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THE FOUR MUSTS OF FINANCIAL REPORTING

An Address By

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THE FOUR MUSTS OF FINANCIAL REPORTING

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Like everyone else involved in this swiftly changing society, you, members of the accounting profession, are caught up in bewildering, confusing, disconcerting, often frightening changes. The author of that best seller of a few years ago, Future Shock, indicated that the capacity to survive in the future would be about coextensive with ability to adapt to change which has and is occurring at what seems like a constantly accelerating pace. Once upon a time your professional bodies, with only an occasional light reminder from a common law court, were the instruments of change. Then the New York Stock Exchange began to be heard. Then came the SEC. New bodies within your own professional organizations -- the APB and now the FASB -- entered the scene. And now, most importantly, the federal courts have much to say with the manner in which you practice your profession and how it should be changed.

All of this is part of this rapidly changing world of ours. And your survival in this world is going to depend in very large measure upon the skill and speed with which you adapt to change, move constructively to direct the line of change, recognize the demands that a changing society is making upon you as well as upon all professionals.

In some measure, though, amid all this the old French proverb, "The more things change, the more they are the same," continues to have a peculiar

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relevance. I look at the changes which the Commission is seeking to bring about in financial reporting and I realize that while, in some instances, these demands may trouble some, nonetheless they relate to rather fundamental conceptions that I think all of us could agree upon. I would like to review some of those fundamentals which should, in my estimation, be beacon lights in the storm of change -- and which, if we do all agree upon them, can be the means of constructive cooperation as we try to deal with the increasing tempo of change.

The most fundamental of fundamentals is this: without an accounting profession we could not have the sort of capitalistic society we have. The bulk of our investment capital comes from private investors -- small and large, individual and institutional -- and not from the government. These investors are, in most cases, at least, rational people who try to make rational choices about where to invest their money. To make a rational choice in any matter, information is essential -- and the possibility of a rational choice is enhanced if that information has certain characteristics. Investors must have information that is sufficient, timely, reliable and fairly presented. And the independent accountant has a critical role in assuring that the information upon which investors act has those characteristics. Hence, his presence is critical for our investment process.

Let me look at each of these in turn and explore with you their implications for public accountants, reporting companies, the financial community and the Commission.

1. In the past few years the Commission has taken a variety of actions to increase the amount of information available to investors. We have tried to increase the analytical content of filings both in textual sections and in the

financial statements reported on by independent public accountants. This means that it is not sufficient to simply throw raw figures at the investor or the analyst and say in effect, "Now try to guess what it all means." Management must increasingly give investors the benefits of its own analysis (and who is in a better position to make an analysis?) and not engage in guessing games, and the accountants increasingly must monitor the integrity of the representations of management implicit in such analyses. In adopting these requirements, we have recognized the fact that there are different audiences for information and that all of our requirements cannot be addressed to the "average investor." As we seek increased professionalism in the use of information, it seems clear that we must supply the professional user with enough information to develop an in-depth understanding of corporate activities. We have, therefore, extended requirements to provide additional details, even though we recognize that such details will not be of interest to all audiences. At the same time, we have attempted to increase the responsibility of management for improved analytical summaries of results primarily aimed at the investor who wishes to obtain a quick but accurate view of corporate results. What we have suggested, therefore, is differential disclosure, based on the needs of users, but not discriminatory disclosure since the more detailed data are available to all. It has been suggested that this differential disclosure poses legal and practical problems for management and auditor. If specified information is important for analysts, might an individual sue because it was not made available to him in, say, the annual report? We are studying this problem and will carefully weigh the means by which the differing demands of the broad spectrum of investors can be served without creating unreasonable legal and practical problems.

We believe that our efforts have helped investors to learn more about the businesses in which they invest and have reduced the attempt to combine all knowledge into a single earnings-per-share figure. While everyone seeks an easy handle, it has been learned from sometimes painful experience that uncritical acceptance of such an apparent short cut to sound analysis can be costly. A reader must be able to discern how a business operates, not just net results. If the past is going to serve as a useful predictor of the future, users of data about past periods must have a reasonably valid comprehension of how and why prior results were obtained.

It is sometimes argued that "people won't understand." This argument has little validity. One of management's duties is to communicate, and most managements clearly possess the skills. They must present the information in a way that people will understand. Here is an area where the accounting profession has the potential to provide valuable assistance but is currently underutilized.

Finally, the specter of huge costs and limited benefits is generally raised when new rules requiring more comprehensive data are proposed. The problem of cost cannot be and is not ignored, but the cost estimates frequently presented strain the bounds of credibility. I suspect that there is a need for the Cost Accounting Standards Board to create standards for the allocation of costs to regulatory disclosure proposals!

In general, we believe that critics of our proposals should emphasize more effective ways of achieving our articulated objectives rather than simply casting a negative vote. Our responsibility to investors and an efficient capital market does not let us make decisions simply by counting letters of comment; if we had done this, we would still be distressingly close to "go." On numerous occasions, however, we have amended and improved our proposals as a result of the constructive comments of the professional and business communities.

2. In addition to sufficient information, investors must receive it in timely fashion to make their economic decisions. Magnificent data rarely presented will not meet the needs of investment decision-makers in a rapidly changing business environment. We all know the speed with which security markets in general and specific stocks can change direction and move in wide swings. This is a part of the accelerating change of which I spoke earlier. This is the consequence of many things: swifter communications, continuing devotion to the performance cult, greater competition among investors for advantage. This means that information must flow quickly into the market place. And it must flow quickly to everyone who wants to have it.

Perhaps accountants over the years have devoted too much attention to the problems of reporting results of an identifiable but arbitrary time segment based on the length of time it takes the earth to circle the sun and not enough to the problems of reporting a continuum. Recent developments, including the Accounting Principles Board Opinion on interim reporting and the Trueblood Committee's discussion of completed and incomplete cycles, indicate that greater attention is being paid to this problem, but there is still much to be done. In the next year the Commission expects to devote attention to the problem of improving the timeliness of reporting. Part of this will include additional development of our policy on forecasts, which is one approach to better reporting of a business continuum. In addition, we expect to study ways in which interim reporting can be improved and to consider other ways in which significant data about business operations can be placed in the hands of investors. The increased emphasis on the review and improvement of 1934 Act filings and requirements which are directed toward continuous reports as compared to the traditional emphasis on occasional 1933 Act registration statements is another example of our concern in this area.

Traditionally, public accountants have not been involved in any substantial way with interim reporting. Their responsibility has been to audit and report on annual financial statements. There has been increasing question as to whether this traditional approach is a sufficient use of the skills of public accountants in the reporting process. Both former Chairman William J. Casey and present Chairman Ray Garrett have publicly suggested that auditors should be more involved in the interim reporting process of their clients. This does not mean that a full interim audit should be required, but that the auditor of record should have some responsibility to assess the client's accounting decisions on a timely basis and to review all public reports prior to issuance in accordance with a reasonable set of standards developed by the profession or by the Commission. "Auditor of record" is an emerging concept in the accounting profession and I would hope that it will be increasingly filled with content. As I understand it, it is intended to identify the independent accountant of an issuer and is intended to connote a continuing relationship -- something akin to the concepts of "general counsel" in the legal profession and "attorney of record" in the litigation scene. The Commission's requirements for reporting auditor changes was an indication of the beginnings of this approach. Out of that connotation of continuity of relationship should flow various conclusions, including conclusions about continuous responsibility for all the financial reporting practices of a company and not responsibility measured only by the annual audit. An early step in this direction was taken last year when the Commission required public accountants to include a letter with their client's timely filings of details about any material unusual charges and credits to income indicating that the accounting methods used were in accordance with generally accepted accounting principles fairly applied. I would hope that the AICPA, instead of running from this notion of continuous responsibility because of exaggerated fears of liability, will see this as an opportunity for fuller service by accountants to the society that sustains them.

3. Beyond sufficiency and timeliness, there is a need for reliability in financial reporting. If data are to be the basis for sound investment decisions, users of that data must be able to have confidence that the numbers reflect the reality. It is here that the accountant has the most clearly discerned role. The very reason for the emergence of the accounting profession was to give reliability to the representations of those who might be tempted to fudge in favor of their own interest -- and if the accounting profession cannot continuously persuade society that it provides significant assurance of reliability in financial representations, then it might as well strike the tents and go after employment elsewhere. The tools to assure a continuing satisfaction of responsibility must be forever adapted to the times: audits must relate to the increasingly complex information systems of sophisticated business enterprise rather than to the traditional ledger and trial balance; the auditor must be alert to management frauds through the manipulation of reported results by a series of non-arms length transactions with related parties; compliance with an increasing multitude of regulatory demands must be tested. For reliability the market mechanism looks at the independent auditor, and it is apparent that vigilance must be increased if confidence is to be restored.

Increased vigilance does not mean more detailed checking or an audit based upon the assumption of an adversary relationship between public accountant and client. Neither of these steps would be productive. In fact, they would be far more likely to result in a worse audit. The record of detailed adversary audits in this economy does not give much comfort to anyone who would advocate them as a solution to the problem of reduced reliability in financial statements. What is needed is improved systematization of audits, better quality control over them and, perhaps above all, an increased ability on the part of auditors to approach their job with healthy professional skepticism. I have been astonished in the time I have been at the Commission at the evidences of the willingness of auditors to put aside their good judgment and uncritically follow the lead of management. Management asserts it will get orders several times greater than it has ever achieved and the auditor accepts this as a basis for deferral of massive development costs; management alleges that sales are made with no privilege of return and the auditor accepts such statements while ignoring numerous red flags that indicate major changes in selling terms and suggests that representations are of dubious validity; management identifies purported verbal commitments and the auditor gives them full credence as a basis for revenue recognition. There are too many cases to write off each as an aberration.

4. And finally, there is the problem of "fairness of presentation." While fraud and error are two sources of misleading data, an even more distressing phenomenon which occasionally appears is the use of generally accepted accounting principles to produce a misleading result. Some management, with the concurrence of their auditors, are prepared to embellish their performance by the use of accounting tricks which reflect accounting results dramatically

different from economic results. Ultimately, the market place exacts a harsh penalty for such activities.

In most cases it can be said that such problems arise because of deficiencies in the defined accounting model and the solution can be argued to lie in improvements in the model. While the Commission strongly endorses attempts to improve the accounting model and has encouraged standard-setting bodies such as the Financial Accounting Standards Board to do so, quite frankly I do not believe that this is a sufficient approach. In the final analysis, we need a standard of fairness as the fourth "must" in financial reporting and public accountants must be ready to insist that this standard is met.

I think it is important to remind ourselves that this notion of fairness as a standard is not found only in the briefs of litigious lawyers or the opinion of Judge Friendly in the Continental Vending case. Leaders of the profession have on occasion voiced their belief that fairness was a standard separate and apart from generally accepted accounting principles. Lee Layton, President of the AICPA, in his address at the 1972 AICPA annual meeting said:

> "Once the auditor, supervisor or reviewer determines that all published standards have been complied with, he should figuratively step back, take a long hard look, and determine that (a) the financial statements as a whole and (b) the method of reflecting any major transaction (particularly those on which there may have been controversy), are fairly presented and not misleading."

I do not belittle problems of definition, but it does not seem consistent with the public responsibility of professionals to say that the blind application of prescribed formulae is sufficient to meet the obligation imposed by society. The auditor must be satisfied in his own mind that financial statements represent an unbiased selection of relevant data presented in an understandable way that makes sense to the careful reader. If they do not meet that test, they are not "fair." The Continental Vending case showed clearly that mere conformance to stated rules does not assure fair presentation. The auditor must view the statements as a dispassionate professional and as a realist. He must not fall victim to the optimism, often commendable, of management.

Fairness in reporting goes beyond the financial statements, of course. The text and highlight sections of annual reports and registration statements and the press releases announcing corporate results and events are an integral part of the public reporting process. A perfect financial statement misinterpreted is only a slight improvement over a misleading statement. It is time for independent public accountants to address themselves to the use and summarization by management of data appearing in financial statements, and it was encouraging to hear that the Auditing Standards Executive Committee will be considering this problem in the year ahead.

The Commission is ready to assist in any way it can to improve the "fairness" of financial statements. Part of this task may be achieved by serving as an early warning system when problems are perceived where the accounting model as defined does not appear to be giving the best answer and by calling for improved disclosure until such time as improved standards can be developed. It would have been well if in the past the Commission had undertaken to say early that the methods by which franchisor profits were swelled, while in keeping with GAAP, nonetheless presented an inadequate picture of the underlying economic reality or if the Commission had early warned that land development accounting might, despite its ostensible conformity with GAAP, lead the unwary into a financial desert. Change is too rapid, the ingenuity of entrepreneurs too fertile, to permit the full deliberations of the FASB, necessary as they are, to be completed before someone sounds the warning, and that someone, I think, must be the SEC. This is not enunciating principles or usurping the functions of the FASB; this is simply common sense: someone with authority must warn, someone whose warning will be heeded.

In carrying out this role, the Commission last week issued Accounting Series Release No. 151 which called attention to the problem of inventory profits in a period of rapidly rising prices. We have also called for special disclosure in a number of specific cases where defined accounting principles led to results that might not have been intended when the principle was established. In a few cases we have asked public accountants to give us letters asserting that the accounting principles used by their clients were in the auditor's judgment the best ones which could have been selected in the circumstances rather than simply falling within the range of acceptability.

All of these steps are designed to produce greater "fairness" in financial statements, and we will continue to work with the profession to achieve this goal.

I would touch upon one other matter before concluding. Competition is the touchstone of our economic life. But we have learned that unrestrained competition, competition blind to other values, may turn into a harmful monster. I think the accounting profession must reexamine its competitive instincts. I practiced law; I know that clients pay bills, that clients educate kids and pay mortgages; I know that losing clients is painful -- to ego as well as purse. But I would suggest that perhaps your profession should reexamine its approach to competition. I think that frequently this competitive zeal has resulted in cutting an edge here and there, and often that sliver off the edge is rationalized by saying that after all each alternative accounting principle is considered generally accepted. And frequently this competitive urge has resulted in willingness on the part of accounting firms to give clean opinions when the competition insisted upon a dirty one. Many of these cases that come to the attention of the Commission involve auditors who succeeded other auditors fired because of their unwillingness to see it management's way. I do not for a moment deny that accounting firms can differ honestly in their opinions, or that often dissension between client and auditor deriving from other causes is masked by asserting that it stems from disagreements about accounting principles. Still, I would suggest that any accounting firm that succeeds another in circumstances where there is some reason to think the withdrawal or removal of the former relates to disputes over financial presentation had best exercise considerable caution before encouraging the potential client to believe that it is more flexible than its predecessor, and I would suggest that those financial statements and the judgments reflected in them might be examined by the Commission's staff somewhat more critically than would otherwise be the case.

Some of my remarks today may have left the impression that I think the disclosure system is in bad shape or that the accounting profession is inadequate to meet its responsibility. This is far from the case. I believe our financial reporting system is the best in the world -- and I think it should remain the best. We are not in the dark -- the benefits of illumination were discovered long ago. Furthermore, the instances in which accountants have courageously withstood the insistences of clients, often at substantial financial sacrifice, are numerous.

We all must recognize that expectations in today's consumerist world are very high and must be met. Like the financial executive reviewing performance, we cannot measure ourselves against last year but must compare our results against expectations, comparing budget with actual. Only when the variance is positive can we pronounce ourselves temporarily satisfied. This is our goal at the Commission and should be yours as accountants as well.