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Harvey Kapnick

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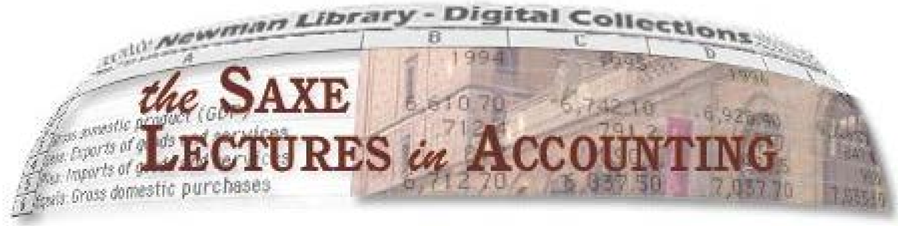

VALUE-BASED ACCOUNTING
EVOLUTION OR REVOLUTION

by
Harvey Kapnick
Chairman
Arthur Andersen & Company
February 17, 1976

[Introductory note: In May 1970 Harvey Kapnick was elected Chairman of Arthur Andersen & Company, the firm he joined in Chicago in 1948. In 1956, at the age of 30, he became a partner and seven years later he was made Managing Partner of the company's Cleveland office. He has been a member of the Board of Directors since 1966.

Mr. Kapnick was born in Michigan. After serving as an officer in the Army Air Force, he was graduated from Cleary College in Ypsilanti, Michigan, and attended Graduate School of Business Administration at the University of Michigan 1947-48. He received an honorary degree, Doctor of Science in Business Administration, from Cleary College in June of 1971. He and his wife and three sons live in Winnetka, Illinois.

A Council Member at large of the American Institute of Certified Public Accountants, Mr. Kapnick is also treasurer, trustee, and director of numerous educational, cultural and philanthropic institutions.

[note: Fair Value Accounting -- this concept has been given new emphasis with the Sandilands proposal in Britain. The demands for international standards of accounting are increasing. The concept of fair value accounting cuts across national boundaries, philosophies and interests so that meaningful international standards are feasible.

If the British go ahead with the Sandilands current cost concept, and, if the United States goes ahead with price level accounting, we will find ourselves in such chaos that international standards are going to evolve whether we like it or not. The only question is how.]

Accounting based on values has been discussed more during the last forty years by accountants as providing more useful data based on economic facts than any other subject. Yet, what results in practice do we have to show for all these speeches, articles, papers, and books? Almost nothing! Why has there been so little real progress when an obvious need for change has become increasingly evident for many years?

While the accounting profession has had its share of inertia and problems, it has also lost great opportunities for service. The leadership in the profession has been ineffective in getting accounting standards in the United States on a sound conceptual basis. Further, business leadership, government regulators, and others have not persuaded the accountants to become realistic in reporting the economics of business operation. Confusion and a lack of realism have been the result.

The Accounting Lag

The rate of change in the way business is conducted has accelerated greatly in recent decades. Today, there are large corporations (including multinationals and conglomerates), complex income taxes, lease financing, pension plans, an energy crisis, electronic computers, and transfer prices. The present business scene includes not only these but also many other far-reaching developments, plus a maze of governmental regulation, a rapid rate of technological change, world-wide inflation, and a perceived need for public financial reporting that encompasses ever shorter time intervals, i.e., quarterly.

Being man-devised and man-implemented, accounting should be expected to adjust to such changing conditions, as do social behavior, ethical standards, and the common law. However, since most individuals are disposed to resist change, a tendency exists, without some overriding force, for changes to lag behind the need. After making allowance for what might be described as a normal lag, accounting still is so far behind the rate of change that has occurred in the environment in which business operates that it is a source of embarrassment. How can our watchwords, "generally accepted accounting principles," receive high marks for providing relevant financial information when the business environment has changed so much in recent decades while accepted principles have changed so little?

A variety of reasons has contributed to the lack of progress. The accounting profession may have failed to grasp the significance of its role despite the increasing importance accorded to the financial reporting of business enterprises. The standard -- setting function is now on third base in the form of the Financial Accounting Standards Board, after being on second base with the Accounting Principles Board and on first base with the Committee on Accounting Procedure. Each of these organizations has had different responsibility, authority, and composition. Whether the team ever scores remains to be seen.

A factor contributing to the delay has been the accounting profession's preoccupation with the need to narrow the range of equally acceptable alternative accounting and reporting practices. An enormous investment of time and resources has gone into the quest for uniformity. This effort has essentially been within an outmoded conceptual framework, and the goal of revising and reformulating accounting principles to better meet the needs of a changing business environment has, for all practical purposes, been lost in the shuffle. Uniformity as a goal within the historical-cost framework may by hindsight have been an unfortunate decoy.

The efforts of the accounting profession to improve accounting standards and principles have been dominated by CPAs in public practice, and the auditing aspects of problems have always been a significant consideration to them. When useful information for investors is our goal, what is easiest to audit may not be the most useful.

Objectives Long Overdue

Accounting has suffered from a void attributable to a lack of agreement about the objectives of the accounting and reporting process. This subject has not been raised much above the level of an academic exercise. This lack of agreement with respect to objectives has seriously handicapped efforts to resolve accounting problems and controversies. Objectives, authoritatively supported, could provide the goal, the road map, the unifying force, and the direction needed to stimulate the process by which accounting standards could become relevant and result in truly meaningful and useful financial statements.

The Committee on Accounting Procedure made a few half-hearted attempts to consider objectives but never really accomplished anything in this regard. The Accounting Principles Board commissioned two research studies in this area. Several years later, the APB produced Statement No. 4 on basic concepts and accounting principles that was nothing but a meaningless attempt to rationalize from existing practices back to concepts and principles, which cannot be done on any reasonable basis. One potentially positive step was the publication in 1973 by the AICPA of the Report of the Study Group on the Objectives of Financial Statements. However, the Financial Accounting Standards Board since its inception in 1973 has dealt with various subjects without any established objectives. A public hearing was held on this subject in September, 1974. A second public hearing will probably not be held before September, 1976. This continuing delay is becoming increasingly intolerable, resolution of this matter in the foreseeable future cannot be predicted with much confidence.

Views of Our Firm on Objectives

In the absence of any authoritative set of objectives, each of us must establish our own in determining what concepts and standards would best serve the users of financial statements in today's environment. Our firm has held the view for some time that the approach to corporate financial accounting should be value based rather than cost based. This was the position taken in 1972, as set forth in our book, *Objectives of Financial Statements for Business Enterprises*. Advocated therein was the viewpoint that the overall purpose of financial statements is to communicate information concerning the nature and value of the economic resources of a business enterprise, the interests of creditors and the equity of owners in the economic resources, and the changes in the nature and value of those resources from period to period.

Later in 1974, our firm published a book, *Accounting Standards for Business Enterprises Throughout the World*, which expands further our views with respect to objectives and sets forth a complete set of illustrative financial statements, including notes, on the basis of the objectives, concepts, and standards as we view them.

Economic resources are defined as those elements of wealth that possess the three basic characteristics of utility, scarcity and exchangeability, which in combination give the resources economic value. Exchangeability, as the term is used, is not intended to suggest that an economic resource is necessarily readily marketable or that it is being held for immediate sale. Rather, exchangeability means that an economic resource is something that is separable from a business as a whole and that has value in and of itself -- that it is not solely dependent on the fortunes of the particular business enterprise to which the resource is attached.

The basic characteristics prescribed for economic resources tend to exclude the wide assortment of unidentifiable intangibles or attributes of a business enterprise that may give it an advantage over others in a relatively free, competitive economic system and, hence, enable it to achieve earnings beyond a normal rate of return on capital. The attributes of unidentifiable intangibles may be extremely valuable -- they may arise through deliberate effort or accidentally -- but information about their quality and potential value should be conveyed primarily by earnings information rather than through direct measurement and inclusion in the balance sheet as assets.

A value-based approach also determines the companion earnings concept. If earnings are based on the measurement of economic resources, then periodic earnings will be determined by the change in the owners' equity shown by comparative balance sheets, after a provision for the maintenance of owners' capital to reflect the effects of inflation and after allowing for additional investments by owners and distributions to owners. In other words, the earnings concept is ultimately based on changes in the value of the net assets. However, unless inflation is taken into consideration, much of what is traditionally viewed as income may not exist in real terms. Thus, making a provision for capital maintenance in terms of purchasing power should be a key factor in income measurement.

An observation made many years ago by one of my former professors, W. A. Paton, is still very pertinent:

> "...it is really values that are the basic data of accounting, and costs are important only because they are the most dependable measures of initial values of goods and services flowing into the enterprise through ordinary market transactions."(1)

Value Basis Does Not Involve Valuing a Business Enterprise As a Whole

An important distinction that is implicit in our approach to the objectives of financial accounting concerns the difference between valuing individual assets and valuing the business enterprise as a whole. The function of financial accounting, in our view, is not to value the business as a whole, but rather to convey value information about the economic resources of a business.

This distinction recognizes the need to segregate the accounting function from the investor function. The evaluations and interpretations made by investors based in part on information provided by financial statements should not be allowed to affect or to be introduced directly into those financial statements. For example, the total market value of a company's securities represents the market's valuation of the enterprise at a particular time, but such valuation has no place in the enterprise's financial statements. Failure to observe this segregation of functions in the past has introduced a circularity that has reduced the usefulness of financial information and has resulted in great confusion in the resolution of individual accounting problems (e.g., goodwill) and in growing confusion over responsibilities for financial forecasts.

Segregation of these functions requires that a careful distinction be made between presenting financial information and predicting the future. While financial statements should be presented in a manner that will assist as much as possible in assessing the future and its risks, the role of accounting and the resulting financial statements is not to predict or to interpret the future. Making predictions and reaching economic decisions are the responsibilities of management in operating the enterprise, and of the investors and other users of financial statements for their various purposes.

Man has always wanted to know about the future so that the uncertainties of his existence can be overcome. Therefore, an interest in every kind of financial information about the future is understandable, since investors are more interested in the future, more concerned about the uncertainty that may surround investments, than in past performance. However, predicting the future is the very essence of the investor function, and the investor who predicts correctly will reap rewards, whereas the investor who predicts incorrectly may incur substantial losses.

Confusion constantly arises between changes in value and changes in purchasing power. The fact is both are occurring and, while there may be an interrelationship, the effects of each should be accounted for separately. Thus, the debate concerning whether value accounting or price-level accounting should prevail is not on point, because in the long run both should prevail. The real changes in value should be segregated from changes resulting only from changes in price levels.

The problem is one of presenting the economic facts in the most useful and understandable manner. This seems so obvious that it is difficult to understand why the accounting profession continues to make excuses for inaction.

Traditional Basis of Accounting Being Challenged Around the World

With inflation being a chronic problem throughout the world for the last twenty years, and with the problems of obtaining and maintaining capital in business enterprises, historical cost has come under increasing challenge -- and for good reasons. In fact, the developments in the United States have tended to lag behind those of many other countries.

The accounting profession in the *United Kingdom* has issued a provisional statement suggesting the presentation of supplementary price-level financial statements; however, that statement is likely to be superseded by the recommendations of the government-sponsored Sandilands Committee for a value approach for productive property, inventories, and marketable securities. The profession in *Canada* has issued an exposure draft dealing with supplemental price-level financial statements and is working on value accounting, whereas *Australia* has two exposure drafts under consideration -- one on price-level accounting and one on replacement-cost. *South Africa* has published a discussion paper on a value approach. *Argentina* has sponsored price-level supplemental statements and is considering requiring this basis for primary financial statements. For many years, *Brazil* has had an indexing system for property and monetary items. *Germany* is considering replacement-cost disclosures for items financed by equity capital. Several companies in *The Netherlands* have used a form of value accounting.

In the United States, the FASB in January, 1975 issued an exposure draft requiring supplemental financial statements on a price-level basis, with a comment period that ended in September, 1975. The FASB has deferred action and apparently does not know what to do now.

The Securities and Exchange Commission has had a proposal out for exposure with a comment period that ended January 31, 1976. This proposal would require disclosure of the current replacement cost of most inventories and depreciable, depletable, and amortizable assets used in the production process at year-end and the approximate amount of cost of goods sold and depreciation, depletion, and amortization that would have been recorded on the basis of the current replacement cost of inventories and productive capacity.

As a result of all of this and other similar developments, it is becoming increasingly evident that these problems exist on a worldwide basis and that attempts to solve the problems without common objectives are makeshift at best and futile a worst. Whereas the United States has had an opportunity to be a leader in objectives and basic concepts on the international scene, it certainly has not done so. All we have here in this regard is confusion and controversy.

Assumption of Stability of Monetary Unit Not Valid

Accounting has used the dollar as its unit of measurement under the assumption that fluctuations in the dollar's purchasing power will be so insignificant as not to undermine its usefulness for such purposes. During certain periods, this assumption has squared substantially with reality. In an inflationary period, however, it is difficult to justify the continued reliance on this premise.

By the use of a general index of purchasing power, price-level accounting adjusts the recorded amounts to restate them in dollars of equal size, generally in terms of current dollars. Price-level accounting also undertakes to measure, and reflect in the financial statements, the gains and losses in purchasing power from holding monetary assets and liabilities. Incidentally, this feature, although generally associated with price-level accounting, can be used in connection with other approaches to financial reporting. That is, computing the gains or losses from holding monetary items can be done and the information disclosed when the books are maintained on a historical-cost basis or on some variant of current value.

Price-level accounting has deserved more support in the past than it has received. There are no serious or mysterious implementation problems because the procedures have been known for years and many experimental applications have been successfully undertaken. In fact, our firm included price-level adjusted statements as supplementary information in its most recent annual report.

Price-level accounting results in comparative statements that are comparable in terms of purchasing power. Even modest rates of inflation erode the significance of comparative data. For instance, it is widely understood that in recent years a sizeable share of the reported annual sales growth may have been the result of inflation rather than of gains in physical volume. Yet, such a condition is widely ignored and conclusions are reached about sales growth by reliance on data that are not comparable. On the other hand, restating each year all of the prior financial statements shown on the basis of current purchasing power has proven to be confusing to many readers.

A move to price-level adjusted financial statements would require much educational effort to communicate the fact that a different kind of measurement of success or failure has been adopted as well as some different accounting techniques. The fact is that such financial statements are not as easy to understand or as complete in reflecting economic reality as value-based statements that include a maintenance of capital concept.

We must recognize that price-level accounting, as it is generally propose, would follow existing accounting principles and rely essentially on the same old concepts. My previously expressed concern that accounting has lagged and failed to accommodate sufficiently the many new developments that have occurred in business will not be put to rest by price-level accounting. Therefore, price-level accounting should not now be viewed as necessarily a logical first step (as it might have been five to ten years ago) that will initiate or lead to a change in the conceptual structure of accounting -- the kind of fundamental change that is needed so much.

Replacement-Cost Accounting

A movement in favor of some form of replacement-cost accounting (sometimes referred to as current-cost accounting) is obviously on the horizon. Many of the present proposals for this approach are partial rather than comprehensive. For example, the replacement-cost proposal of the SEC would disclose isolated and supplemental data only for those assets and associated expenses related to inventories, plant and equipment, and natural resources. The position advocated by the Sandilands Report, which would reflect current values in the primary financial statements, has a similar weakness in that the financial reporting of some companies and some industries would be unaffected by the kind of current-value accounting being advocated. Because a financial institution is not required to invest significant amounts in inventory and plant and equipment, it may be exempt from the proposed accounting. However, it does not follow that such an entity is unaffected by inflation. Also, the proposal does not reflect the inflationary effect on other items in companies that do have inventories and productive property.

Should those proposals advocating a partial system of replacement-cost accounting be changed to reflect a more comprehensive approach, there remains a weakness associated with any replacement-cost system of accounting -- the reliance that is placed on a single value concept. In some cases, replacement costs may increase while realizable values or earning potentials decline for specific assets. How relevant is replacement-cost information under such circumstances?

While the replacement-cost approach tends to provide for the maintenance of productive capacity, because specific increases or decreases in expenses that will likely be incurred when existing assets are replaced are in effect anticipated, maintenance of productive capacity is usually a far different goal than is the maintenance of equity capital.

Suppose that a change in technology occurs during an inflationary period. Are earnings being realistically computed by applying lower than historical-cost depreciation during inflationary times unless some provision is made to preserve the general purchasing power of the capital invested in the business? If depreciation charges are reduced because replacement costs are lower, and as a consequence greater earnings are reported and distributed as dividends, then conceivably the resources retained within the business entity, though possibly sufficient to replace existing assets, might not have the purchasing power invested initially by the stockholders or committed when earnings were retained in the business. This kind of accounting can lead to misleading interpretations.

A replacement-cost system that does not incorporate within its framework some mechanism for capital maintenance is subject to serious question. Some of the current proposals for piecemeal replacement-cost accounting do not include such a general provision for capital maintenance.

Further, to require supplemental disclosure of certain replacement-cost data in notes to financial statements may mislead investors rather than provide useful information about the value of business assets. Unfortunately, the replacement cost of an asset often does not represent the "worth" or "value" of that asset. The realizable value of a half-occupied office building may be far less than replacement cost.

Disclosure of replacement costs for inventories may imply that sales prices are based on such costs, which may or may not be the case. Also, replacement costs for productive facilities may be considerably higher in some cases whereas such new facilities may materially reduce operating costs, and an incomplete portrayal of this could be misleading.

Value Concepts Readily Understandable

The kind of fundamental change that deserves attention is a major shift to value accounting. Such a move does not require accountants to settle on one particular value concept now as the best for all or in developing different value concepts, but reliance on a single value concept will probably never be desirable. The value concept used should be one that offers the prospect of indicating the most relevant approximation of an asset's value, taking into consideration such factors as feasibility and verifiability. Because there has been relatively little use of value data in accounting, the practicing accountant has not been really challenged to search for evidence about values. More verifiable support for value information probably exists than is generally believed.

The cost basis is frequently defended by pointing out the complexity of value concepts and the extensive differences of opinion that exist about values. Cost is not greatly different from value in this regard because cost concepts are also complex. There can be many differences of opinion about the computation of cost. Not only does cost-based accounting result in differences of opinion about the initial recording of cost but, in the case of depreciable assets, estimates must be made about useful life and salvage value. Hence, there is introduced into our present system of accounting the opportunity for using a variety of amounts in accounting for similar, even identical, assets. In other words, differences of opinion will exist in accounting whether it is cost-based or value-based.

Some interesting research was recently conducted by Professor James E. Parker that illustrates my point.(2) He obtained information from businesses owning a specific model of a printing calculator about the depreciated cost shown in the accounts when the asset was six years old. The amounts reported ranged from zero to $280 for the same asset, all at the end of the sixth year. Furthermore, there was no central pattern for the book values reported. Professor Parker also visited a number of businesses dealing in office equipment. He showed them the same six-year old printing calculator and asked whether they would be interested in purchasing it outright, not what it was worth as a trade-in. He received a number of bona fide offers to purchase the six-year old asset. The bid prices ranged from $40 to $120, but 60% ranged between $60 to $80. This range is distinctly narrower than the zero to $280 reported following cost-based accounting, where a range of $80 to $200 was required to include 60% of the businesses visited.

It would be inappropriate to generalize very much from this limited research. On the other hand, this research illustrates what I believe to be true, that sweeping assertions to the effect that value ranges would necessarily be wider than amortized cost balances are not necessarily valid. Accountants rely so much on cost concepts and cost computations that they tend to lose perspective about how much complexity and estimation are associated with the application of cost-based accounting.

Value-based accounting is really not radical. Considerable reliance is presently placed on value in the application of the lower of cost or market approach to inventory valuation and the net realizable value test for various assets. Managements regularly work with and are concerned about values. Many knowledgeable people consider the present-day balance sheet as being of limited usefulness because it conveys so little meaningful information.

Where Are We and Where Are We Going

Where are we and where are we going? The first part of the question is easy to answer. We are in a conceptual mess. With respect to objectives and basic concepts and with respect to considering the best way to reflect economic realities as they exist in business enterprises, the FASB has displayed no effective leadership.

The second part of the question with respect to where we are likely to go is much more difficult to answer. How much can be done on a piecemeal basis? What should be supplemental information and what should be shown in the primary financial statements? Would price-level accounting prove to be a step toward value account-ing? Can anything in this regard be done without first establishing objectives?

This leads to the question -- do we now need evolution or revolution? For many years, I favored evolution based on sound objectives because this would seem to be the orderly and sensible way to achieve progress. However, the accounting profession has procrastinated for so long that the time for evolution has been frittered away.

Therefore, this bicentennial year would be a good time for a major change in our approach to accounting -- a rededication to establishing appropriate objectives to reflect economic realities. Let us not be satisfied with piecemeal and half-baked efforts to dabble with our accounting problems. Let us not be lulled into a sense of false security by complex disclosures and other superficial and confusing patches. While the accounting profession proposes education for investors so they presumably can better understand what is turned out by accountants, I propose that we first produce financial statements that present the facts in as concise, clear, and understandable manner as possible.

What is needed so much as soon as feasible is a value-based system of account-ing supported by sound objectives and implemented by consistent and coordinated standards, This should be accomplished in the primary financial statements and not by complex supplemental disclosures, additional columns in the financial statements, or by other patches on an outmoded approach.

1976 would be a great year for this kind of an accounting revolution!

(1) Paton W. A., "Accounting Procedures and Private Enterprise", *The Journal of Accountancy*, April 1948, p.288.

(2) *Parker James E., "Testing Comparability and Objectivity of Exit Value Accounting", *The Accounting Review*, July 1975, p. 512.

SELECTED QUESTIONS AND ANSWERS

Question:
In connection with value accounting, first as someone who has had some experience over the past two score years in estate planning and estate taxation, the problems of determining value are so grievous that somehow or other in those contexts of value I can't help but think of the punchline of that classic accounting anecdote where the question is, "what number do you have in mind?" Second, Mr. Kapnick, I'm going to refer to a play that you're intimately familiar with, undoubtedly, Arthur Miller's play, The Price. What is the price to be determined, value and use, value and exchange? But let me zero in even more aggressively. Let me refer to three incidents that you're intimately familiar with where value was certainly the standard. First, when Berny Corrifeld wanted to skim $10 million out of the Investors Overseas Services mess, he took $15 million, I believe the number was, of land cost and zoomed it up to $115 million and skimmed off $ 10 million, and when your firm was challenged, how did you permit this to happen? The response in writing was "we're accountants, we have nothing to do with appraisals, we cannot evaluate." Then in another context, a grievous one, the Four Seasons Nursing Homes situation, where it is true its percentage of completion accounting which is a cost base approach but yet approaching value, to try to factor in the value added as a result of the productive process. The briefs that your firm wrote very persuasively and very effectively pointed out the fact that we are accountants, we are not engineers and appraisers, and the third, far more recent when we read the Price Waterhouse commentary, as the special auditors in behalf of the courts in a matter of Mattel, Inc., where the inventory of that toy manufacturing outfit had to be brought down to value because of the obsolescence.

The accounting firm which was committed to a value standard even now according to Price Waterhouse, fouled the nest grievously. The point I'm making is related quite directly to three incidents that you are familiar with and then to say now you tell us how you are going to implement the value concept.

Answer:
I would like to comment on each of those cases specifically because they are important in the understanding of the value concept. I would like to mention first, as you indicate, that there can be wide ranges already in the cost basis, and that is one point that I tried to make during my presentation. That is nothing different as to the existence of ranges, whether you are on a cost basis or a value basis. Since you refer to three cases, I would not want to go on without some comment on each of the three. I think that the one thing that has been completely misunderstood in the IOS case, and I believe you refer to this in your book, is the fact that the Board of Directors was required to value those assets. In a mutual fund there is no way that the Board of Directors can avoid valuing those assets. Therefore, as to our responsibility in that case, I want to make sure that everyone understood that we were reporting on the basis of values determined by the Board of Directors. If anyone were to refer to our certificate in that situation you would find it quite clear. We indicated that these values were based upon the opinion of the Board (not the opinion of our firm), and that based upon such values the rest of the financial statements were presented in conformity with generally accepted accounting principles. I believe that this was a clear discharge of an auditors' responsibility to point out that there was a very large asset on which we were not giving an opinion as far as the valuation was concerned.

On the second case, the Four Seasons Nursing Homes situation, it should be remembered that the court found two of our people innocent and had a hung jury of ten to two for acquittal on the third person. In the Four Seasons case, the accounting that was followed was never successfully shown not to be responsible accounting. Some of those who have talked a great deal about the Four Seasons case must remember that to date no court has found the accounting to be lacking. We might digress a moment to say in that case, as in other cases, the most frightening thing to the individuals involved is the power of a Federal government to bring criminal action against individuals with unfounded allegations. The facts that I have discussed, both publicly and privately, have supported the lack of credibility of the government's case.

As far as the Mattel case is concerned, that is still in litigation, and I should not talk about that in detail. However, it must be pointed out that where you have huge management fraud at the top officer level it is very difficult for an auditor to detect, because the collusion is such as to present an almost unauditable situation. Since that case is in major litigation, Mr. Briloff, I would prefer not to make any further comments on it.

Now, let's address the more fundamental issue. Do those three cases destroy the idea that value is a proper concept for reporting to shareholders? You refer to your experience in the estate planning. I am not naive enough to believe that value accounting is easy. I do believe that in this world in which we live the investor deserves better treatment in the type and amount of information than he is now receiving. When you see the complex footnotes that are constantly being proposed for additional disclosure, it is almost impossible for anybody other than the most sophisticated to understand the financial statements. If that is where we are headed, we should take a good hard look at whether or not the individual investor can determine for himself what is a proper security for him to invest in. I would hope that with all the techniques that are available today we could come to a value approxima-tion that would be just as significant to the investor as the historical cost basis, with respect to which he doesn't understand what the values are.

One other matter that is important is the role of the independent auditor. I could encompass a lot in this if I really wanted to cover everything, but the greatest disservice to the investor has been the use of the short-form auditors' report. He reads that report and he thinks everything is all right. You refer to the one qualified opinion of our firm that addressed itself to the very issue that you criticize, and yet how many investors look at the report and think if there is a signature of a large firm, everything is all right? There is a company in bankruptcy that was discussed in The Wall Street Journal this morning, but I won't mention its name, in which a qualified opinion was given. What is the role of the auditor in those situations? If he issues a qualified opinion, is that adequate? Some people are apparently beginning to believe, but I don't happen to believe, that the role of the auditor should be expanded to such a point that he has a right to determine whether or not a business survives. Our only responsibility is to make sure that the facts are properly laid out. We may make a mistake once in a while, and we have to pay for them because we are human too. But the real role for the auditor is to qualify his report, rather than to walk away from the audit. The auditor should not have the power to bless or destroy. Rather, in my opinion, his role is going to change that.

Question:
I think I got the feeling that you and your firm have proclaimed their independence from the Financial Accounting Standards Board. What I'm interested in is that recently Touche Ross came out with a program designed for experimentation where they also went into a value accounting approach. Now, to the best of my knowledge of the reports I've seen from Arthur Andersen, there is that company in Indiana where you have given an opinion on price-level-adjusted statements, but what is your program, not for implementing the mechanics of value accounting but for implementing its acceptance, its use?

Answer:
There are several companies that are adopting, on an experimental basis, price-level accounting based on general purchasing power. The one you refer to is Indiana Telephone Corporation, which was headed by a very fine man by the name of Pierre Goodrich, who for many years felt that inflation would destroy America. He tried to show what the inflationary impact was on private enterprise. What is our approach to experimentation? I would like to see some real hardheaded dedication to what is really needed. It does not take several years to adopt a sensible approach to the objectives of financial statements. In a recent article we indicated that one of the fallacies that appears to be evolving at the FASB is that political pressures are wrong. They say they are getting pressures from accounting firms, from Congress, from industry, from academia, and from everywhere else. This is the democratic process, and if you are going to have "due process, " you must have the ability to withstand the pressures and make the necessary judgement decisions. The Board members were selected because of their integrity and all of the attributes that were needed to withstand pressures. This is like what Harry Truman said, if you can't stand the heat get out of the kitchen. We are at such a crucial point today that we need action. We published statements on objectives of financial statements in 1972 and 1974, and we would like to see companies experiment with them. In certain countries we are doing a great deal of work trying to help clients determine values.

In one situation we had the SEC agree that supplemental financial statements on a value basis could be put in a report to shareholders. Unfortunately, that client decided at the last minute that they did not want to take the risk that went with that information at the particular time. There is a lot of experimentation that could occur, but the first thing that must happen is to reach agreement on concepts. Experimentation isn't going to be worth anything unless concepts are established by accountants and others who are going to make this decision. If the accounting firms and the FASB can't get that decision made, then all the experimentation that takes place is worth nothing, because we need to have agreement on objectives first. There is no way that business is going to accept a change in approach unless it is agreed upon as a uniform basis by the body which we've all agreed sets accounting principles. I have told Russell Palmer, and I congratulate Touche Ross, that their booklet is excellent, and they have come out with an excellent presentation. There may be a couple of other firms that will support this concept, but why can't we seem to get it done and implemented?

Question:
I too support the concept, but I'm concerned and would like to comment on some of the things you said were happening. Principally relating to the revolutionary aspect of affecting the change. You mention that it has been some forty years since the price-level accounting techniques were first developed, and

you express your disap-pointment at the slow pace of evolutionary change. Yet, when the FASB finally came out with their exposure draft on price-level accounting, much of the responses that they received commented on the lack of understanding and lack of familiarity with the proposal and the consternation that would result from price-level-adjusted financial statements on the part of an uneducated public. It strikes me that after 40 years we've just reached a stage that to suggest revolution, when the techniques for determining value as a sound concept may not have evolved at the same pace or to the same extent, could result in a revolution that produces more in the way of chaos than improvement. If we have a developed price-level accounting technique, even if it doesn't do the same thing and perhaps it isn't the first step to reflect the impact of inflation on financial statements, perhaps it should be introduced on a supplementary basis. The public would begin to get used to the concept of at least accounting for the impact of inflation and might be better prepared then to cope with the new concept of accounting for other factors that cause change in value. We should allow a period of time to lapse during which corporations, the profession, and perhaps government could develop more specific types of tools that business and the profession need to come up with current values that wouldn't be attacked as being too conjectural and too subjective to have any usefulness. Could you comment on some of those thoughts?

Answer:
The basic issue that you are referring to, the issue of whether it will be understood by the public, is whether there is a middle ground. I tried to indicate this in my presentation. I think that a middle ground was available in the 1950's and the 1960's and certainly in the early 1970's, when price-level accounting was the way to address the problem. However, we need to define the problem, because the facts are being mixed up with a whole conglomeration of different concepts throughout the world. You can have replacement accounting here; you can have general price-level accounting here; you can have some historical cost in one place and the current cost under the Sandilands report in the U.K. Then I have to ask, what does financial information mean on a worldwide basis? If we're going to really have meaningful data, we have to have a common concept, the same as we have had a common concept of historical cost. Except for the Netherlands, and except for Brazil where there was major inflation, we have had essentially a cost concept throughout the world until now. Now the issue is -- are we willing to have a fragmentation of that concept with all the variations that are being introduced? I have concluded in my own evaluation that we can get self-satisfied with all the footnotes and all the supplemental statements that we could have, but the investors are not going to understand them. They are not going to be able to have a base on which to make the transition. Therefore, it seems to me the leadership that's needed here is to develop a uniform value-based concept throughout the world.

We should stop to think about the third world. The problem of the next decade is transfer pricing that is evolving in the U.N., in the OECD, and in other countries throughout the world. Transfer pricing isn't a U.S. problem; it is not a U.K. problem; it is a world problem. How are we going to solve transfer pricing problems? We finally have to get back to whether or not we have answers today, and this leads to some sort of value-based concepts. This gives us the solution or the possibility of the solution to many problems. The real thrust should be to reestablish the leadership of the United States profession in getting to a value-based concept as quickly as possible. All changes should be stopped, except what is absolutely needed, until we establish a new direction and start moving toward it.

Question:
We were privileged about a month ago to have a speaker who managed to describe financial accounting as a joint costing problem. In particular I refer to Arthur Thomas. Yet today you came before us and said, I can dismiss this notion of synergism between assets -- I can dismiss this notion of the firm as a bundle of related assets. Could you go a little bit further and elaborate perhaps a little on how you reached the conclusion that I can view assets individually without their synergism or joint effects?

Answer:
I'm not sure I have your point, but you may be talking about my comment that we do not look at the value approach as encompassing the valuation of the entire enterprise. To determine value based upon earnings becomes circulatory. The assets that are exchangeable and that have value in and of themselves

can be valued independently of the valuation of the total enterprise. For example, some assets might continue to be valued on a cost basis; other assets might be valued on discounted cash flow; others might be based on appraisal values. We believe that there is a whole variety of types of value concepts that could be applied to provide meaningful data independent of the valuation of the total enterprise.

Question:
Somehow I believe that with a value system, though it is very good, shareholders would be quite confused by having a new type of financial statements. We are now on a value base system and using the consumer price index; we are not the same as last year and would have a problem with consistency. Then again, you have to also consider some investors do not have the sophistication to even understand what we do have already in annual reports, 1OKs, I0 Qs, and in various other items that we present to the public. This is illustrated by the number of people who send away the little cards for the 10K that various companies present. You also have to consider something else. For an unsophisticated investor, what information does he really need in terms of value? If we change around value, some companies are going to be very happy about it and some companies won't. Those who won't be satisfied with changing values will be those who have high fixed assets of various kinds whose depreciation will change and their performance will look worse than it did before. Or you'll have companies who look even better now than they did before. If we are going to do something like this, we should have a setup that is fair to the investors in terms of giving them information that they can handle at a pace they can handle instead of just throwing it at them all at once. An example is the treatment of gains on the exchange of debt. First, we threw it into retained earnings; then we took it out and put it on the income statement. Now there is talk of bringing it back and putting it into retained earnings again. The investor is looking at this and he sees high earnings, and there it is below the bottom line. There are gains from exchange of long-term debts of $14 million with total net profit of $16 million. At least we've exposed it, but by constantly changing things back and forth the benefits for either side really do not outweigh each other. Someone is going to benefit more than the other, and it's not going to be the unsophisticated investor. It is going to be the sophisticated investor. It is going to be mostly the company that is doing extremely well, and it will be those companies that have something to benefit. Perhaps a jewelry concern who can play around with the value of various stones. I have a client who would be happy to have something like that. You have to be fair to all sides.

Answer:
There is always a good way to have a debate, and that is to answer a question with a question. You made a very sweeping statement. Some companies are going to be better off and some companies are going to be worse off. In relation to what? If I'm the investor, I'm paying for economic value. Sometimes a stock gets up to 100 times earnings, or 120 times earnings, where supposedly investors are trying to predict the earnings stream. Are you better off with economic value or are you better off with a matching concept? The first question is -- what is the most reliable economic information that you can give an investor who is reasonably intelligent? You say some of them might not understand it. Then you get to the second point which obviously is the transitional problem. I think that in a transitional period we probably should have not only the statements on a value basis but also statements on a historical-cost basis. To ask a man on the street whether a building which is worth $500,000 should be put on the balance sheet at $500,000, or whether it should be carried at its cost years ago, $100,000, you will find out what he understands best. He doesn't need to be the most sophisticated investor to understand value.

As I travel around the world I find that people do understand value. They understand that cost which has no relation to today's economic value is not meaningful. There are people who would say -- forget about double entry if cost is to be the basis. Why do people make balance sheets on scratches of paper when they are making acquisitions? They don't talk about cost; they talk about value. Don't underestimate the small investor. Give him the right information, which does not take fifty pages of financial statements, notes and schedules with all their complexities. Just give him 4 or 5 pages of real basic information.

Question:
I hope the question is sophisticated enough. I'm in accounting now, and we basically work with

historical cost. I just finished taking an income tax course. Income tax is a big element in the business field, and I'd like to know how value accounting would affect income taxes. Would it take a whole restructuring of tax laws currently existing?

Answer:
Well, not necessarily. I think that we may be evolving to where we are going to have to have two or possibly three different types of systems in order to properly control a business. We will need a management control system, which may be somewhat different from the financial reporting system to shareholders. I realize that taxes are a very important part of the U.S. business climate, but taxation should not control financial reporting. If we ever get to where the principles of taxation control accounting, we get into a never, never land, because the purpose of taxation is to provide revenues, not to present financial position and results of operations. There is a possibility that if some sort of value-oriented accounting is adopted, the impact of inflation could become a tax deduction, I understand that this was a major consideration behind the Sandilands report in the U.K. If some of you will talk to your Congressmen and Senators, you will quickly find out that they tell you -- don't come to the Congress on an inflation deduction unless you are prepared to report it to your shareholders. They are not even going to consider a deduction for inflation unless companies are willing to report it to their shareholders. In Brazil, it is a deduction. There is a tax deduction in Brazil for the fixed assets and working capital, based upon indexes published by the government. These programs can be worked into the taxation systems, but I would not hinge my case on the adoption of value accounting for taxation.

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