

NEWS

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 755-4846



An Address By

Roderick M. Hills, Chairman

Securities and Exchange Commission

January 7, 1976

AMERICAN INSTITUTE OF
CERTIFIED PUBLIC
ACCOUNTANTS

Statler Hilton Hotel
Washington, D.C.

When I arrived at the SEC just two months ago, I was urged to pause for awhile before speaking -- to first secure a three-dimensional view of the Commission. In theory, the three-dimensional view would provide a more accurate assessment of what is being done and what should be done. In fact, I fear that the three dimensions are the three different approaches to SEC matters taken by lawyers, accountants and economists.

Simply, and only somewhat facetiously, the lawyer is said to be writing laws and regulations until he gets what he wants -- the Wall Street Journal, as you know, has explained that the lawyers have passed well over 35 million laws to enforce the Ten Commandments.

The feelings of many economists, on the other hand, were perhaps best summed up a few weeks ago by Professor Homer Kripke:

"The economists almost totally ignore the SEC, treating it like some imperfection in a communications system, like some static. Its role is obviously not of fundamental importance to their thinking."

At least, we are not ignored by the accounting profession, nor can we possibly ignore the prodigious bundles presented to us by Sandy each time a new accounting issue arises. But, from these materials and from comments of the accounting profession, it is apparent to me that the perception of accountants differs from that of lawyers

and economists. Priorities are stated differently by accountants, and to some degree, the problems of the securities industry are defined in a different fashion.

One difference which I find particularly pleasant is the fact that on occasion, some accounting issues solve themselves before we get to them. We see, for example, with some pleasure, that our benign procrastination with respect to the problem of the lawyer's letter has been rewarded by a successful effort by the two professions to reach a reasonable solution. Or at least, I am glad to say that we perceive a more acceptable understanding by the lawyers and the accountants of each other's problems.

Under the approach now advanced, accountants will accept less precision in the lawyer's letter given them in exchange for the lawyer's willingness to accept more explicit professional responsibility for their clients' disclosure of contingent matters.

Obviously, a gap is left. How can either the Commission or the investing public be certain that each lawyer recognizes and respects his professional responsibility and why are we not still at the mercy of company officers who are willing to ignore lawyers' counsel? Perhaps there are such issues left! -- but reason tells me that this agreement gives far more incentive for adequate disclosure of real and important contingencies. It is, I believe, a major step forward.

We are equally pleased to see that procedures for unaudited review of interim data by independent accountants are being developed, and that the FASB announced today that it will deal with the accounting issues raised by debt moratoriums.

While the Commission has perhaps given fewer Christmas presents to the accounting world this past year, you have plenty of evidence that our accountants are earning their keep. In the early Fall, we published final rules on interim reporting and proposals for bank disclosures and replacement costs. Preliminary work done during this period on liquidity disclosure, disclosure of business uncertainties, along with revised Regulation S-X rules on consolidation, may well be displayed in 1976.

The Commission is particularly interested -- and I think wisely -- in the activities of the Financial Accounting Standards Board and the Auditing Standards Executive Committee of the AICPA. In two weeks, we will have a meeting with the full FASB, both for an up-date on their work and to address specific matters. Similarly, we will be closely following former Chairman Cohen's Committee on Auditor's Responsibilities.

More particularly, the Commission has launched an effort of great importance with respect to current value accounting. We have asked for comments on a limited proposal to require

supplemental footnote disclosure of the current replacement cost of inventories and productive capacity and of disclosure of cost of sales and depreciation computed on that basis.

This recognition by the Commission of the need to deal with the impact of inflation on individual business firms should be our most significant accounting initiative in 1976.

There can be little question that one of the major forces existing in our economic environment today is inflation. While its impact varies dramatically from one business and one industry to the next, there are no business managers who are unaffected by it. A major test of any management, therefore, is its ability to cope with inflation, changing costs and selling prices are a way of life, and if a business is to be successful, its managers must have good information as to what is happening, and what the implications are for the future. A business must have current cost data reflecting inflationary impact.

This is primarily a principle of good management and only secondarily a principle of good accounting.

Similarly, aggregate data based on current costs is important information for the investor so that he can perceive how well the management is dealing with an

inflationary environment. Investors just as managers must understand the current economics of a business in order to make reasonable judgments about its prospects. Financial statements based only on historical costs are not sufficient in an inflationary economy characterized both by substantial relative changes in the prices of specific goods and services as well as general upward price movements.

I wish to stress the point that we are careful not to suggest that present financial statements are valueless, only that they need to be supplemented, and we have also asked for comment on whether these data we seek should be labelled "unauditet" and whether they should initially be required only of companies over some size.

We also ask for specific data as to the cost of implementing such rules. Some initial responses tell us the cost is prohibitive. One specific utility, with total assets of about \$3 billion, advised us that an "extremely conservative" estimate of the cost of implementing our proposal on a limited basis would be \$3 million, that it was likely that the actual cost would be substantially above this figure, and that the cost of implementing the intent of the present proposal would be many times the

\$3 million figure. But other companies who have studied the matter supply us with cost estimates of a far different order of magnitude.

- Another major utility with substantially more assets than the one I mentioned earlier, states that they estimate a cost of four to six man years to put a meaningful system into effect, an amount less than one percent of current accounting costs.

- A diverse manufacturing company with assets in the range of \$200 million estimated a first time cost of \$100,000 to develop a full set of financial statements on which their auditors were prepared to report.

- The actual experience of one paper company with \$60 million in assets was that it cost \$15,000 to develop publishable and auditable data on a replacement cost basis.

These are not small numbers, but they indicate costs are within manageable limits.

Moreover, I cannot easily accept the argument that it is too costly to secure the data we are speaking about, for I cannot believe that good managers are not already using the same kind of information in their decision-making. How, for example, can any cash flow projections that go forward three to five years ignore current cost data?

It is, of course, too early to make final judgment with respect to the proposal and there may well be reasonable adjustments that will ease the expense. Still, I believe that most will see the value of the information we seek and will, therefore, find acceptable methods to secure it without excessive cost.

We do recognize these are legitimate questions about the proposals. Some replacement data is particularly subjective in nature, such as the cost of new types of capital equipment, still in development, that will replace the old. Good managers may fear liability if they guess wrong about such costs. I suggest, however, that such fears can be dealt with -- they do not outweigh the real values to be obtained from the display of current cost data.

The comment period ends on January 31. I urge you to develop specific responses to assist us. Our schedule is to publish final rules by mid-year, so that companies will have at least six months to develop the necessary data. Our Chief Accountant has promised us summarized comments and an outline of issues for discussion by the Commission by mid-March, and final staff recommendations by May 1.

We, of course, intend the final rules to be beneficial to investors and managers. We also believe they will better communicate business realities to those who make tax policy and to those responsible for macro-economic policy.

I fully share the view that today's tax structure is biased in many respects against capital formation. A business cannot deduct the cost of maintaining the current level of productive capacity under an historical cost system. Businesses, suffering from inflation are taxed on so-called "income" which is not income in an economic sense.

This means that capital is being eroded except where reported income is large enough both to provide for higher replacement costs and for a reasonable return to owners. But the fact is that many economic policy makers, particularly among elected representatives, appear to believe that corporate profits as reported now are excessive.

At present, there simply is no systematic data being developed by the business community which demonstrates what is happening. In the absence of such data, it is unlikely that a convincing case can be made for tax reform. Managements cannot continue to report only a rosy profit picture to shareholders while preaching a different gospel to tax policy makers.

I do not suggest to you that tax reform will magically follow adoption of the proposed rules which would require disclosure of the increased costs resulting from inflation, but I do believe that without some reasonable first step in data development, we will not even see movement toward tax reform.

In this connection, it is encouraging to see that the Department of Commerce will be publishing some estimates of aggregate capital consumption allowances based on current replacement costs for the first time in 1976.

I must also mention a major element in our tax laws which discriminates specifically against equity capital -- the preferential treatment given to debt compared to equity through the deductibility of interest payments. In the post-war era, we have seen substantial shifts from equity to debt in the composition of corporate capital structures, arising, at least in significant part, from this tax preference. Between 1951 and 1975 the ratio of debt of equity for manufacturing corporations has increased from less than 20% to more than 40%.

While many tax preferences are inserted into the tax laws, the basis of a specific benefit, it appears that this preference grew up inadvertently through the adoption of the accounting approach. It is by no means clear that this preference is consistent with the public economic interest, and I would submit that the weight of the argument is on the other side.

Preference for debt tends to increase corporate leverage, which in time builds an instability into corporate earnings. Earnings' coverage of debt service for all industries has decreased dramatically from more than 12 times in 1951, to only about 2 times at present. Increased leverage also increases the risk of corporate failure, with the attendant economic dislocations.

In addition, the tax disincentive to dividend distributions tends to encourage enterprises to keep unneeded capital rather than return it to the capital market for reinvestment.

Finally, the lack of dividends makes equity capital investments less attractive in the aggregate, since in the long run, dividend distributions are the real source of ultimate stock values.

A logical tax policy would make dividend payments deductible from corporate taxable income and thus achieve parity between debt and equity capital. Such action would encourage corporations to use equity financing by lowering its cost. It should make equity investments more attractive to investors.

This approach would not have any significant impact on the basic progressive tax structure which underlies our

tax system. To the extent more dividends are paid out to individual taxpayers, more taxes would be payable, since dividends are generally paid to persons at higher income levels.

Tax policy, of course, is not directly within the purview of the Commission's responsibility, but I believe it is appropriate for the Commission to be heard on economic issues which effect the attractiveness of equity investments. This seems to me entirely consistent with our statutory mandate of protection of investors.

It is certainly both appropriate and desirable for the accounting profession also to focus its attention on matters of economic and tax policy. You are uniquely situated professionally, with expertise in economic measurement, disclosure and taxation.

There is a further matter on which I wish to comment, which in my view, at least, promises to be of vital interest to the securities industry and to the manner in which the Commission acts in the future.

It is timely that we face up to the criticisms of economists and accountants and lawyers that our disclosure policies overall are not as relevant as they could be. We are mindful of the criticisms of those who feel we disclose both too much and too little. Too much of the irrelevant and too little of the material.

Five years ago, Frank Wheat's review of disclosure policies told us that it was time to put our emphasis increasingly on continuing disclosure rather than devoting our time primarily to new issues. This, and other recommendations, served as a basis for much of our disclosure policy in the years since.

But, in the ensuing five years, markets, attitudes, opportunities, laws, debt/equity ratios, and the economy have all changed. While I have confidence that, on balance, the regulatory efforts of the SEC have proven their value, and that the integrity of our work is particularly material to continued investor interest, I cannot easily dismiss the conclusion of Professor George Stigler that:

"The SEC did not (in over 30 years of effort) appreciably improve the experience of investors in the new issues market by its expensive review of prospectuses."

I believe we can be sure enough of our integrity and of our real objectives to accept the Stigler challenge and begin now a reassessment of all disclosure policies.

We can take it from the start, and seek from a base of zero to create a new disclosure policy that reflects today's realities, one that managers, lawyers, economists and accountants can understand and implement. We will seek to define our objectives with precision and list our means to those ends.

I expect, therefore, to announce soon, on behalf of the Commission, the commencement of a comprehensive reassessment of the objectives of our disclosure policy and our means of implementing those objectives -- one that will be guided by an outstanding group of informed outsiders and executed in conjunction with the full support and participation of experienced staff.

My own prejudices, those which I brought to the Commission, influence my support for the effort, but its primary thrust comes from those who best understand the issues, from Alan Levenson, Director of our Division of Corporation Finance, from Sandy Burton, our Chief Accountant, and from the other Commissioners who stressed the need for this effort before my arrival. The study could be substantially completed in from twelve to eighteen months. I will leave a better description of its personnel and methodology to a later time this month, but let me add that this new study will give increased consideration to the role of empirical evidence in formulating policy and particularly in monitoring policy decisions to seek better evidence as to whether the objectives of regulation are

being met.

I confess to you that I approach this reappraisal just as I approached this speech, with due skepticism about the relevance of lawyer's logic, and with due respect for the relative certainty of accounting principles.

But I must tell you in closing, as I seek to ingest the mystic of accounting conventions and of generally-accepted accounting principles, I take great comfort from my first accounting lesson, given by the writings of Robert Frost:

"Nobody was ever meant
To remember or invent
What he did with every cent"