

Speech by

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Tonight I want to talk to you a little bit about the varying responsibilities which I perceive as existing in the reporting process, and then I want to speak a little bit more specifically about one particular related accounting issue which arises out of some of the comments that the Chairman made. In looking at responsibilities in financial reporting, I think we should address ourselves to the various parties at interest, namely management, the accounting profession and the regulatory agencies – primarily the S.E.C. Management, of course, traditionally has said it has the basic responsibility for financial reporting. I think it is fair to say that they have the first responsibility, but certainly not the sole responsibility. I think it's quite apparent that the accounting profession is increasingly developing a sense of joint responsibility where it comes to financial statements, but nevertheless, good financial reporting is a function of a management ready to tell the corporate story – both in good times and in bad – and most corporations seem to experience some of each. I think it's quite apparent that if management is able to establish credibility with the financial community, the analytical community, their access to the capital markets will be improved and they will find that this has not only social benefits, but both short-and long-run economic benefits to them in tapping the capital markets. At the same time, if the management of a firm is not trusted by the financial community, then their legitimate accomplishments are discounted, and I think we can all look at a number of corporations whose shares sell in the marketplace at lower than normal multiples of earnings, to a significant extent, because there is a credibility gap and legitimate accomplishments are discounted. I think management has to recognize that earnings should be managed only by managing operations, not by an accounting department. Where earnings are created in the accounting department, it is generally a sign of problems in the operational department. It is apparent that management also must make a number of decisions as to what disclosure is necessary. We may help them, their accountants may help them, but in a very large sense, the determination of what magnitude of disclosure will exist, what form of disclosure, still remains with management, subject to certain minimum requirements. I think it's quite fair to say that minimizing disclosure is not in the corporate interest. I think that managements must give more information, I think they must give more analytical information, and this is part of their responsibility. Second, the accounting profession has a set of significant responsibilities. As I said before, I think the accounting profession has joint responsibility with management as consultants in financial reporting. They have a responsibility to investors, stockholders, to management and, perhaps most important, to the public. If the accounting profession is to serve as our partners in this process, they must recognize their public responsibilities as being primary, and their client responsibilities as being secondary. This doesn't mean it's unimportant, only secondary, where the two come into conflict. In addition to the responsibilities of the accounting

profession in dealing with individual audit situations, there is also a professionwide responsibility associated with the establishment of measurement principles. Here it might be worth saying a few words about the posture of the Commission in terms of establishing measurement principles. Here it might be worth saying a few words about the posture of the Commission in terms of establishing measurement principles. I think that you are all aware that the Commission has basically supported the Accounting Principles Board for many years. We've endorsed the new Financial Accounting Standards Board. We are very hopeful that the new Financial Accounting Standards Board will be a more viable entity which will be able to improve measurement principles and work more effectively in this regard. It is certainly a fact that the entire financial community has a large investment in the success of the new F.A.S.B. I believe it will be successful. I don't know what will happen if it isn't, but there is certainly a large stake in its success. Implicit in this, I think, is the fact that the Board cannot, if it is to be successful, be a puppet of the S.E.C. I guess many of you have read Chuck Horngrew's article in *The Journal of Accountancy*, where he identifies the S.E.C. as top management and the Accounting Principles Board as middle management; and while, of course, I have always lusted to be a top manager, I don't believe that's a fair statement as to the way in which the S.E.C. and the A.P.B. relate, and I'm sure it's not a fair statement as to how the new Financial Accounting Standards Board will relate to the S.E.C. If it was our view that the Board was simply there to promulgate our views, it was immoral on our part to let them be established. A very substantial investment has been made in time, talent and money, and we certainly do not view them as merely a conduit to which our views can be made effective. We intend do not to overrule them since if we do, It's quite apparent they will cease to be able to get competent men or resources for creditability, and we at the Commission do not have the men or the resources. I believe the Chairman, who has articulated this, and the staff of the Commission are convinced that the private sector can do the job best in the establishment of measurement principles and that the perpetuation of our policy of nearly forty years' standing in this respect is in the public interest. People say, "How will we relate to the F.A.S.B.?" I think I like to describe our relationship as one of mutual nonsurprise. I don't think that we should surprise them, and I don't think they should surprise us. We expect to work with them, but we will not be a formal part of their apparatus simply because the S.E.C. does have certain statutory responsibilities which, it seems to me, preclude this from being a part of the formal apparatus. We expect to be in communication, but not to impose our judgments and preferences on accounting issues on the Board. If this is to be the profession's responsibility, the question then arises: What is the responsibility of the regulatory world, and specifically, the S.E.C., in regards to the establishment of measurement principles? Certainly we will refer issues to the Board as we have done for the A.P.B. We will refer both general problems, which we think need resolution on a

timely basis, and we will refer specific problems as they come before us when we think they need answers. I guess an example of the way in which we expect to work with the F.A.S.B. is the way we worked with the A.P.B. on our most recent accounting series release on pooling of interest accounting, where we identified a situation which we felt represented a violation of the basic concepts of an A.P.B. opinion, whereby business combinations were being accounted for as poolings, although they did not constitute a legitimate sharing of risks between the parties. We identified this and discussed it with the Board. There was general agreement that this was a problem. The Board authorized its staff to issue an interpretation which mended this problem, and we managed to do an accounting series release which endorsed the interpretation and made it public a little sooner than it otherwise would be, and indicated how we would interpret this interpretation in factual situations. This is merely because the Board does not see fit, and appropriately so, to make rules relating to registrants, where we have to give guidance to registrants. I think that we will work with the F.A.S.B. on a similar basis where situations develop. There may be times when we can't wait for an answer, and under those conditions, we may have to put our guidelines subject to subsequent amendment if it is the judgment of the F.A.S.B. that we have done down the wrong road. At the present time, for example, we are faced with a significant problem as to how to account for the divestiture of segments of the corporation's activities. What happens when you sell off a division or subsidiary to the public? We are in the process of studying this issue. We have taken a position in a number of cases where a hundred percent of the division or subsidiary is sold to the public in an underwritten original offering, that this creates a new basis of accountability. The price that is paid by the public for this subsidiary or division should be a basis for revaluation of assets of the division. This is an area which is somewhat controversial, where we have a number of problems that say: All right, that's the general principle, but how do you apply it in case A,B,C,D, and we're trying to put something out that will represent a guideline. We see it as an area where there are problems in accounting theory. If the F.A.S.B. ultimately comes to a different conclusion, we can live with that, but in the meantime, there have to be some answers so that people aren't going all off in different directions. Another current example is subject to catastrophe reserves of casualty insurance companies. We are seeing a very substantial development in the creation of the catastrophe reserves. We have asked the insurance committee of the Institute to consider this, but at the present time they have been deeply involved in getting out an audit guide on accounting for the stock insurance companies, and I'm not sure that they are going to be able to move sufficiently rapidly to deal with the need. I don't really know whether it's good accounting to create a catastrophe reserve. In one sense, it seems to me to be a matter of income leveling; on the other, to recognize the fact that there are catastrophies. Like so many things, you can look at the subject from two points of view and get different answers, but it is obviously not

in the public interest to have many different corporations treating this subject differently. I think you probably have to get something else in this respect. These are areas where some answers have to be developed, and maybe the S.E.C. has to put forth the guideline which is subject to review by the F.A.S.B. The Chairman, in a widely quoted statement in that speech, said that he was forced to the view that the Commission should exercise more vigorous oversight and force the pace with which the profession meets the multiplicity of demands made upon it. This was widely interpreted as a threat. I would say that I view this as a supportative statement rather than a threatening statement. If it were a threatening statement, it would say that the Commission should do these things – not exercise oversight and enforce the pace, as long as the Commission is prepared to work through the institutions of the private sector, through referring items to it, through calling attention to the problems – through needling occasionally. This is still a supportative role, and this is how we view our role in this respect. Now, when we move past measurement principles and look at the subject of principles of disclosure, here we feel we have a more primary role, although the F.A.S.B. has a role as well. Disclosure cannot solve all the problems, but it can help in many cases. We do not feel that disclosure can offset financial statement misstatements. You cannot mend with a footnote a basic deficiency in the face of the financial statements. It is not appropriate to say, well, a reader who is intelligent can perceive by reading footnotes that the financial statement is without meaning, so disclosure is by no means the total answer. However, it can supplement, meaningfully, financial information, which, after all, is not truth but data. It can also, on a number of occasions, have a salutary behavioral effect. The light of disclosure may have a beneficial effect on the behavior of corporate managements and others, and therefore disclosure may serve an exhortatory purpose as well. An example of this, I guess, is our recent release on material unusual charges or credits to income, which came out about ten days ago. Here we have a proposed rule making which will substantially extend required disclosure associated with material unusual charges or credits to income. We hope, incidentally, that both analysts and accountants will comment on these proposed rules. We know the corporations will comment on them. It is, of course, somewhat persuasive to the Commission when they look at the comments on the rules and they find that there are 85 comments, of which 83 are negative. This does create some behavioral problems on the Commission's part, so we urge you to participate in our decision-making process by commenting on such rules – not just on a firm basis but as individuals, as you have experience that can be brought to bear. Basically, this release requires, in the first place, disclosure of details and material unusual charges to income, charges or credits on income, so we will know what type of assets is being written off. Are there provisions for future losses? Are there fixed assets being disposed of? Is it R&D? What are the details? Second, where provisions for future losses are involved, we've asked the disclosure as to the periods by quarter of estimated loss incurrence,

and subsequent quarterly filings and 10-Q's will compare the actual loss with the anticipated loss and present a complete reconciliation of any charges or credits that the reserves created. Where past costs are charged off, we ask the pro forma restatement of prior years so that you can see what the prior years would have looked like if you then knew what you now know. Finally, we have asked that in the 8-K filing that gives this detail and that must be filed ten days after the month from which the event occurs, auditors submit a report on the propriety of accounting, on a timely basis, so that we will obtain some form of audit report – not a formal audit and not a formal opinion, but some form of report from the public accountants. We have referred this to the committee on auditing procedure for specific recommendations as to what form of report, what kind of work should be done, and we expect to work with that committee on this. Now, obviously, this type of proposal will supply useful information to analysts in trying to understand what is the meaning of such unusual charges and credits to income. We also hope that it will have some behavioral effect, perhaps discouraging what appears to us to be an evident willingness to make super charges in bad years, which offset an apparent good trend for prior years and create a good trend for subsequent years, and we have been concerned by the magnitude of these things. We are working in other areas of disclosure as well. We expect to produce more information on the subject of line of business reports. There are a surprising number of corporations who seem to view themselves as a single line of business where credulity is sometimes strained in seeing this analysis. There is even one who has currently presented the Commission a fourteen-page justification of the fact that they are a single line of business, while at the same time there is an analyst's report out (obtained after discussing various lines of business with the company) which breaks the company's earnings and sales down to seven lines of business. This does create some behavioral reaction in us. We are working in the area of improved disclosure of liquidity positions. You probably saw that for hot issues in our Hot Issues releases, we suggested that new companies supply tax budgets for a period of time in the future. This was not an attempt to move dramatically in the area of forecasting, but rather an attempt to deal with the problems of liquidity, which do concern investors in both new companies and old, which the following does not require tax budgets of old companies. I'm not sure this is the right approach. We are working to consider various approaches to the liquidity information. In addition to this, we are trying to develop better approaches to interim reporting. I will discuss this in greater detail later, as I do want to indicate to you some of our expectations of problems in this area. Now it may sound as though our efforts toward disclosure are simply directed to more and more, and corporations occasionally accuse us of this, but I hope this will not be the case. We want disclosure to mean that the historical requirements are obsolete and we should do away with them. In this connection, we are currently looking at some of our requirements to parent company reporting to see whether or not it is indeed needed as

extensively as it is set forth in our reporting requirements. We have recently appointed a committee of outsiders to review our requirements for reporting to see whether they are logical, consistent and necessary. Frank Weston is on this committee. He's a C.P.A. and a partner in the Arthur Young Company, and there are also representatives of the investment banking community and the corporate community on this committee. They will be looking to see whether we have obsolete or unnecessary or duplicative requirements. In addition to our responsibilities in the area of measurement and in the area of disclosure, I believe we also have some significant responsibilities in the area of increased communication with registrants and professions. I think you are entitled to know what we are doing and what we are thinking. We will therefore see more releases concerning our decisions in particular situations, and probably more releases concerning our philosophy. We are currently in the process of trying to prepare a meaningful release on the subject of form versus substance. I'm finding it difficult but we are working on it. Next, I think we have a responsibility for a better surveillance over corporate reporting. This is not just a question of investigation, but an alertness to developing problems. This means that we must be alert to individual deficiencies to see whether or not they are symptomatic of something more significant, and in this connection, we eagerly invite your participation – both in identifying areas which you consider to be a problem and in presenting to us examples of reporting difficulties. I think we have the responsibility of support for our partners in the accounting profession. Part of this is exhortation, as you're hearing tonight. Part of this also, I think, must be encouragement of the profession to accept its responsibilities, develop new standards in meeting these responsibilities so that the new responsibilities will not bring on disabling liabilities. I think it is worth quoting the Chairman's remarks in this respect, because he, I think, has a sympathy with the liability problems of the profession. In fact, he says, "While I have great sympathy for the liability problems of the profession," I am troubled by the approach that some members of the profession are taking to reduce them. Liability can be either an incentive or a constraint, to the point where liability enforces responsibility. At some further point, unpredictable liability can generate a flight from responsibilities. It is rare, however, that flight accomplishes its purpose. As Joe Lewis once said about an opponent, "He can run, but he can't hide."

My own view, and a strong one, is that one gets better protection from liability by moving forward to broaden the area of responsibility rather than by trying to narrow or restrict it. Attempts to narrow liability run the risk that a court will force it upon you unexpectedly in a hard fact situation, and it's apparent that the courts today are not willing to take a narrow view of the role of the accountant. What this means, therefore, is that accountants must accept responsibility, but they must do so while developing standards to meet it. I believe that if reasonable standards are developed by the profession, which meet public expectations, that the

profession can avoid some of the problems of liability which it currently fears. Now, to give you an example and discuss one of the areas where I think that the problem of expectations can be met, I'd like to turn to the subject of interim reporting. I'd like particularly to call your attention to it because it is an area where public accountants are involved and they may not know it – and that's a bad situation. When you don't know something and you know you don't know it, you can't get into too much trouble; but when you think you know something and you don't know it, then you can get into big trouble and accountants who think they can avoid responsibilities when they can't, could be a problem. Let me once again refer to the gospel in this area, just to introduce some of my remarks on the subject of interim reporting. The Chairman said, "The auditor must feel a sense of responsibility for continuing participation in all phases of public reporting by his client. A once-a-year appearance on the scene to bless a man who audits reports does not conform to public expectation of the auditor's role." In my view, an auditor must carry a responsibility for knowing what is going on at his client, what the fundamental business situation is, and whether the public reports being prepared adequately reflect these things. The auditor must recognize that he is the only independent public representative immediately involved in the reporting process with the ability to take timely action, where necessary, to protect both management and investors from misleading reports. No enforcement proceeding after the fact can possibly have the same impact. Perhaps we should address ourselves to the subject of interim reporting and the responsibility therefor. The first problem that I think has to be addressed is the problem of principles, because in the area of interim reporting I don't think accountants or corporations even know what they are trying to do. There is an A.P.B. committee at work on the subject of interim reporting, but I don't know what they are going to say. The key philosophical problem in interim reporting is whether or not income smoothing is appropriate in interim reports. This is an area where there is much diversity of view and much to be said on both sides; depending upon how you look at something, you can come to quite different conclusions. I guess it's a little like the story of the prohibitionist who went down to the Kentucky hills to give a speech on the evils of alcohol and decided to use a dramatic example to culminate his speech. He brought forth two glasses – one filled with pure mountain water and the other filled with Kentucky Moonshine. As he came to the end of his speech, he held up a worm and he said, "Now, I have here a worm and I will demonstrate to you the impact of alcohol. First, I will drop it into the water." So the worm swam happily around, whereupon the prohibitionist fished the worm out and dropped it into the corn liquor, where the worm jerked three times and fell to the bottom, dead. The prohibitionist then said, "Now, what does that prove?" An old mountaineer in the front row said, "Well, if you drink corn liquor, you won't have worms." So a lot of things depend on how you look at it. Interim reporting is one. The question of income smoothing. There is much to be said for income smoothing. In the first

place, it can be argued that, within an interim, it reflects business as a continuum, which it is. Discrete segments of time are artificial, and the shorter the segment, the more artificial the time period is – even the year may be artificial. Relatively few business enterprises today can reasonably be divided into time periods measured by the length of time it takes the earth to circle the sun, but nevertheless, we live with that – perhaps we’re used to it. As the time periods grow shorter, quarters, there are real problems as to whether or not such artificial segments shouldn’t be presented without some smoothing. It is also true that as we observe the market impact of small changes in quarterly earnings, these impacts indicate that the predictive assumptions being used in interpreting these small changes, which are to project the small change for the next forty years, is inconsistent with reality. There is a very great danger that random fluctuations are being projected in a fashion that shouldn’t be the case. It’s also true that a good and consistent interim smoothing system may reduce short-run management controllability of income. It may avoid the tendency to do things, either operationally or in the accounting department, solely for their impact on earnings for that quarter. It’s certainly true that without a smoothing device there is a strong behavioral tendency to put things away for a rainy day, to smooth, despite a decision that we shouldn’t smooth, and this creates problems. I remember the first time I ever was on an audit. I was auditing a plant of a defense manufacturer. Early in the game I took off the trial balance and discovered an account labeled “budget miscellaneous account.” I asked that a budget miscellaneous account was and was told it was for the Home Office. I explored it a little further, and they said, “Yes, if we don’t use that and we show a variation from our budget, the Home Office gets very upset; therefore, we just charge or credit that account as needed to avoid upsetting the Home Office.” So, as they said, you know, a monthly figure has no meaning so we want to smooth. There is a human tendency to smooth. If you can develop a good, consistent interim smoothing system, you may reduce what might be called a short-run management controllability system. In addition, it’s fair to say that the accounting model itself is a long-run averaging process. This is the rationale underlying the matching concept – trying to develop a matching of a long-run average cost against revenue. Finally, seasonality may mislead. I was a director of a corporation that traditionally reported earnings of about two dollars and a quarter a share per person nine months of the year, and then a loss of ninety cents a share for the fourth quarter. We always had to spend a great deal of time in every quarterly report explaining how, although the earnings looked high, and comparing them with the total earnings for last year, and we discovered that you can’t deal with it that way. I’m sure there were some people who knew this and wrote the company after our third quarter. They were not terribly critical viewers, particularly if they just looked at the price earnings ratio now being so conveniently quoted in the daily newspapers and in the *Wall Street Journal*. These are a variety of arguments that suggest perhaps there should be some form of smoothing. On the other hand, you can look at the other

way too – and there are some powerful anti-smoothing arguments. Certainly, the generally accepted accounting principles articulate that income equalization is not an acceptable basis for financial accounting. It's also true that smoothing results are less sensitive to meaningful change. The problem is: Is the change random or is it meaningful? If it's random, it's good to smooth it out; if it's not random, but it's meaningful, then it's not good to smooth it out. There is sometimes difficulty in perceiving whether or not a change is, in fact, meaningful or random. Managements occasionally have behavioral responses which leave them with something other than rational analysis. In addition, and perhaps most powerfully, it's quite apparent that the world isn't smooth, even though we might like it to be. Shouldn't we tell it like it is? Well, fortunately, matters of measurement principles are already identified as problems of the Financial Accounting Standards Board, so I don't have to tell you whether I think we should smooth or not. I can tell you that this is an area of measurement principles and that we do need some answers to this basic problem before we get operational techniques approved. That's the first problem associated with interim reporting. We are doing some research today on what some of the aspects of this are, but I don't think we have any answers even close. However, it is possible that, through improved disclosure requirements, we may be able to take some significant steps forward in the interim reporting – and we may move in some of these directions. Certainly, as a starting point, present interim disclosure is rather sketchy, even though 10-Q requirements are felt somewhat. As a start, more details are needed, perhaps some balance data, perhaps some line of business data, perhaps other aspects of information. If people are going to look with great care, as they do at quarterly results, it seems apparent that we should give them more information. In addition, it may be that we could require, on some analyses, the reasons of variations from historical trends. Analysts look with great care at trends, and where there are variations from historical or expected trends, perhaps part of the quarterly reporting system should require a management analysis of these variations, which may mean that we should have more frequent reports of certain particularly significant information. Is quarterly frequent enough? Maybe it's too frequent for some companies, maybe it's not frequent enough for others. Maybe we should take ourselves away from the concept that we just get quarterly income reports and that's what it is. Maybe some parts of disclosure should not be quarterly, some should be monthly. Maybe some should be semiannual. I don't know if these are areas. It's possible that we should relate interim data to longer term forecast results. It may be that the key variable is not what happened to the quarter, but what the experience of the quarter has told us about our expectations for the year. The Commission is far from coming to a conclusion as to whether or not forecasts should be disclosed and in what form they should be disclosed – if they should be. There is a whole range of possible answers, and we are awaiting a number of research studies from various organizations on this. Certainly, if you do move toward forecasting information, it

is perhaps reasonable to relate interim data to expected changes in longer term data. Perhaps there should be a twelve-month rolling disclosure rather than a quarterly disclosure, where you continually present a twelve-month period. Although I suspect people would perform a subtraction and return to the quarterly results, as that's what they are used to. Perhaps we should require the disclosure of four quarterly earnings figures and a footnote to annual accounts, both to make the fourth quarter explicit and to relate auditors directly to the quarterly data. Perhaps we should have a separation of unusual adjustments, particularly year-end, from operational results. There are many of these things. When I say "perhaps," I mean the things we're thinking about are far from emerging as yet. One thing, however, that I think we do feel is implicit in much of what the Chairman said, is that interim reporting can have considerably improved reliability through increased responsibility taken by public accounts for this information. Now, here, quarterly audits are not what we have in mind. I think that what we are really looking for is the establishment of standards for interim reviews, perhaps analysis of the S-1 reviews that are currently performed, although probably on a different level of detail. Certainly, a review prior to the publication of interim reports would represent a perspective to the directors, the stockholders, the management, potential investors, and perhaps most importantly, to auditors, since they would be sure they knew what was going on at a time when they could take timely action to adjustments. The question of what kind of actual audit steps might be undertaken is one on which I have a number of suggestions, but I'm not, again, trying to dictate to the Committee on auditing procedures. I think they have to look to this. Perhaps there should be a review – an analytical review – of the interim statements of management prior to publication; a review of internal budget versus actual reports; a review of minutes of directors of executive committees and so forth; a discussion with management as to the operations of the business; consideration of any accounting problems on a continuing timely basis; and a review of quarterly reports before they go out – both the stockholders' statements, including but not restricted to the financial data, and any press release announcing the results. Now, when I suggest this, I believe it is something that a significant number of auditors are doing to varying degrees at the present time, but I think we are trying to get across the idea that if an auditor is on the books, he has a continuing responsibility. Perhaps it is not, at the present time, a legal responsibility, but it is a public responsibility. Very frequently, legal responsibilities follow public responsibilities. I think that this area of the continuing responsibility of the auditor is one that needs considerable study. We do not have a firm conclusion, but I think the idea is firmly implanted in the public mind. The Commission, through its requirements for disclosure of auditor charges, encouragement of audit committee, reports on unusual charges, and others, I think, is trying to communicate the message to you. I'm very optimistic about the future of the accounting profession. I think it will meet its challenges, and I think in the years to come it will be viewed by the public as a vibrant force,

serving the public interest in a manner profitable to both the profession's members and the public.