

New York State Bar Association Meeting

John C. Burton
Chief Accountant

Securities and Exchange Commission

January 29, 1976

* The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues on the staff of the Commission.

MR. POTTER: Well, for a gathering like this I suppose one speaker really requires no introduction. The subject that has brought us together is one in which he really is one of the most active participants. John Burton as most of you know is the Chief Accountant of the Securities and Exchange Commission, and before accepting that position he was Professor of Accounting and Financing for ten years at the Graduate School of Business at Columbia University. He's a graduate of Haverford College and received his Master's and Doctorate from Columbia here in this city. He was a member of the accounting staff of Arthur Young for four years before joining the Columbia faculty. He's the author of Accounting for Business Combinations and the co-author of Auditing--A Conceptual Approach, and if he's not the author he's certainly one of the co-authors of the most recent SEC pronouncements on the subject of bank financial statements. It is with a great deal of pleasure that I introduce John Burton to speak on a subject of great interest to all of us.

(Applause)

MR. JOHN C. BURTON: Thank you, Ham. It's a pleasure to be here before the New York State Bar Association. There was a time when I would have quailed at the sight of a hundred lawyers in front of me, but after working at the Securities and Exchange Commission for three and a half years, I hardly know an environment where there are not a hundred lawyers in front of me. Incidentally, I was most pleased to see my Columbia affiliation highlighted in the program to give me some legitimacy along with my current position at the Securities and Exchange Commission. When I was at Columbia as a tenured faculty member, I was responsible only to the Lord. At the SEC, I am told to start every speech with the usual disclaimer. The Securities and Exchange Commission as a matter of solemn policy takes no responsibility whatsoever for the musings of its missionaries. Accordingly, my remarks are my own. My views may, on some occasions, coincide with those of my colleagues at the Commission, but the correlation coefficient is considerably less than one.

(Laughter)

When I speak about banks the correlation coefficient is probably less than .5 in some circumstances. It's a pleasure to talk about new developments in bank financial reporting, because there are some, although not as many as there should be. Perhaps I should start however with what I view to be the good news in the banking community today, and in economic terms I think there is very good news. We have completed a year of highly favorable interest spreads which has left the banks in sound condition despite loan losses of record size. We have seen a recession weathered by the banking community, and we see a very positive economic outlook at the present time. It's a well known fact that business prosperity can convert bad credit decisions into good loans even as the opposite is true, and so as we look today at the banking scene I think we have reason for optimism. There are still problems. However, I believe that the problems have largely been recognized and that's a significant step forward. A year and a half ago it was less clear that was the case. Certainly the real estate industry is not yet out of the woods, and the related REITs are still causing problems for banks. There are problems in the international field. There are still problems areas in the economy. However, I think that again most of these can be identified today, and can be dealt with.

Finally, it seems to me the last couple of years have been very educational for banks as they have learned to deal effectively with a large number of potentially destabilizing factors, one of the most significant of which are the foreign exchange rate fluctuations as they affect major banks in the international world. So, in economic terms, I think the banking industry is in good shape. I think the news is good.

It is somewhat ironic, however, that at the same time I believe it's fair to say that the credibility of bank financial reporting is at an all time low and sinking. There is a strong feeling which I've heard expressed by a number of bank analysts that banks did not tell it like it was during the bad days of late 1974 and early 1975. Perhaps in part this was because bank information systems were not sufficiently good to let management know how it was, but that is not good news to investors. In addition the banking industry has developed an image of fighting disclosure for the last two or three years, maybe longer. In some cases banks have apparently

elected to stay out of the new issues market to avoid disclosures despite evidence that disclosures did not prevent new issues being sold.

In addition to this general feeling, we are now in a time when we are seeing almost daily revelations appearing on the front page of the New York Times and the Washington Post about problem lists, examiners' reports and other things which had always been thought to be confidential. These have certainly reinforced the view of investors that they were not told the whole story at a time when they felt and were expressing the need to be told this story. I should say that I deplore the publication of candid individual views written privately about management, and I deplore the publication of internal memos of regulatory agencies since I believe the effect of this publication will be to lessen the candor and hence the usefulness with which bank regulators communicate and deal with one another. I am not a great believer in extreme privacy when it comes to information about public companies, but I do believe that where regulators are charged with responsibilities they should be able to communicate with one another without the thought that their communiques might be published.

Increasingly in our post-Watergate environment in Washington, and possibly in New York as well, writing is no longer used primarily as a means of communication but rather as a means of making a record. This strikes me as inefficient at best since we've spent several thousand years developing writing as a means of communication. It is a shame to see it ceased to be used in that fashion, and yet that is clearly one of the things that we are seeing both in the public and the private sector as a result of, first, the tendency of almost everything to be publicized one way or another, and secondly, some of the litigious approaches taken by elements of our society. Nevertheless, the disclosures that we have seen have shown gaps in our continuous public disclosure system. I believe it is quite likely that if disclosures had been regularly and systematically made, there would be very limited news content in examiners' reports. The personal opinions about management certainly added spice to the reports, but it was the facts which were newsworthy. That was what made it page one news.

Ironically, it appears that the market had assumed much of the news even without full data since the revelations have not had a dramatic effect upon the stock prices. It's my very strong view that the market can best absorb bad news when that news is systematically reported, and where analysts have confidence that the full story is being revealed.

This matter of confidence is very important. I have heard from many different bankers how important confidence is, and this has been used as a basis for nondisclosure. I personally believe that the need for confidence is the reason for disclosure not for nondisclosure. This is not to say that even if you have a very comprehensive disclosure system the market will not respond to bad news. It will. It should. The role of the market is to reflect economic phenomena and to allocate capital. But in the long run investor confidence is the key to market appraisal. I believe that banks will pay a price, and a significant price, in their multiples for years to come as a result of the concerns that have been generated over the past year, year and a half, about the candor of bank reporting.

In addition to the worry about disclosures, I think credibility in bank financial reporting is continuing to be eroded by the apparent determination of banks to defer recognition of economic losses in their financial statements. In my judgment this is bad accounting. It is bad economics. It is bad management judgment, and it is bad politics. Yet it is clearly a matter of high policy decided at senior management levels of major banks. Let me cite three particular examples that have existed of late and still exist.

First, there is the question of New York City securities. Banks towards the end of last year mounted a massive and successful political effort to avoid requirements to write down New York City securities, even though a substantial majority of accountants felt a write down was needed, and the Accounting Standards Executive Committee of the AICPA had published at least an exposure draft in this regard. The SEC concluded after listening to various arguments that it should not require any particular accounting, but I believe the banks made an error in their judgment that those securities should not be written down. While a number of technical accounting arguments were made about whether there was permanent impairment, whether there

was an accountable transaction, and these are relevant accounting issues, it seems to me the facts of the matter were fairly clear. Contractual terms of an investment security were unilaterally altered by the issuer to the economic detriment of the holder. A loss had occurred. Interestingly it appears that at least some banks are now exploring the possibility of deducting the loss of tax purposes while at the same time not reflecting it on their books for financial statement purposes.

I think that from the point of view of bank management, their position on this issue was a mistake. I think it was a mistake because first, the investment community knows about the situation and there is disclosure of the amount of holdings. It does not make a whole lot of sense for bankers to say "Well, we'll just not reflect any losses because that would have an adverse effect upon the evaluation of the bank's securities out of proportion to what it should."

In a political sense it is also questionable whether or not banks should take pride in the fact that they have not suffered any loss in the New York situation when it appears a great many other people with considerable political clout have suffered very substantial losses. Ken Axelson's talk last night was interesting and to the point in this regard.

A second example is the area of loan swaps. We have seen a significant number of situations in which banks have exchanged their loans with REITs for some of the assets of the REITs, in some recording the value of the assets received at the same amount as the loan book value. The Commission may speak on this subject in the next week or two since we are very concerned about whether or not this can be in any way justified within the framework of generally accepted accounting principles.

When you have a transaction where you exchange a loan for other assets, you have an accountable transaction. The basis for that accountability cannot be simply the book value of the assets swapped, but it must reflect the fair value of the assets acquired. When speaking of fair value, one must think of asset values which would yield a return equivalent to a return which one would get when making a new loan to such people or acquiring these assets. This is a difficult empirical question, and I don't belittle that problem, but the issues of asset valuations in swaps must be addressed.

Another problem is in the area of loan renegotiations with reduction in interest. We have seen a number of cases where substantial interest reductions have been negotiated with no charge-off taken on the theory that there was no loss. The historical distinction between contractual principal and contractual interest has disappeared amongst economists. It has largely disappeared in portfolio management also except for some legal niceties, and in much of accounting since the issuance of APB 21. Today we look at contractual cash payments in total and at their present value which we believe is the key to analyzing any business transaction of this sort. Nevertheless the distinction between principal and interest seems to be alive and well in the bank accounting world. Again, it appears that bankers may be failing to face reality. When a loan is renegotiated from 130% of prime to a no interest or 1% interest loan, it is very hard for me to see how it can be argued that no loss has occurred. The present value of your contract is worth a lot less no matter what rate of discount you apply to it.

These types of problems are raising serious questions about the credibility of bank financial statements today. I do not see any significant improvement. This is not to suggest that bank accounting problems are new. Bank accounting has had problems for many years. For example, there is a major problem that has existed and continues to exist in the area of investments. How do you deal with changing market values which are not reflective of changing credit standings of borrowers but rather are simply reflective of changes in basic interest rates in the economy? There also have been problems for years in estimating the amount of loan loss reserves and of making estimates of the uncertainties involved. These problems still exist.

It seems to me that in trying to deal with such problems, in general . . . although there are certainly exceptions the industry has fought against changes in accounting in these areas. It has responded negatively to the initiatives of others, and it has largely resisted innovations. It seems to me that at the present time substantial initiatives are needed, and at the moment those initiatives, the ones we have seen, all seem to arise outside the banking community.

Perhaps I've been overly critical of the banking community, because they have during the past five or ten years taken one significant positive step. They were exempted by status from the

securities legislation in the 1930's; however, in the course of the last ten years, recognizing the need for this type of protection, recognizing the benefits of SEC regulations, they have changed their legal structure in such a way as to bring themselves under the SEC's framework by forming bank holding companies. I think this is a productive and positive step which they have taken in the reporting field. Although some of them have argued, despite my willingness to give them credit for this, that there were some other factors which also entered into their decisions to form holding companies, I'm certain those factors could not have been quite as important and perhaps have not subsequently turned out to be as significant.

(Laughter)

In any event, I was speaking of accounting and disclosure initiatives from outside the banking community. The SEC has issued two proposed guides for the preparation of 33 and 34 Act filings for banks. We don't pretend that these are perfect or ideal. We really don't pretend we have great expertise in banking, although these guides were developed with substantial consultation over a six or eight month period between the Commission and the banking regulatory agencies. Although we don't agree on every element, I think that both we and the bank agencies have developed a respect for each other and a respect for each other's problems and objectives. These guides have been put out for comment. Comments have been received. They are being digested. We believe that in the course of the next few months we will be moving ahead to finalize these guides. I suspect we will make some significant changes. I suspect that we will not view this as the final answer. We see problems, particularly in the international area and in the loan loss reserve area which still have to be dealt with. We have tried to be responsive to the concerns of the bank agencies, and we will try to be responsive to comment letters. Unfortunately the tendency of the comment letter is to say, "You can't do what you want to do," rather than to say, "Here are various approaches we're trying in an attempt to achieve what you want to do."

A little more than a year ago, the SEC issued Accounting Series Release No. 166 which dealt with the generic problem of coping with uncertainty and the appropriate disclosures to

cover uncertainty. This in a sense was the thing that started us down the road to Guides 61 and 3. Once again, we don't think we have the final answers in this area. We think the appropriate response to uncertainty is to disclose more so the people can understand the basis for estimates, but we aren't sure exactly what is best.

Dealing with uncertainty is a major problem for accounting in general. It is a major problem for banks, and I think that it is important that initiatives be taken to try to cope with it. It's one thing to say we're going to pick a single valued number for the amount of the reserve for loan losses, or we're going to pick a single valued number for the estimate of bad debt reserves, but then to say that that number was picked on the basis of "management judgment" doesn't tell people very much about what you've done. The investor who is trying to understand and to make judgments about the financial statements has to know more in order to appraise the uncertainties associated with the loan loss provision. That's a major element of uncertainty as it affects banks, and I think the answer has to be in terms of more disclosure so that investors can compare the approaches taken by different banks. They cannot do this perfectly. I'm not suggesting a list of all loans and percentages, but investors need to know more than they know now, and a simple statement that reserves are based upon management's judgment, while certainly true, is not sufficient.

In the year ahead, as I say, we may be issuing a release on the subject of loan swaps, trying to set forth our views in regard to the current requirements of generally accepted accounting principles in this area. The FASB, of course, is moving ahead on the broader subject of loan renegotiations now, dealing with the issues both from the point of view of the debtor and of the creditor, in response to the year end problems associated with New York City and others. We are very hopeful that in the year ahead the FASB will develop standards which will be uniform, sensible, and will assist the banking community in making appropriate disclosures and in accounting for these areas.

Fundamentally it seems to me, however, that the banking community itself should be taking a far more positive and forceful role in the accounting area. Today there is a very

substantial need for bank initiatives in dealing with the long standing problems of investments, which is an area not now actively under consideration by the FASB or the Commission. Perhaps, for example, the traditional approach of recording gains or losses only upon realization is no longer reflective of the reality of the situation. Obviously, the traditional approach gives a great deal of flexibility to management in selecting when to take losses and when to take gains. It may also have led to some bad investment decisions where people have kept securities so as not to report losses. Neither of these make sense. Perhaps we should be dealing with some system which marks portfolios to market, although through a separate section of the income statement as opposed to being part of the operating earnings. There are major problems in lumping the effect of market value changes into operating earnings because small changes in interest rates, if reflected in the market values of securities held, might well dominate operating trends. On the other hand, perhaps a separate section of the income statement could reflect such changes. Perhaps there should be some averaging process whereby the portfolio is not marked to market each quarter or each month or each year, but rather there is an averaging process taking into account market changes over a two or three year period. In this way one could avoid having the situation where the accounting value of a portfolio carried at cost bears no relationship to the market in the real world, but at the same time avoid erratic movements in reported earnings.

In the area of uncertainty there is a great deal that also could be done. Again I would urge banks to move forward and develop innovative and creative approaches. For example, there are subjective judgments in loan loss reserves. There are subjective judgments that are made in many different aspects of banking. It is important that banks try to develop disclosures which will express these subjective judgments in a fashion that can be understood by investors.

I don't mean . . . well I guess I do mean . . . to paint a somewhat bleak picture today as to the state of bank financial reporting and disclosure. I believe that adversity can be and should be a source of future strength, and when one looks at the situation we have gone through in the last year there is the potential for substantial improvement. However, the opportunity is slipping away. My own view is that it is most important that this opportunity be seized, and it can best be

seized by those who are most knowledgeable in the banking world, and that is the banking community itself. Thank you.

(Applause)

MR. POTTER: Thank you very much, Sandy. I don't suppose that we could find unanimity within the room as to the views you expressed. We are, I'm sure, unanimous in our indebtedness to you for a very vigorous presentation of views that have at least for the purposes of this meeting been identified as not being those of the Securities and Exchange Commission.

(Laughter)

MR. SHORTER: I would like to call your attention to the yellow questionnaire that you'll find on your tables. We would appreciate it if you would take the time to fill those out and drop them on the table near the door as you leave, because it helps your Section Chairman and your Executive Committee to put on the type of program that you're interested in, and particularly we would be interested in any suggestions that you might have for future programs, because it's your section and we try to key this to the things that are of interest to you.