

THE SEC AND THE CHANGING WORLD OF ACCOUNTING

By

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As one looks at an uncertain world, one of the most certain things that is going to occur is that change is going to occur. The real key to the future is the response of the business community, the accounting world, and others to this change. If change is viewed as a threat to be resisted, the result may be unfortunate. If it is viewed as an opportunity, the result may be highly beneficial. I think that one of the most important things that accountants, businessmen, and the financial community can do is to treat change as an opportunity to work with and strengthen the institutions in the financial reporting environment. Of course, this may be said in much broader terms, but I am speaking from my own particular area of interest.

Looking at the accounting world, it is clear that the next few years are going to show substantial changes in accounting principles, changes in the reporting environment, changes in the role and expectations of public accounting and public accountants, perhaps changes in the responsibilities of such persons. One of the real dangers that exists in a changing environment is that there will be significant groups that resist change and by resisting will accelerate its effect when it comes. Evolution, not revolution, is far preferable; otherwise the basic structure which is excellent may be destroyed. I personally believe that the basic structure of financial reporting in the United States today and the basic structure of our financial market system is a good structure, not one that should in any sense be torn down. The financial community must learn that it is far better to participate in change rather than simply be swept along by it or attempt to build a wall against it.

In looking at the SEC's role in this changing world of accountancy, I think the first thing to recognize is that it is very difficult and very undesirable to isolate the SEC impact. When I gave the title of "The SEC and the Changing World of Accountancy," the "and" is really the key. In reviewing both the past and the future, which I would like to do this morning for a few minutes, it is not appropriate, therefore, to emphasize SEC actions except as part of a broad effort, because the SEC cannot succeed without the good will of the financial community and the accounting profession. We rely tremendously upon this good will, upon compliance in spirit with what we are trying to do, which means essentially that there must be a consistency of

objectives. Today, therefore, I would like to look back and look forward from my viewpoint at the SEC but without attempting to identify the SEC as the key element. What, rather than who, is important. Accomplishments are joint, not individual.

As I look at the year past, I think we have seen a year of accomplishment in financial reporting. Probably the greatest accomplishment is the establishment of the Financial Accounting Standards Board as a viable, working entity. The Board is now well organized, its first statement and its first discussion memorandum are out. I think it has demonstrated a willingness to face and put on its agenda difficult subjects: R&D, line of business reporting, leasing, business combinations; these are not topics which would be selected by someone who was looking for the easy route to success. And it's clear that the FASB does not have an easy route to success. I am quite encouraged by the developments that are taking place in Stamford, Connecticut. I think that the Board's schedule is ambitious but achievable, and it's my judgment that 1975 financial reports of corporations are going to look quite different as a result of the activities of the Financial Accounting Standards Board. In addition to its work on broad, general subjects, the Board has re-established an informal communication structure with the SEC and with the accounting profession so it can be aware of what small fires are burning, and I think that this will be beneficial in its interpretive process and in its understanding of the problems that the real world is facing. The Accounting Standards Executive Committee and the firms are making inputs, and I think the SEC is also technically helpful in this respect. Basically, I believe that the relationships of the FASB and the SEC are good.

In Accounting Series Release 150, which we issued at the end of last year, for the first time the Commission put itself on record as endorsing a body of the private sector as the source of authoritative pronouncements. It is, I think, a significant step, and I think that in so doing it was our intention quite clearly to identify our reliance upon the Financial Accounting Standards Board as a private sector in this respect. Now, I should admit that our relationships are not perfect, and this is, I suppose, inevitable. We have dedicated ourselves to an atmosphere of mutual non-surprise, but this does not seem to work 100%. I suspect that the Commission staff

is probably at fault as often or more often than the FASB in this regard. Sometimes, instead of mutual non-surprise, we deal in an environment of mutual surprise where the press assists us, and of late we have seen a couple of cases where the press has written articles indicating what one or the other of us was doing, and neither of us was aware that this was being done.

I guess the classic case was in the Wall Street Journal not too long ago, where there was a piece that said that the Commission was considering a release on the subject of the impact of high interest costs on financial reports. It identified the Office of the Chief Accountant and the Division of Corporation Finance as the ones who were working on this, and when the head of the Division of Corporation Finance and I got into the office we were both mad that the other had not told us that he was working on it. Then Marshall Armstrong was on the phone, and he was mad that we hadn't told him that we were working on it. We have yet to fully understand where that particular story came from, although there are rumors that some general remarks of one of the Commissioners may have led to the story. But even though we occasionally have problems in communication, and I think this will happen from time to time, I believe the relationship between the Board and the SEC is good and will get better. We are also very encouraged by the Board's adopting as one of its major agenda items a study of the qualitative aspects of financial reporting using the Trueblood Committee Report as a framework; we are hopeful that this will put some attractive clothes on what we think represents a good skeleton in trying to develop some material on the objectives of financial statements.

In addition to the FASB in this past year, I think one of the other steps that has been taken is a new articulation of a disclosure philosophy by the Commission. The fundamental idea is to provide better and more usable information for all parties. In order to accomplish this, the concept of differential disclosure has been articulated. This is based on recognition of the fact that all users of financial information cannot and should not get the same raw material to work with because they have different backgrounds and different needs. On the one hand, we have identified the need of the average investor for more analytical summarization of financial results and for more information of a general sort in the annual report. We now have two proposals of

this sort: one amending the guidelines to the preparation of registration statements to call for an improved analytical summary associated with the five-year summary of earnings, and a second calling for more information of a general nature in the annual report, including line of business data, data on working capital expectations, and a variety of other types of information.

In addition to this recognition that the average investor needs both more and focused information, we have also recognized the fact that many of the investment decisions on behalf of the smallest investors in the marketplace are made by professionals and that professional analysts also have a right to the kind of information which will assist them in developing an understanding in depth of corporate activities. Therefore, we have during this year put out a number of rules and proposals dealing with data which we identified as being primarily of interest to the professional- -details as to compensating balances, short-term borrowings, lines of credit, details as to tax extension, and details as to the impact of accounting alternatives. These are data which we think that someone who wishes to make a comprehensive study of corporate activities needs, but at the same time they may not be of primary interest to the average investor who wishes to spend lesser time and get a good general picture. It must be recognized that differential disclosure does not imply discrimination against any class of investor since the information that we identify as being primarily needed by the professional is to be available to all as data filed with the Commission. Nevertheless, we recognize that there are some practical problems that arise in saying that certain information should go in financial statements filed with the Commission but not in standard financial statements prepared on the basis of generally accepted accounting principles. This is something the Commission is continuing to consider so as to minimize legal and practical problems of implementation while retaining the concept. I think that the basic idea of a rifle approach related to the needs of particular parties being more satisfactory than a shotgun approach is a concept that makes sense, and it is one that we will be working with in the year ahead.

In addition, this year a number of proposals have emerged dealing with what has been called "as if" disclosure- -disclosure of what things would have looked like if they had been

accounted for differently. We have received more criticism on this than almost any other topic. People argue that one of the basic problems of this type of disclosure is that it will reduce the faith of investors and others in financial statements. I guess my answer is that this is exactly what we have in mind. Financial statements should not be a matter of faith; they should be a matter of information. One of the problems of the financial accounting world is that there has been too great a tendency to encourage child-like faith in both the truth of financial statements and the scope of audits which is just not realistic. If we can use this as one of several means of moving away from faith to reasoned understanding, this will represent a significant step forward.

I guess this could be called part of a program also to recognize the fact that the precision associated with financial statements represents a false precision. Perhaps we should seek imprecision to a greater extent. One of my favorite stories in this respect came from a former dean at Columbia who once explained to me his view of accountants. He said that it was substantially influenced by an experience he had when he was flying down to Argentina. He was sitting on the plane next to a man who identified himself as a C.P.A. As the plane passed over Brazil, the CPA tapped him on the shoulder, pointed out the window, and said, "There's the Amazon river. That river is one billion and two years old." The dean said, "That's very interesting. How did you know that?" And the accountant answered, "It's easy. Two years ago, I was flying down with a geologist, and he told me it was a billion years old." What we really need is a search for imprecision, not for precision.

In addition to general approaches in the past year, the Commission, the Accounting Principles Board, and the FASB have dealt with a number of special problems of disclosure: problems of leasing, extraordinary items, cash flow per share, and, recently, our release on inventory profits calling attention to some of the problems of the basic accounting model under conditions of substantially rising prices.

One other important step which was taken this year, jointly by the Commission and the AICPA, was a step toward the concept of peer group review of public accounting practices. The Commission, in the case of a particular problem with an accounting firm, suggested that as part

of a total settlement the firm agree to have an inspection of its practice by a group of its peers from the AICPA to determine whether the firm's quality control procedures do meet the standards which they think they meet. The Commission has been working with the AICPA to develop techniques for such a review. We think that this represents a step toward improved profession-wide quality control, which is something the Commission feels most strongly about. While it is part of a sanction in a sense, it is not probation for the accounting firms who are involved in this type of program. Rather it is an attempt to look at the total problem of quality control and the need of the profession to move in this direction. We believe that in the year ahead the profession may take this approach away from the SEC by adopting it on a broader scale, and we hope they do. We think that quality control is best handled on a profession-wide basis, although there are certainly problems to be worked out in this regard.

While a look back is useful and a source of some satisfaction, a look ahead is probably of more interest to you. As I look at 1974, it seems to me that if 1973 could be called the year of increased disclosure, 1974 might be called the year of the auditor. Perhaps it is not coincidental that in the Chinese calendar the year ahead is known as the year of the tiger! I believe that 1974 will see the beginnings, and perhaps to some extent the conclusions, of a number of major steps that will affect the accounting profession primarily in its role as auditor rather than in terms of measurement and disclosure. First, improved quality control and the problem of professional discipline which I have already touched upon will undoubtedly take a high priority in the year ahead both at the SEC and the AICPA.

Secondly, I think the question of the auditor and fraud is one that has to be attacked in the year ahead. The historical posture of the auditor, which seems to be that fraud is not what they are responsible for finding, has to be revisited. This is not to say that the auditor should devote his attention to looking for thefts from the petty cash fund, which I think is what the auditor is primarily talking about when he said he is not responsible for fraud. We have seen too many cases of massive management fraud where management has obscured the reality of corporate activity from the auditor. This is something to which the accounting profession has to turn its

attention. I believe that the AICPA committee headed by Marvin Stone, which is looking into the Equity Funding case with the purpose of articulating the lessons to be learned, is one that will help in this direction.

A third area that I think will see some substantial development in 1974 is what has been called the "auditor of public record" concept. Increasingly it is being recognized that the auditor has some responsibility beyond an annual visit to the corporation in order to audit the financial statements of a particular year. I think that the auditor has to recognize that he has a public responsibility in the broad framework of public financial reporting by corporations. This means that as long as he is the auditor of record, which in the case of a public company means that there has been no 8-K filed with the Commission that indicates he has resigned or been fired, he should feel some responsibility to review all public financial reporting of that company on a continuing basis. It is apparent that what has to be done in this respect is to develop meaningful standards for auditor responsibility. I do not contemplate, for example, a quarterly audit. But on the other hand, it seems to me that public accountants with their public orientation and reporting expertise should have greater impact on interim statements than has been the case traditionally. This is not an area into which the SEC or the accounting profession should rush blindly, but it is an area where there must be considerable attention given. I think that 1974 will see that attention given.

The year ahead should also see a better approach to the problem of how uncertainty should be dealt with in the auditor's opinion. The Auditing Standards Executive Committee is now hard at work on this subject.

In addition, we should see progress in dealing with a number of problems of independence. On one front, the Ethics Committee of the AICPA is working on the problems of family relationships. A paper should be forthcoming shortly. On another, the Commission is looking very seriously at the problem of independence as it relates to adversary relationships in lawsuits. The litigious world we live in has created a number of problems in this respect.

Even more fundamentally, I think there has to be some attention given to the most basic problem of independence which is the problem of appearance which arises because the auditor is paid by his client. By saying this I am not advocating in any sense that the auditor should not be paid by his client. I do not favor some of the proposals that have been made which suggest that there should be a sort of central pot out of which the auditor is paid. But I do think that a number of institutional steps may be taken to improve the basic appearance problem, and I think that these are consistent with the way in which outside directors are increasingly feeling. One step might be the increasing formalization and use of the audit committee of the Board of Directors. Another possibility is the extension of the period of time for which an auditor is appointed. While I would hesitate to suggest the academic concept of tenure, a three or five year term might be appropriate. This might tie in with the "auditor of public record" concept. Some additional legal rights such as those that exist in the United Kingdom where auditors have an absolute right to attend stockholders meetings and to communicate with shareholders in the event they are displaced may be appropriate. In addition it may be that auditors should have the right to attend meetings of the Board of Directors. Other legal rights may well be part of this package.

An additional auditing and accounting problem which has to be solved in the year ahead is that of related party transactions. On the accounting side, this requires attention to whether or not profits may be legitimately reflected in financial statements when they result from transactions with related parties. It may be, for example, that such "profits" under some circumstances should be treated as contributions to capital. From an auditing viewpoint, the question of what responsibility exists for the problems of auditing outside the particular entity that you are looking at must be faced. It may be that an auditor must have access to the books and records of all parties which are related to the entity he is auditing. Some of our most dramatic cases in the past year include the Westgate case and the U.S. Financial case, where the related party problem was the key. Somehow or other an auditor has to get some kind of handle on this.

So, as I look at 1974, it seems to me that perhaps the most significant new steps that are going to be taken will be taken by the profession and the Commission in regard to the audit function and audit responsibilities. This is not to say that I think the year will be inactive on the reporting front. Of course, the FASB is going to be moving ahead in bringing items out from its pipeline, and these will be significant. The SEC has a number of outstanding proposals on which final action will no doubt be taken this year. Our analytical summarization proposal, the annual report proposal, the accounting alternatives proposal, and our statement of policy on forecasting need to be developed during the year. Beyond this, there are some general problems in interim reporting, price level and fair value, working capital, and uncertainty which will need some attention in the year ahead, although there are no specific plans for releases in the near future in these areas.

Basically, what I'd like to leave with you, however, is my view of the SEC's role in this changing world. I believe the Commission is going to be an active participant. I think it will be a catalyst. But I don't believe it can be a dominant force. The accounting profession and the business community must accept change in these areas. The Commission can encourage, but we can't do more. If we are able to work together, I think all of our interests will be served. I personally remain very optimistic that this will be the case in 1974 and in the years ahead.