NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR 7:00 P.M. RELEASE, NOVEMBER 14, 1973

A NEGLECTED DIMENSION OF FINANCIAL REPORTING

An Address By

A. A. Sommer, Jr., Commissioner

Securities and Exchange Commission

November 14, 1973

Cleveland Treasurers Club
Cleveland, Ohio

A NEGLECTED DIMENSION OF FINANCIAL REPORTING

A. A. SOMMER, JR. *
Commissioner
Securities and Exchange Commission
Washington, D.C.

In recent years accounting publications, conferences of accountants, SEC releases and meetings like this have been surfeited with discussions of the liability exposures of independent accountants and of the numerous civil, administrative and even criminal proceedings which have been brought against accountants and their firms. The names of BarChris, Simon, Utilities Leasing, Four Seasons, Continental Vending, Yale Express are familiar to anyone who has had concern with these developments. I have on numerous occasions, both before and after assuming the toga in Washington, discussed these problems, the practices which have led to the burgeoning liabilities of accountants, the means by which such exposures might be limited. It is not my purpose tonight to thrash around with those problems again. Rather I would like to focus upon other people and other problems: the treasurer, the financial officer of a company, and their problems.

---

* The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or speech by any of its members or employees. The views expressed here are my own and do not necessarily reflect the views of the Commission or of my fellow Commissioners.

The conventional wisdom of the accounting profession is that the financial statements of an enterprise are not the accountants'; rather the statements are prepared by the management of the company and the function of the auditor is simply to express an opinion concerning those statements. This opinion is neatly, briefly and somewhat mechanically set forth in the short-form report. This customary definition of roles is substantially correct, although my experience would indicate that the footnotes, which increasingly carry a heavy burden of significant disclosure, are often the handiwork of the accountants with management performing the chore of reviewing the accountants' prose for accuracy and adequacy. And it is not unknown that the auditor will have something of a hand in putting the final touches on the statements themselves. Beyond that, often the statements prepared by management will reflect advice with respect to accounting treatment given earlier by the auditor.

Be all that as it may, the statements on which the auditors report are management's statements (even though the auditor must assume a joint responsibility for them); with minor exceptions they ar prepared by management, conceivably in some consultation with the auditor (as I will discuss below, not always a bad practice). They are management's statements.

Now what does that signify? It means that in every case where an accountant has been charged with some deficiency of conduct, there has been a deficiency of the management which prepared the statements -- and more particularly, a deficiency of the financial management. The deficiency may be something as raw and base as simple deceit, concealment, misrepresentation - lying, if you will. I should mention that in such cases there is ample authority that if the conduct of the auditors has been sufficiently circumspect and careful, but nonetheless the deceit resulted in their opining favorably with respect to statements falsified by management, they incur no liability. Not long ago the Commission recognized this and refused to name an accounting firm in an action where it appeared that, though there were some warning flags flying which might have caused an accountant to extend his investigation and perhaps uncover the fraud, nonetheless, in the final analysis the accountant was the victim of management fraud rather than the wrongdoer himself.

The outright fraud cases are really the easy ones. When such cases occur, the management wrongdoers get sued. The suits may take the form of civil proceedings by the Commission, damage actions by wronged investors, and in some cases, criminal action by the Department of Justice. In those cases the problem of the auditors is satisfying the appropriate tribunal, if sued, that they exercised whatever measure of care was appropriate.

The tougher cases for all of us are the cases where management has not concealed anything, has not misrepresented anything, in the grossest sense, but rather has prepared the financial statements which it submits to its auditors for their opinion in an artful fashion that results in difficult professional choices for the auditors as they contemplate whether the statements have in fact been prepared in accordance with generally accepted accounting principles and whether they present the financial position of the company and its results of operations fairly. And then not infrequently management coaxes and cajoles the auditors, argues with them, engages quite frankly in a debating contest over the propriety of the statement preparation (with a somewhat overpowering argument, the fee, on the side of mangement), in an effort to have them put the blessing on the management-prepared financials.

An example comes readily to mind. In the Simon case, the criminal prosecution brought against two partners and an associate of a respected national accounting firm, the Court of Appeals for the Second Circuit concluded rather strongly that even if the financial statements were prepared in accordance with generally accepted accounting principles, they were deficient to an extent justifying criminal prosecution because of their failure to present the financial situation of Continental Vending fairly. The deficiency was found in a footnote which failed to disclose with sufficient particularity the relationship between the company and an affiliate and their common controlling person. The accountants were found guilty of a crime. But, according to accounting theory, and let's assume in this case the theory was realized in practice, the offending footnote originated with management -- and more, with the financial management of Continental Vending.

The point of this is simple. Increasingly in recent years the courts and the Commission, not to mention the popular and law review writers, have discussed at length the responsibilities of the auditors -- and rightfully so, for they must be prime protectors of the public interest and they must adhere to standards that maximize their ability to be such. However, in the course of this emphasis there has been insufficient attention to the obligations of internal financial management.

I think it is time we focussed upon the responsibilities of the financial management of publicly-held companies. It is not incorrect to designate this as a professional responsibility. Most of the ranking financial officers of corporations have accounting pedigrees entailing professional responsibility which I suggest should carry through, whether they ply their trade in accounting firms or corporations. Furthermore, they are largely responsible for the most critical information investors use in making crucial investment decisions. And I think most corporate financial officers think of themselves as professionals and take pride in the thought.

What are the responsibilities of these inside professionals? I will try to enumerate a few of them as I see them.

First, I would suggest that the totality of the inside professional's responsibilities to the investing public is as broad and even broader than that of the outside independent accountant. It is the obligation of the inside professional to produce financial statements that are prepared in accordance with generally accepted accounting principles, just as it is the obligation of the auditor to determine whether they have so been prepared. But beyond that it is the obligation of the inside financial officer, as it is of the auditor, at least since the Simon case, to determine whether the financial statements present fairly the financial position and results of operations of the enterprise.

Let us dwell on that notion for a moment. The complaint is frequently made that the notion of "fairness" is so nebulous, so incapable of quantification, so value-laden, so subjective that it should not be a factor in financial reporting. I would suggest that is nonsense. Time after time in our everyday lives we make quick and sure judgments concerning fairness and not infrequently we forego significant personal advantage because we think a course of action would not be "fair" to a friend or business associate or opposite number in a business deal. I would suggest that an experienced, conscientious financial executive should have little trouble in determining whether financial statements are fairly presented.

I would suggest the obligations of the inside professional go deeper than those of the outside auditor, and this for a simple reason: the inside professional knows more about the company than the auditor ever can. The auditors may spend manyears pouring over the books and records of an enterprise, but they weren't there when deals were discussed in the privacy of the executive suite, they weren't there when the impacts of transactions and corporate decisions were discussed in terms of earnings per share, they weren't there when the five year forecasts were put together. They are not and can not become privy to the plethora of detailed information that is the natural possession of the financial executive because of his submersion in the day-to-day business of the enterprise. I would suggest that obligation follows closely opportunity. The financial executive has the opportunity to know better than the auditor whether financial statements are fairly presented, and there follows after that opportunity a commensurately heavier obligation to be sure they are fair presentations.

There is a further obligation on financial executives. They have, in my estimation, an obligation not only with respect to the integrity of the financial statements, but they must also make their responsibility the full program of corporate financial reporting. They must be alert lest the more meticulously prepared financial statements are not prostituted by misleading graphs, charts, or assertions in the textual portions of annual reports and other published documents.

Increasingly the Commission is concerned that investors are denied much of the information available to management which could be of significant help to investors in analyzing financial statements. This concern is expressed in a number of recent actions taken by the Commission. Recently, we approved changes in Regulation S-X requiring fuller disclosure in footnotes of important information concerning financing leases and their potential impact on income. And yesterday the Commission approved amendments to Regulation S-X regarding disclosure of compensating balances and short-term borrowing arrangements.

Most significant in this regard are the proposals to amend Guide 22 of the Guidelines for the Preparation and Filing of Registration Statements under the Securities Act of 1933. This Guide (which would become Guide 1 of Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934) would in general require that the summary of earnings be preceded by a textual statement explaining material changes in the amount and source of revenues and expenses, including tax expenses, and changes in accounting principles or methods of their application that have a material effect on the comparability of net income. In addition, the Commission has exposed for further comment a proposal to expand information with respect to taxes so that investors may judge better the quality of benefits that have accrued to the company because of policies or events which have reduced the impact of income taxes.

I would suggest that there is a particular responsibility upon financial executives in connection with interim reports. Historically, these have not been the subjects of audit and as a consequence have frequently been significantly inferior as purveyors of accurate information. As markets have become more volatile, and very vulnerable to short-term influences and information, it is more important than ever that interim financial statements approximate as nearly as possible the quality of audited annual statements. I realize the difficulties of this -- the absence of physical inventories, account confirmations, and all the other procedures that accompany an audit -- but I would suggest that there is ample room for improving the care and precision with which interim statements are prepared. It would be desirable to have the company's auditors more closely associated with the interims, and I would urge the accounting profession to develop reasonable standards by which this association can be achieved.

And there is another responsibility which I think rests upon the financial executive. It is a responsibility, but it is also a challenge and an opportunity -- and that is the challenge and opportunity to work with the Commission in upgrading the standards of financial reporting.

When the Securities Act of 1933 was proposed, a massive cry went up in financial circles. Requiring the disclosure of material contracts would give enormous advantages to competitors; disclosing the compensation arrangements of directors and the highest paid officers would lead to labor unrest; disclosing transactions between the corporation and its insiders would mislead shareholders into thinking the officers and directors were misusing corporate resources. Virtually every proposed advance in disclosure since then has been met with almost identical arguments: disclosure of line-of-business sales and profits; disclosure of compensating balance arrangements; disclosure of tax variations and reasons therefor; disclosure of marketing plans -- all summoned the same outcries.

I would suggest that financial executives can perform a significant public service by commenting on proposals of the Commission, not with shibboleths, but with constructive ideas based upon enlightened appreciation of the role of disclosure in our financial markets. It is heartening to read many comments from industry that are thus animated; these can and do have impact upon the approaches of the Commission and the staff.

In one area in particular you can be of assistance to the Commission and its staff. I am sure all of you know that the Commission has, as a result of considerable experience, eloquent writings by critics of the present disclosure system, and significant court decisions, decided to consider the abandonment of ancient prohibitions against the inclusion of forward-looking information -- estimates, projections, forecasts -- in filed documents and has published the outlines of a system for making forecasts more responsible and available on an equal basis to all those in the marketplace. The staff is presently working on rules to flesh out the proposals contained in the outline.

This is a very controversial topic. Your professional organization, the Financial Executives Institute, has opposed this development strongly and responsibly. They have been joined by others. On the other hand, the financial analysts and others have vigorously argued the other side of the case.

Personally I believe the Commission should act to make forecasting more responsible, less subject to abuse, more available to everyone. Having said that, there is considerable room for discussion of the means by which these goals are to be attained. When the proposed rules are issued the Commission will welcome your thoughts, always framed with the ideals of full, fair and useful disclosure in mind. You can give us much information concerning your experiences with forecasting, the methods by which forecasts can be stated most meaningfully and carefully, the pitfalls the Commission should avoid in framing the rules governing forecasting. It will be tempting for you to simply be against it. If that is the limit of your comment, you may lose the opportunity to significantly shape forecasting requirements.

I have on occasions commented upon the necessity of there being "an early warning system" that would send up flares whenever an accounting practice emerged that, though apparently in accordance with generally accepted accounting principles, nonetheless had within it the seeds of seriously misleading the public. All of us can recount instances where corrective action came only after millions, perhaps billions of dollars had been invested in reliance upon financial statements that were widely regarded with skepticism with nobody doing anything about them: franchise accounting, land development accounting, computer leasing accounting come readily to mind.

I doubt if the Financial Accounting Standards Board is the body to do this. They are concerned with long-term problems and their approach must be one of careful analysis, public participation, deliberative action. I admire the care of their approach. Their activity, however, must be supplemented by the activity of others who will blow the tocsin early in the history of bad accounting practices before millions are down the drain. I would hope that increasingly the Commission will fill that role and develop procedures which would warn investors that a given accounting approach, though in accordance with generally accepted accounting principles, nonetheless has a tendency to distort economic reality, which after all accounting is intended to mirror with as much precision as possible.

It is no trivial matter with which you and the Commission are concerned. All of us share the concern over the absence of the individual from the marketplace and particularly from the new issue market which is where the genius and ingenuity of America find the financial means to translate that genius and ingenuity into everyday comfort and higher standards of living. This concern is not confined to small enterprises and their investment bankers; many huge enterprises are finding their suppliers imperiled because of limited availability of capital.

The absence of the individual from the market, and particularly the new capital market, has many origins, including high interest rates and concerns over inflation. Certainly one of the most apparent causes is the terrible holocaust suffered during recent new issue markets. In many instances those disasters were accompanied by shabby financial reporting practices, initiated by financial officers and joined in by supposedly independent auditors. Until investors have confidence that these practices are as dead as many of the new issues they invested in I would suspect they will stay out of the market and find places to put their money where its safety will not depend upon the integrity of the financial reporting process.

One last word. The Commission is not your enemy, and it is not engaged in an effort to embarrass industry by mandating awkward disclosures, bestow advantages upon competitors, or hamper development. It is concerned with carrying out conscientiously the Congressional mandate given to it 40 years ago to protect investors by mandating disclosures that are useful, meaningful, complete and accurate so that the investment process may be rational and informed. I do not think it is an exaggeration to suggest that your enterprises without exception have been the beneficiaries of the activities of the Commission in carrying out that mandate, for each of your enterprises has been the beneficiary of capital markets which have in large measure derived their strength, which is the envy of the world, from the fact that they are informed markets.

The Commission looks to you to assist in keeping them that way.