND OTHER USERS OF THE FINANCIAL INFORMATION BE ALERT TO THE POSSIBILITY THAT A PRESENTATION IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES MAY NONETHELESS LEAVE A RESIDUAL PROBLEM OF FAIRNESS.

I THINK IT IS EASY TO EXAGGERATE THE DIFFICULTY OF THIS APPROACH. IN THE FIRST PLACE, I WOULD SUGGEST THAT IN THE OVERWHELMING NUMBER OF CASES THE APPLICATION OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES YIELDS A FAIR PRESENTATION. FURTHERMORE, AS THE NUMBER OF ALTERNATIVE ACCOUNTING PRINCIPLES AVAILABLE TO MANAGEMENT IS REDUCED, THE POTENTIAL FOR UNFAIR PRESENTATION WILL SIMILARLY DIMINISH. FINALLY, I WOULD SUGGEST THAT AUDITORS ARE NOT AS INEXPERIENCED IN MAKING JUDGMENTS OF FAIRNESS AS SOME OF THEIR OPPOSITION TO THIS RESPONSIBILITY MIGHT SUGGEST. THEY, LIKE ALL OF US, ARE MAKING RELATIVELY SUREFOOTED JUDGMENTS OF FAIRNESS EVERY DAY. WE HAVE HIGHLY DEVELOPED NOTIONS OF FAIRNESS WITH REGARD TO THE CONDUCT OF OUR CHILDREN, OUR WIVES, OUR BUSINESS ASSOCIATES, OUR GOVERNMENTS. THE TRANSPORTATION OF THESE

CONCEPTS, WHICH SHOULD BE MORE FULLY DEVELOPED IN THE PSYCHE OF PROFESSIONALS THAN ELSEWHERE, INTO PROFESSIONAL LIFE SHOULD NOT BE DIFFICULT.

THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' AUDITING STANDARDS EXECUTIVE COMMITTEE HAD BEEN CONSIDERING MEANS OF DEVELOPING STANDARDS FOR THE DETERMINATION OF FAIRNESS. THE CHIEF ACCOUNTANT OF THE COMMISSION, DR. JOHN C. BURTON, HAS RECENTLY IN HIS EMANUEL SAXE DISTINGUISHED ACCOUNTING LECTURE AT THE BARUCH COLLEGE OF THE CITY UNIVERSITY OF NEW YORK ARTICULATED HIS CONCEPTION OF THE CONTENT OF THE NOTION OF "FAIRNESS". I DO NOT PAUSE TO ANALYZE THESE POSITIONS, THEIR DIFFERENCES, OR THEIR RESPECTIVE MERITS. I WOULD RATHER CONFINE MY COMMENT TO STATING DELIGHT THAT THE SUBJECT IS NOW BEING DISCUSSED AS IT SHOULD BE, NOT IN A MOOD OF DESPAIR OR DEFEAT BECAUSE OF THE ADDITIONAL LIABILITY EXPOSURES PRESENTED BY IT, BUT RATHER IN AN AFFIRMATIVE ATMOSPHERE CHARACTERIZED BY A DETERMINATION TO MAKE FINANCIAL STATEMENTS MORE MEANINGFUL AND USEFUL AND BETTER MEDIA FOR EFFECTIVE COMMUNICATION OF FINANCIAL INFORMATION.

ANOTHER WAY IN WHICH WE CAN FOCUS UPON ECONOMIC REALITY TO A GREATER EXTENT IS BY RECOGNIZING THE UTILITY OF ILLUMINATING THE CONSEQUENCES OF THE USE OF ALTERNATIVE ACCOUNTING PRINCIPLES. THE COMMISSION HAS MADE A PROPOSAL FOR AN EXPANSION OF DISCLOSURE WITH RESPECT TO THIS AND HAS, AS YOU MIGHT EXPECT, MET WITH GREAT OPPOSITION TO THIS SO-CALLED "AS IF" ACCOUNTING. I WOULD SUGGEST THAT GREATER ATTENTION TO THIS PROPOSAL AND THIS APPROACH MIGHT WELL BE A MEANS OF FOCUSING BETTER UPON SUBSTANCE. AT THE PRESENT TIME, THE TRADITIONAL MODE OF PRESENTATION HAS TENDED TO MISLEAD THE PUBLIC INTO THE BELIEF THAT THERE IS ONLY ONE EARNINGS FIGURE, THAT THERE IS ONLY ONE WAY OF PRESENTING BALANCE-SHEET VALUES, THAT THERE IS A KIND OF MATHEMATICAL CERTAINTY WRAPPED UP IN FINANCIAL STATEMENTS. FURTHER EXPOSITION OF THE CONSEQUENCES OF THE USE OF ALTERNATIVE ACCOUNTING PRINCIPLES WOULD, IN MY ESTIMATION, BRING HOME TO

THE PUBLIC THE TRUE REALITY OF FINANCIAL STATEMENTS, NAMELY, THAT AT BEST THEY ARE APPROXIMATIONS AND THAT THE INVESTMENT PROCESS CANNOT AND SHOULD NOT BE A BLIND WORSHIP OF EARNINGS PER SHARE STATED AS A SINGLE FIGURE.

THESE REMARKS ARE ONLY SUGGESTIONS OF DIRECTIONS IN WHICH FINANCIAL REPORTING MIGHT DEVELOP TO ASSURE THAT OUR SIGHT IS ON THE DONUT AND NOT THE HOLE. NO ONE SHOULD DENIGRATE THE IMPORTANCE OF THE FASB DEVELOPING ACCOUNTING PRINCIPLES SUCH AS THOSE CONCERNING CURRENCY TRANSLATION AND THE TREATMENT OF RESEARCH AND DEVELOPMENT. STILL WE SHOULD, I THINK, TAKE CONSIDERABLE SATISFACTION IN THE FACT THAT THEY HAVE ALSO UNDERTAKEN THE MORE DIFFICULT TASK OF DEALING WITH THE IMPLICATIONS OF THE TRUEBLOOD COMMITTEE REPORT. THROUGH THIS RESEARCH AND THOUGHT I AM CONFIDENT THAT WE WILL MOVE MUCH CLOSER TO THE ULTIMATE GOAL OF FINANCIAL REPORTING, THE PROVISION OF INFORMATION THAT IS INDEED USEFUL IN THE MAKING OF ECONOMIC DECISIONS.

ALL OF US HAVE A ROLE IN THIS PROCESS. ALL OF YOU HAVE A STAKE IN IT; THE ACCOUNTING PROFESSION AS A WHOLE HAS A STAKE IN IT; THE SEC HAS A STAKE IN IT. MORE IMPORTANTLY, THE AMERICAN ECONOMY HAS A HUGE STAKE IN IT, FOR WITHOUT ADEQUATE, RELIABLE FINANCIAL REPORTING PRACTICES, IT IS UNLIKELY THAT THE CAPITAL NEEDS OF OUR NATION CAN BE SATISFIED IN THE YEARS AHEAD. AND UNLESS THOSE NEEDS ARE SATISFIED, WE SHALL PASS ON TO OUR CHILDREN AND THEIRS AFTER THEM A LESSER WAY OF LIFE THAN WE HAVE KNOWN. NO GENERATION WISHES TO DO THAT.