1973

Financial Accounting, The Standards Board, and Economic Development

David F. Hawkins

FINANCIAL ACCOUNTING, THE STANDARDS BOARD AND ECONOMIC DEVELOPMENT

by
David F. Hawkins
Professor of Business Administration
Harvard University, Graduate School of Bus. Admin.
November 12, 1973

[Introductory note: Dr. Hawkins serves as the accountant consultant to Drexel Burnham & Co., a Wall Street securities firm. His writings, books, monographs, articles and texts, cover a wide range of critical areas in accountancy, management, finance and economics.

Educated at Harvard, he holds the AB, MBA, and DBA degrees. He has been a member of that institution's faculty since 1961, attaining the rank of full professor just nine years later in 1970.

Professor Hawkins's lecture, "Financial Accounting, The Standards Board, and Economic Development," will consider the ways in which accounting principles should contribute to the economic and social well being of the nation. This goal is higher and more pragmatic than simply requiring that corporate reports serve the more narrow needs of investors or conforming to some theoretical concept of business income.

This subject is especially timely since it considers the interface between our major corporate entities and our total environment -- a major theme of Dr. Hawkins's colleague, Professor J. K. Galbraith. Our distinguished guest lecturer's remarks will undoubtedly serve as a significant input for the Financial Accounting Standards Board.]

In the winter of 1969 the *California Management Review* published my article entitled "Behavioral Implications of Generally Accepted Accounting Principles". In that article I argued that the Accounting Principles Board should strive to create a set of generally accepted accounting principles that was both technically and behaviorally sound. Behaviorally sound principles were defined as those that did not encourage corporate actions that gave the illusion of performance where none existed or that were at variance with prudent management practices.

Tonight, after a four year hiatus I would like to pick up again this thought and expand it to incorporate a new dimension. Now I believe that those responsible for determining accounting standards, such as the Financial Accounting Standards Board, should strive to set accounting standards that are technically and behaviorally sound *and that are not at variance with the national economic goals and the government's programs to achieve these goals.*

Initially, let me give you my thinking that led to this addition to my 1969 statement and my assessment of its significance for the Standards Board as it tries to decide how it will incorporate the recommendations of the Trueblood Committee into its own goals statement. Later, I will discuss its relevance to the resolution of some of the accounting issues facing the Standards Board.

The contents of corporate financial reports are relevant financial data inputs to the analysis that precedes a wide range of micro economic decisions. The data presented in corporate financial reports also influence the behavior of the makers of these micro economic decisions. Collectively, the economic behavior of these individuals determines the state of our economy at the macro level. The Trueblood Committee recommendations recognize the first fact, but not the other two. As a result, accounting, for the Committee, is simply an activity that measures and communicates material economic data related to business activity that is relevant to economic decisions. Somehow, the Committee assumes, if this is done well the correct allocation of resources in the economy will occur in some mechanistic way. No recognition is made of the behavioral aspects of corporate reporting.

In contrast, those in Congress and the Executive branch of the Federal Government who are charged with managing the nation's economy are becoming more and more aware of the behavioral aspects of corporate reporting and its macro economic implications. Increasingly, I believe, these policy makers will demand --particularly in times of economic turmoil -- that the decisions of those charged with determining what constitutes approved corporate reporting standards result in corporate reporting standards that will lead to Individual economic behavior that is consistent with the nation's macro economic objectives. Viewed from this perspective, corporate reporting standards are an economic planning tool that can be used to reinforce the effectiveness of the other instruments used to achieve economic goals. This awareness on the part of economic planners brings accounting standards setting into the realm of political economics.

AN ILLUSTRATION

To illustrate the last observations I would like to refer back to the Accounting Principles Board's last effort to adopt the deferral method of accounting for the investment tax credit. As you all recall, the Principles Board exposed an Opinion recommending the deferral approach. Subsequently, several key members of Executive Department and Congress caused the Board to withdraw its recommendation. In my opinion, the circumstances that led to the defeat of the Board's recommendation were: First, by denying to business the immediate boost in income from the flow-through method, the Principles Board was blunting the effectiveness of the tax credit as a device to stimulate the economy. Second, at a time when the public confidence in the economy was low and the public needed some sign of recovery, the Principles Board was deliberately reducing corporate profits, which is one index of the health of the economy, in a situation where there was clearly no single right answer as to how to account for the investment tax credit. And, finally, the principle alternative approaches each had substantial support from responsible, knowledgeable accounting authorities.

The behavioral hypotheses implicit in these arguments are clear: First, with the option to use flow-through accounting open to them, businessmen were more likely to respond to the tax credit incentive than if the deferral method was mandatory. Second, the rate at which the public became more aware of the recovering economy and more confident in their consumption plans and actions would be faster if corporate profits rose significantly and sooner than if they rose slower and less dramatically.

THE LESSONS

Now, what can we learn from this experience that is relevant to my theme?

First, those who are responsible for economic planning believe in the behavioral power of corporate reporting. Or if they do not fully accept this theory they do not reject it, just in case it is valid.

Second, when we think of the behavioral implications of corporate reporting we must recognize we are talking of the behavior of both the issuer and user of corporate reports. The economic planners' goal for the investment tax credit was to influence the behavior of businessmen to invest and the behavior of the public to consume.

Third, the economic planners believe no private body -- such as the Principles Board or the Standards Board -- has the right or the power to require action by its constituents that will work counter to the efforts of our federal government to manage the economy.

Fourth, the goal of the body charged with determining accounting standards must be different from the goal of the accounting process itself. This is a critical difference. Let me explain. The Board has to achieve results in an environment where it must rely on others to gain acceptance of its recommendations. Thus, its statement of objectives must be responsive to the interest of those who hold veto power over its actions or whose cooperation is needed to bring about change in accounting standards. In contrast, the accounting process is concerned with the technical performance of tasks related to the measurement and communication of relevant economic data. It is not concerned with the problem of standard setting. So, those concerned with the accounting process can ignore the political realities that face the standard setter.

Fifth, the determination of what constitutes approved corporate reporting standards is a political process involving the interests of many parties, with the government as the dominant interested party. Those who make decisions on corporate reporting standards must be responsive to the political considerations. At this level of responsibilities accounting becomes a branch of political economics.

In my opinion, the Trueblood Committee Report deals with the accounting process, not the problems of the setter of accounting standards. Therefore, I believe if the Financial Accounting Standards Board accepts and acts consistently with the Trueblood recommendations -- all of which flow from the primary objective of the accounting process to provide relevant, useful data for economic decisions -- the Standards Board will have the same fatal flaw which led in large measure to the disintegration of the Accounting Principles Board. Namely, the APB found itself in conflict with national economic objectives because it did not recognize an obligation to help, in a responsible manner, the government to reach its goals. Also, the Principles Board made the mistake of clearing its proposals only with the SEC, which is not a planning body but a tool of the economic planners. This approach hastened the Board's demise. To avoid this fate, the Financial Accounting Standards Board must add one key proviso to the overall objective expressed in the Trueblood Committee report. With this addition, the Committee's primary objective as adopted by the Standards Board would be that corporate reporting standards should result in data that are useful for economic decisions *provided that the standard is consistent with the national macro economic objectives and the economic programs designed to reach these goals.*

THE OUTLINE

Let me leave the unhappy history of the investment tax credit and its lessons to discuss in detail some of the key assumptions upon which my conclusions rest. Then, I will take up some of today's accounting controversies and indicate how they might be resolved by somebody who accepts the notion that accounting at the level of the Standards Board is a branch of political economics. Finally, I will point out some of the dangers that are inherent in the use by politically motivated governments of corporate reporting standards as tools for implementing economic planning goals.

THE KEY

Central to my belief that it would be a legitimate and wise policy of the Standards Board to accept explicitly as part of its primary objective to set corporate reporting standards that are not at variance with the national economic goals and programs is the notion that corporate reporting standards influence economic behavior.

What evidence do we have to indicate that this is so? There is very little formal research on this aspect of corporate reporting. However, we do have a considerable amount of expert testimony which supports the notion that economic behavior is influenced by corporate reporting standards.

For example, there are numerous statements in the popular press, academic journals and responses to Principles Board exposure drafts that indicate behavior relations such as:

> Pooling of interest accounting before Opinion No. 16 encouraged corporations to grow through acquisitions made on terms that qualified as poolings. Non-capitalization of leases encourages leasing over purchasing. The exclusion of warrants, options and conversion features from the computation of earnings-per-share before Opinion No. 15 encouraged the use of such equity capital raising devices. The exclusion of the deferred taxes earned by the Domestic International Sales Corporation from the comprehensive tax allocation requirements of Opinion No.11 would encourage the creation of DISC's for export purposes.

Those are only a few illustrations of the ways accounting standards bias behavior. I think they support my basic assumption.

Some of you may believe it is possible for the Standards Board to set accounting standards that will not influence behavior. I believe that is impossible. Every decision the Standards Board reaches will make certain kinds of business activity more or less attractive. For example, when the Principles Board defined common stock equivalents it made the issuance of low-yield convertible debt unattractive. Similarly, every decision will make some corporation's profits higher or lower and its financial ratios better or worse. These differences in turn will influence the way investors, creditors, suppliers, employees and the public will regard the firm. For instance, it is said that if nuclear fuel leases are capitalized, the rating services will be forced to formally include these lease costs in their fixed charges coverage ratios. Some members of the utility industry and some utility security analysts believe this action would lead to both less capital and higher capital costs for utilities.

Once my behavioral assumption is accepted, it is an easy step for me to accept the notion that the Standards Board has a responsibility that goes beyond the search for accounting standards that lead to the communication of useful economic data.

Any private citizen or group of private citizens, such as the Standards Board, has an obligation to help the government to achieve the nation's economic goals. The Standards Board has more power than the individual citizen to influence the trends in economic activity, since the Standards Board can issue pronouncements that will influence economic behavior. Therefore, its obligation is even greater. Furthermore, since economic planning is a government responsibility, any powerful private body, such as the Standards Board, that wishes to keep in the private sector decision-making prerogatives that can influence the achievement of economic goals has a right to do so only as long as its actions are consistent with the popular elected government's goals. If the Standards Board wishes to reserve to itself the right to set accounting standards, it must recognize this obligation.

Some of you may question this concept of social obligation, *but* substitute the words "General Motors" for the words "Standards Board" in my last thought and ask yourself whether or not you agree with my statement. I think you will agree. Just as the public expects General Motors to cooperate with the government's economic plans, so will the public expect the Standards Board to cooperate. The Standards Board cannot duck this responsibility.

Before going on to the action implications of the proposed role for the FASB, let me briefly summarize what I have argued to date.

First, accounting standards do influence economic behavior.

Second, the Standards Board cannot set accounting standards that do not influence economic behavior.

Third, because the Standards Board has the power to influence economic behavior it has an obligation to support the government's economic plans.

Fourth, if it fails to meet this obligation the government has no choice but to take over the determination of accounting standards or to give the task to a more responsible and responsive private body.

Fifth, because of this fact the Standards Board as an operating entity must have a somewhat different set of objectives than those set forth in the Trueblood Report. The Standards Board can set as its goal to implement the Trueblood Report, but it must also state as an objective that it will not deliberately scuttle or weaken the nation's economic planners programs. For the Standards Board to simply say its objective is to implement the Trueblood Committee's major objective for corporate reporting is to court disaster.

EXAMPLES

Now, how would a Standards Board that is responsive to its obligation to assist in the achievement of national economic goals and is sensitive to the fact that it must work closely with national economic planners, if it is to achieve its own corporate reporting objectives, handle a number of the issues confronting the Board today.

Leases: Transport and Utility. Perhaps the hottest topic on the Board's current agenda is accounting for leases. If you look at the transportation and utility fields, you must be struck that these are industries that rely heavily on leasing. People from those industries argue that it is not in the national interest to require capitalization of leases. Alvin Zises, whose work some of you have probably read, is a vocal proponent of this point of view. I must admit Alvin is a highly biased proponent of it, but nevertheless he has already convinced a number of people in Washington that leasing is critical to the continual development of the transportation and utility industries -- industries that have trouble attracting capital from other sources. Already there are signs in Washington that the government officials concerned with economic development and the balance of the development of our economy are responding to this argument. The Financial Accounting Standards Board has already received a number of letters from Congressmen to this effect.

If this kind of thinking is accepted -- that lease financing is important to the development of the transportation and utility areas -- and the second thought that lease capitalization would make leasing and other sources of financing more costly for this area, I think that as the Standards Board faces up to the question of what to do about accounting for leasing by lessees and lessors, it has to recognize this developing concern of people at the national level. I would urge the Board to move slowly, to be sure that they argue for lease capitalization only in those areas where there is widespread belief that lease capitalization is warranted. I would suspect that acceptance is going to be a critical factor in what the Board will in fact come up with eventually.

Full and Field Costing. Another area in which we face tremendous problems of the moment of course is the energy area. It is estimated that between now and 1985 the oil and gas companies will have to raise 600 billion dollars in additional financing to take care of our energy needs. Clearly this kind of an economic problem must have some bearing on the controversy of full vs. field costing in the petroleum area. As you know, the smaller companies have argued that they would not have access to capital if field costing were the only way they could account for their exploration and development costs. I think that their argument has gained some acceptance in that the Federal authorities who regulate natural gas transmission have already approved full costing despite the fact that the Accounting Principles Board was leaning towards field costing.

Again, I think the Standards Board must be careful how it proceeds. I see good arguments for both full and field costing just as I see good arguments for both capitalization and non-capitalization of leases. I have my personal preferences but in both cases I am impressed by the fact that there are knowledgeable people who have come to a different conclusion than I did. I suggest, just as I suggested in the leasing area, that the Board move warily and perhaps in a rather limited way, which would certainly not satisfy some of the academic critics or some of those from the Wall Street area. But I would argue again in the full vs. field costing controversy that the political way to handle this problem is for the Board to move slowly, perhaps even drag its feet. I would think hard and long before I tried to impose field costing knowing that there is substantial support in Washington for full costing as a means of attracting capital to the smaller companies.

Goodwill. There are anti-trust implications in this area. A number of people in Washington are very much concerned that foreign companies are moving into the United States and buying up American companies -- buying interests in them. One of the things that has come to light is that the foreign companies are not troubled by the requirement to account for goodwill by writing off against income. Some of the American companies who have apparently not been able to match the foreign companies' offers for local company interests have said that to purchase them would have created goodwill which would have hurt their earnings. There was an accounting research study which suggested that goodwill ought to be written off in the capital section rather than being run through income. The study was done by two distinguished accountants from Arthur Anderson and their conclusion was supported by Leonard Spacek, the former chairman of the firm. That such people should think this way makes me have second thoughts about how goodwill should be handled. Now I'm less sure.

The goodwill issue is surely going to be raised because the whole area of business combinations and business purchases is one to which the Standards Board has indicated it will give high preference on its technical agenda. Surely we can no longer ignore accounting's impact on the Federal government's attempts to control investments of foreign companies in the United States and how the government wants U.S. companies to account for goodwill. I think the Standards Board might well begin to consider something other than present rules, perhaps in a way that would impose less of a burden from goodwill write-offs on a company's earnings.

Flow Through of Foreign Income Taxes. Tax accounting for foreign income which is permanently invested overseas runs very much counter to the whole thrust of the trade bill -- the Burke-Hartke Act -- and some efforts of the IRS to discourage foreign investment by U.S. companies and to bring investment back to the United States. The accountants have encouraged foreign investment by allowing flow through tax accounting even though it runs counter to the general thrust of Opinion No. 11. I think this is another area in which accountants may find themselves out of step with national economic planners, and there may be a growing pressure on accountants to apply comprehensive tax allocations. Personally I have trouble seeing the difference between a permanent deferral overseas and a domestic permanent deferral, but we seem to account for them differently. So this is an area where current accounting which favors business may have to be changed because it encourages business to invest overseas and therefore runs counter to a federal tax and trade policy which seems to be evolving.

Research and Development Costs. One of the items on the FASB's agenda is the question of capitalization or non-capitalization of research and development expenditures. Unfortunately, this is an area where I have seen too many disasters -- companies that have deferred intangibles and ended up by having to write them off. Yet the Standards Board needs to think about the interest of the nation in maintaining technological advancements, particularly among small firms who feel they need to have profits to enter the public capital markets. Here again, there may be some pressure on the Board not to come up with an opinion that would outlaw capitalization of R&D entirely. I think what we are looking for is a policy which says R&D capitalization is appropriate, given some sort of reasonable assurance that it is in fact a realizable asset. That may be the present situation, you say, and if it is implemented no better than the present rules in this area, it may degenerate into just management's choice as to what to do. However, if the accountants eliminate the "subject to" opinion, I think that this particular hard choice as to whether or not it has some future value will be made in a more realistic manner. But I do not believe the Board can eliminate the alternative capitalization.

SAFEGUARDS

I could go on and on in these examples, but let me turn now from the examples to another aspect of my theme. After arriving at my position on the appropriate overall objective for the Standards Boards, I had two nagging questions:

1. If my theory is correct, what is to stop an unscrupulous government from trying to use accounting standards to "puff" up corporate profits like some "go-go" company?

2. How far should the FASB go in cooperating with government economic planners?

In my opinion, the best protection against an improper use of accounting standards by economic planners is to keep the responsibility for determining corporate reporting in the private sector and to insist that the responsible group be individuals of the highest integrity, moral character and accounting capability. It is also desirable that they have a good dose of common sense and a sensitivity to the needs of the other groups with a stake in corporate reporting. Such men are not likely to be part of any scheme to use accounting standards in an unethical or grossly misleading way. Their protests and threat of resignation should be enough to dissuade any government planners who begin to think like "go-go" company managers. On the other hand, such men are likely to cooperate with reasonable demands.

In addition, I believe that a safeguard can be a well developed and accepted theory of the reporting process. Such a theory of corporate reporting would set a standard to judge how far corporate reporting was being used for cosmetic purposes to reach economic goals.

Finally, the insistence upon the observations of a firm policy of full and fair disclosure should make obvious misleading uses of accounting standards by either government economic planners or a too sympathetic response to the planners' pressures by the Standards Board.

How far should a Standards Board go in cooperating with national economic plans and programs? This was my second nagging question.

First, I believe that in cases where there are persuasive arguments for each of the most acceptable choice of solutions to an accounting controversy, the choice that best serves the national economic interest be selected. Of course, the identification of this alternative should be done in consultation with the economic planners.

Second, priority should be given on the Board's technical agenda to those controversial areas that are of highest importance to the national economic goal priorities.

Third, in all cases where national economic development may be an issue, the weight to be given to the national economic development consideration in selecting the appropriate solution should be among the most significant relative to other considerations. How significant will be determined by the judgment of the Board given the circumstances of the moment. The selection of outstanding individuals of the type I feel should be members of such decision-making Boards is the best protection against undue weight being given to national economic interests in unappropriate ways.

Fourth, the Board should seek competent, independent advice on the national economic significance of its proposed decisions. It should also encourage research into the relationship between economic analyses and behavior and accounting standards. This will provide some expert advice and substantive data which might be used to develop better our understanding of how and under what circumstances and to what length the Board should cooperate with national economic planners. These data should also be made available to economic planners so that they may use it as a guide to making their requests for Board cooperation. Hopefully, it would help both the board and planners to identify unreasonable, unnecessary or ineffective proposal to use accounting standards in the achievement of economic goals.

Let me now conclude the formal presentation by anticipating a challenge that may be thrown at me. This will be a personal statement. However, I believe my final observations are relevant to all of us who advise or criticize the Standards Board in its efforts to set accounting standards.

MEA CULPA

Some of you may dredge up some of my other earlier writings and confront me with an inconsistency in my own position on the accounting for the investment tax credit and my 1973 definition of the Board's objectives. I would like to now state that, as I look back over my own efforts to convince the Principles Board to adopt the deferred method of accounting for the investment credit, I now believe my advice was poor and irresponsible. Also, I now believe the cries of outrage that I published when the government stepped in and caused the Principles Board to back off its recommendation were naive and unfair to the government officials involved.

I had assumed the Principles Board had to find an answer to the investment tax credit accounting problem that was consistent with some acceptable concept of economically useful data or a definition of business income. Also, I assumed it was unsound behavior to adopt an accounting method that encouraged corporations to earn material profits immediately by purchasing assets.

Such an approach may have been acceptable and tolerated by the economic planners if the economy was strong and untroubled. But the economy was weak and troubled. The reinstatement of the investment tax credit was ample evidence of this fact. Under these conditions I believe now it was irresponsible for me to urge the Principles Board to deliberately take action which would lessen the effectiveness of the tax credit in a situation where sound accounting arguments could be made for both the deferral and flow through approaches. I was advising the Principles Board to adopt a course of action that any responsible government concerned with the well-being of the total economy and body politic had to reject in the public interest. If I had recognized how accounting shifts from a micro economics measurement science, which naively assumes that if income is measured correctly the optimum allocation of resources will automatically follow when discussed in the classroom, to a branch of political economics at the level of the Principles Board, I would have argued for the approval of *both* the flow through and deferral methods by the Board. Or, if only one method was to be chosen -- my choice would now have had to be the flow through approach.

This self realization of the political realities of the Board's existence has led me to conclude that when I act as an advisor or critic of the Board I have a responsibility to recognize that the Board's objectives must be responsive to many more considerations than accounting theory or our notions of economically useful data. Any advice or criticism related to its actions on standards that does not take into account these broader considerations is not very helpful to the Board. In particular, tonight I am suggesting one of these considerations is to fulfill an obligation to meet national economic plans. If the Standards Board incorporates this consideration in its goals, I believe each of us has a responsibility in our comments on the Board's actions to help the Board to reach responsible decisions on standards that do not lead it to run afoul of our nation's economic goals and programs. I for one hope I will not be guilty in the future of the same poor judgment I displayed in 1971.

Similarly, I hope the Standards Board will also not show in the future the same poor judgment as did the Principles Board when confronted with the interests of our economic planners. This can be avoided if the Board faces up to its responsibility to cooperate with our economic planners and set objectives and policy guidelines in advance of such, confrontations. I believe the Standards Board can make a significant start in this direction by a simple modification to the Trueblood Committee's objective for the accounting process, namely, the adoption as a fundamental objective of the Board, a statement similar to the following:

> The Board will seek to implement the recommendations of the Trueblood Committee Report in such a way that its actions are consistent with the economic goals of the nation as communicated to the Board by those responsible for the management of the nation's economy.