

# STATEMENTS IN QUOTES

## The SEC and financial reporting: the sand in the oyster

*In this adaptation of an article\* from the Winter 1982 issue of Hermes, the Columbia University Business School magazine, John C. Burton, CPA, Ph.D., calls the Securities and Exchange Commission a "creative irritant" that provides stimulus to the public accounting profession. Burton, who as of July 1 will be dean of the Graduate School of Business at Columbia, New York, is Arthur Young Professor of Accounting and Finance at the Columbia business school and a former chief accountant of the SEC.*

The pearl is one of nature's most beautiful creations. It is formed by the reaction of certain oysters to an irritant, usually a grain of sand, that becomes embedded inside the shell. The oyster coats this grain with layers of nacre, and ultimately a pearl is formed. The pearl is the joint result of the irritant and oyster; without both, it cannot be created.

Professional accounting standards and practices may not achieve the luster of the pearl, but the process of their development has many similarities. Both currently and historically, the accounting profession has exhibited a comfortable, conservative commitment to the status quo in the absence of an external stimulus for change.

The process of innovation in accounting, therefore, has required

the cooperative efforts of a creative irritant that provides the stimulus for change and of a responsive body to build on it. Since its inception in 1934, the Securities and Exchange Commission has been a principal source of creative irritation in accounting, and the practicing public accounting profession has generally served as the host which builds on it. This combination of SEC stimulation and professional reaction emerges logically from the historical and economic forces at work and results generally in a satisfactory balancing of diverse interests and objectives. In today's financial reporting environment, substantial change will not occur without SEC stimulation. If there is to be innovation, the commission must be a principal source. At the same time, the commission must operate within the limits of a consensus that the various parties involved in financial reporting help to define.

It is only fair to report that many do not see this process in particularly pearly terms. Some suggest that the SEC has been neither creative nor a force for improvement but, rather, that it has hampered the development of financial reporting by its omnipresence and its disregard of market factors and that it has not offered concomitant benefit to the investors. At the other end of the spectrum are those who suggest that the SEC has been captured by the accounting profession, that it has not accomplished its mission because of its inaction.

There are also wide differences in the perception of the results of the process. Some view financial reporting in the U.S. today as a model to be emulated; others see primarily its deficiencies and shortcomings.

It is difficult for many to accept the view that a governmental agency should be the catalyst for change while the private sector and the marketplace seem to stand as defenders

of the status quo. They suggest that leadership and dynamism should come from creative individuals responding to the incentives of the marketplace.

While this is an appealing model, it does not reflect current realities. If government were a neutral force, the marketplace could be the source of risk-taking innovation in financial reporting. In fact, however, securities regulation in the U.S. is legislatively designed to protect against perceived abuse by raising the cost of error in auditing and financial reporting through the imposition of substantial liabilities on both registrants and professionals involved.

In addition, the courts and the SEC have liberally interpreted congressional intent in this regard, and the plaintiff's bar has been creative in its litigation thrusts. The commission's increased enforcement activity, aimed at professionals who fail to maintain professional standards, also has added to the pressure. Even though a number of recent Supreme Court decisions limit liability to some degree, the aggregate result of securities legislation and its judicial and regulatory interpretation has been to impose on registrants and experts the onus of avoiding any presentation that might be deemed misleading.

The economic forces brought to bear by this regulatory structure have resulted in substantial pressure to find means of reducing risk of liability. Accountants have been urged to define standards with greater precision, and the commission has been asked to specify its requirements with ever-increasing detail. Auditors have expanded their work and their quality controls to decrease the likelihood of undiscovered error.

At the same time, companies have been very hesitant to experiment with new and untried accounting and disclosure techniques, particularly those requiring uncertain estimates that may later turn out to be incorrect. The possible benefits of such estimates to investors are far outweighed by the potential costs to the corporation and, more specifically, to the decision makers involved. A strong tendency to value objectivity above relevance has de-

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veloped in financial reporting. For many years, the SEC's policy was also a force in this direction.

In preregulatory days, it was not unusual for an enterprise to perceive market advantage in presenting data in an innovative way. A presentation might then be emulated by others and ultimately become common practice; other innovations might prove to be without value and would gradually disappear. In this environment, standards were developed from practice. Although abuses existed, and commonality among presentations was lacking, the system was a dynamic one. It resulted in substantial development in accounting and reporting during the early decades of this century, even though this development was selective and uneven across companies.

## Protection rather than innovation

As the environment changed and greater emphasis was placed on uniformity and the avoidance of abuse, the economic incentives changed to favor protection rather than innovation. This was not necessarily a bad social result—the abuses of the 1920s had high social costs—but it did change the behavior of those reporting financial results. They sought certainty and the avoidance of liability, which had the effect of changing the standard-setting process as well.

Originally, standards were developed from what was seen as the best practice, and they evolved as practice developed. Increasingly, however, standards came to be viewed as authoritative pronouncements, imposed on all enterprises and enforced. This approach provided protection but made evolution more difficult, and the standards themselves tended to emphasize objectivity and conservatism.

Since private sector standard setting is largely in the hands of those who are exposed to the costs of disclosure, it is not surprising that standards seem to enshrine the status quo and to minimize uncertainty and risk. Only under external pressure have standard-setting bodies demonstrated significant innovative spirit.

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of accounting, with changes in practice resulting from changes in standards rather than the other way around. At the same time, the market incentives for standard setters to avoid change and endorse the most conservative practices have increased.

Abuses have not been avoided entirely by this approach, since circumstances still exist in which the potential benefits of "creative" accounting outweigh possible costs, such as in new and high-risk businesses. It was in such businesses that the application of principles designed for other circumstances provided much material for the accounting critics of the 1960s. Computer leasing and franchise operations are two principal examples. Unfortunately, economic incentives only become substantial enough to outweigh possible costs when the potential for abuse is particularly high.

Another reason why the SEC's regulatory mandate has provided countervailing incentives to the development of an efficient information market as an alternative to authoritative prescription is the underlying commitment of the securities laws to fairness in the disclosure process. To make the capital markets fair, and perceived as fair, the commission prohibits the disclosure of significant information to one investor in preference to another. Insider trading rules have been carefully developed, and the use of inside information to obtain economic gain in securities transactions has been made illegal. The commission has been largely successful in making information a public good, and thus the incentive for investors to seek and pay for new kinds of disclosure is substantially diluted. Incentives for change have, therefore, been reduced, on both the supply and the demand sides of the market for information.

While some may assert that, in the absence of regulation, suppliers of information would have an incentive to produce the optimum amount of information based on their own economic self-interests, this is neither analytically nor empirically demonstrable. The incentives and the timing of those incentives are not always consistent with

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the interests of an informed investor. For example, an enterprise under economic stress and seeking capital may have powerful short-run incentives to hide the state of its affairs from potential investors. In addition, the fragmentation of the market of capital suppliers doesn't make it clear that the necessary cost-saving and power-centralizing coalitions would form and then make the bargain for information an effective one, in the light of existing frictions. Even if market forces worked well in a historically unregulated market, they would be unlikely to be as effective in a world where behavior patterns have been shaped by 45 years of regulation.

The regulator in this setting must be able to provide additional incentives for necessary change when market forces fail to do so. In a sense, the regulator must replace the very market its own activities have biased in favor of the status quo. Its regulatory objectives of a fair and efficient capital market require a dynamic system of information exchange to reflect an ever-changing world.

To do this, the commission must take the role of advocate for investors to offset the preparer bias that institutionally exists in the standard-setting process. Subjective judgments about the needs and interests of investors are required. In reaching such judgments, the commission relies on the representations of analysts and investor organizations, expressed in letters of comment, appearances at hearings and informal contacts, plus a continuing survey of the literature of security analysts, such as the *Financial Analysts Journal*. In addition, the experience of members of the commission and its staff plays a significant role.

In making these judgments, the commission's objective is to achieve a level of public disclosure at least the equivalent of the disclosure likely to be sought by a provider of capital who negotiates on an arm's-length basis and who has equivalent power with a capital user. If the commission errs in this objective, it seeks to do so on the side of providing more information rather than less, since an underlying

premise of its regulatory purpose is to assure the existence of adequate information so that the capital-allocating mechanism of the marketplace will work effectively. The potential benefits of such a mechanism are substantial, although they are difficult to demonstrate empirically. Compared to these benefits, the costs of providing additional information are likely to be small. The commission does not, however, disregard cost factors in reaching its judgments. It regularly requests comments on the costs of its proposals from information preparers, including both out-of-pocket costs and possible costs arising from competitive disadvantage. The SEC staff also does research on these matters.

This representation of the investor viewpoint offsets the fact that the investment community is made up of many investors. The benefit to any one investor of devoting substantial resources to gathering information would not be economically justified, perhaps even without the constraint of insider information rules. Thus, the commission acts as a countervailing force to offset the economic weakness of investors in their pursuit of adequate information.

The commission inserts itself into the negotiations for investor information in a number of ways. In part, it offers suggestions through the speeches of its chairman, its commissioners and its senior staff. Although each speech carries the traditional disclaimer that the speaker is presenting individual views and not those of the commission, major policy addresses serve as a significant means of communication. In addition to speeches, the commission exercises the rule-making powers granted to it by Congress under the Securities Act of 1933 and the Securities Exchange Act of 1934. In the accounting area, it has chosen to use these powers with considerable discretion; it has consistently recognized the difficul-

ty of taking over the standard-setting mechanism, and it also has realized the importance of leveraging its resources by using the private sector. Governmental rule making has inflexibilities that do not exist in the private sector, and, in addition, the human and financial resources of the SEC have historically been less than those of the private sector. The securities acts give the commission permissive rather than mandatory standard-setting authority, and they leave the audit role explicitly to independent public accountants.

The importance of the permissive nature of the commission's power under the securities laws is great. If the commission had been directed to establish standards, it would have done so and the results would probably have been quite different. To cite one recent example, the commission was mandated by law to deal with the oil and gas accounting issue. Results were demonstrably different, in both process and outcome, from the commission's normal dealings with accounting standard-setting bodies.

#### **The SEC as rule maker**

In a number of cases in which no mandate existed, however, the commission exercised its discretion and concluded that it was necessary to enter the rule-making forum. There are a number of reasons for this, varying in degrees for different rules. Most significantly, the commission acts when it concludes that important data are not being made available to investors on a voluntary basis. Without such a conclusion, rules are not adopted. A rule also may be adopted primarily to provide protection to registrants who would otherwise fear liability from certain disclosures. By creating a disclosure requirement, the commission provides assurance that particular classes of disclosure may not be deemed by a court to be misleading per se. When a new kind of disclosure is required, this may be important. Replacement costs, the capital value of leased assets and forecasts are examples.

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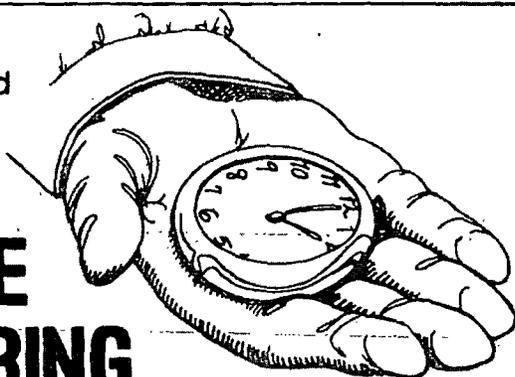
More recently, the commission moved to reduce risk by adopting safe-harbor rules, which attempt to offer additional legal protection by recognizing the uncertain nature of some disclosures, and by providing that good-faith errors in estimation will not be viewed as violations of certain sections of the securities laws.

Besides reducing legal risk, rule making provides protection against comparative competitive disadvantage. Companies often hesitate to make disclosures because they believe that making certain disclosures, which their competitors do not, will put them at a disadvantage. If everyone must make the disclosures, there is less concern, although the impact of disclosure requirements may still fall with unequal weight on competitors. Line-of-business profit disclosure is an example of an area in which voluntary efforts were not making much progress until the commission's rule-making authority was brought to bear.

Legal risk and competitive disadvantage are two of the most common factors that deter disclosure initiatives in the absence of rule making or of clear economic incentives. Other fears of a less specific nature also are significant. The law of anticipatory multiplication, which provides that both the probability and the potential cost of unpleasant possible outcomes are multiplied whenever change is being considered, suggests that the estimation of the expected value of change is likely to be biased in favor of the status quo. Thus the commission, by rule making, often plays the role of one who pushes a reluctant swimmer into the water to demonstrate that the experience will really not be as bad as it may appear from the dock. In this way, corporations can observe the lack of the frequently predicted disastrous impact from disclosure initiatives.

While disclosure requirements serve an end in themselves, they also may create an environment that is more sympathetic to the development of basic reporting standards by private sector entities. In addition to forcing a trial of new methods, such rules also may provide standard set-

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ters with a data base to support subsequent actions. This was the case, for example, in lease accounting, in which the commission mandated the use of present value techniques to compute a lease liability figure, and in the area of replacement cost accounting, in which a rule was adopted requiring certain companies to provide replacement cost information. In both cases, the Financial Accounting Standards Board was provided with information and was able to adopt or propose more extensive rules that brought these disclosures into a more systematic framework.

Rule-making powers also have been used to prevent the erosion of current accounting standards and practices. Anecdotal evidence suggests that, in the application of accounting principles, techniques develop and become commonly used that accelerate the recognition of income or create other effects desired by management. These effects may not be consistent either with economic reality or with the conventional application of the accounting models, and they are widely perceived as abuses. They raise questions about the validity of accounting measurement in general. Some of these cases arise when the interpretation of an established standard makes possible results that were not anticipated by the standard setters.

Beyond its rule-making powers, the commission extensively uses its review and comment process, together with the power not to accelerate the effectiveness of a registration statement, to discourage accounting applications its staff believes inappropriate.

In addition to adopting formal rules, the commission sometimes uses accounting series releases as a vehicle for identifying general problems, which it then urges registrants and public accountants to address in financial reporting. These releases may deal with limited topical problems, or they may identify problems of great breadth and very general application, such as disclosure of inventory profits and disclosure of unusual risks and uncertainties in financial reporting. Such exhortation is frequently a means of calling attention to a problem that

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the commission believes ultimately should be dealt with by a private standard-setting body.

#### Contact with standard setters

While speeches, rule making and public releases are effective techniques in the commission's stimulation of standard setting, direct formal and informal contact with standard-setting bodies in the private sector also is essential in the exercise of its oversight role. The commission and its staff spend a great deal of time monitoring professional standard-setting bodies, and they frequently see representatives of such bodies who are seeking communication, counsel and sometimes approval of proposed actions. The commission's chief accountant frequently discusses current problems from his vantage point, urging actions of various sorts. In a few cases, the standard-setting body has been asked to take action on specific problems, presenting the clear alternative of formal SEC action if no professional standard is promulgated. These cases are the exception

and, in most circumstances, the informal communications between the bodies are simply part of a cooperative effort to achieve the best solutions to difficult problems.

In the case of accounting standards, the commission does not make formal responses to FASB proposals, because the commission's statutory authority is such that it can't express an official view on a standard and then accept a significantly different result. In the case of auditing and other kinds of standards, however, the chief accountant, with the authorization of the commission, does sometimes offer specific comments and, from time to time, these comments may forcefully express concern. Such expressions are normally given considerable weight by the bodies involved.

Beyond its impact on standard setting, the commission has exercised significant influence on financial reporting by overseeing the audit function and the activities of the public accounting profession. It has devoted substantial resources to the

assurance of audit quality and independence, and it has encouraged expansion of the auditor's role. This has been done in part through enforcement activities the staff has investigated in which it has sought to correct shortcomings by developing remedial sanctions and through extensive reports of the commission's view on audit deficiencies.

The commission also has steadily supported the formation of corporate audit committees through a series of exhortative releases and proxy disclosure rules. It has encouraged the accounting profession to develop improved concepts of auditor independence, and it has led the profession in a number of respects by imposing its own guidelines. The commission also has moved to develop the concept of continuous auditing and the more regular involvement of auditors with corporate reports.

#### Conclusions

In summary, the SEC's role has been an extremely active one, one in which its encouragement of inno-

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vation and change has contributed to the development of financial reporting. Looking to the future, it seems likely that the importance of the commission's role will continue. The basic economic forces that impinge on standard setters seem to point in this direction.

To suggest this, however, is not to suggest a dominant position for the SEC. The commission's role is to contribute to an environment in which standard-setting bodies can work with greater imagination and creativity than they otherwise could. Traditionally, the more active the commission, the more active the private sector in developing accounting methodology and disclosure approaches. The dynamism of accounting in the 1980s, therefore, is likely to depend on the joint action of the private sector accounting institutions and of their creative irritant, the SEC.

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## Accounting in the Bible

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*Certain "modern" accounting concepts, such as internal control procedures, and many financial and managerial accounting topics can be traced back to the Bible. In this adaptation of an article from the Fall 1980 Accounting Historians Journal (pages 71-76), published by the Academy of Accounting Historians, Robert L. Hagerman, CPA, Ph.D., associate professor of operations analysis, School of Management, State University of New York at Buffalo, links the Bible to current accounting thought and concludes that many ideas in use today were recognized a few thousand years ago.*

The beginnings of modern accounting are commonly traced to Fra Luca Pacioli in the fifteenth century. Actually, many of the funda-

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Author's note: I appreciate the comments of Cynthia Hagerman of Williamsville, New York, and Ronald Huefner, CPA, Ph.D., professor of operations analysis, School of Management, State University of New York at Buffalo.

mental ideas that underlie modern accounting may be traced much further back. The Bible, which is generally viewed as covering events between 1800 B.C. and A.D. 95, contains several references, both direct and indirect, to accounting and basic accounting concepts. In particular, it discusses financial accounting, internal control and management accounting. This article discusses the Bible's relationship to accounting thought.<sup>1</sup>

### Financial accounting

One of the major purposes of accounting is to monitor the performance of management. In addition, accounting helps to ensure that an enterprise is not defrauded either by its agents or by outsiders. The Bible discusses this in a negative way in 2 Kings 12:16, which has the following to say about the building of the Temple: "No accounts were kept with the men to whom the money was paid over to be spent on workmen since they were honest in their dealings."

This is virtually repeated in 2 Kings 22:7. We can infer, therefore, that accounts would have been kept if the contractors were less than honest. Thus, the Bible points out that accounting is necessary to reduce fraud.

The Bible also provides the motive for monitoring agents. In the New Testament there is a parable about a steward. In the parable, the owner hears that his steward is wasting money and in Luke 16:2 says, "What is this I heard about you? Draw me up an account of your stewardship."

This indicates that accounting was used as a control device to monitor performance and also suggests that the master-owner should have insisted on periodic accounting reports to detect the problem with the steward earlier.

Accounting also serves the purpose of resolving disputes between parties, ensuring that debtors and

creditors agree on the amounts due and that partners and other classes of owners know their share of the earnings. The Bible makes this point in Ecclesiasticus 4:1-2, where it states, "These are things you should not be ashamed of—keeping strict accounts with a traveling companion." The idea here is that these accounts will reduce conflicts between the travelers.

The Bible provides very little in the way of describing how to account for transactions. There seems to be only one place in the Bible in which a particular accounting system was required. Eccles. 14:7 states, "Whatever stores you issue do it by number and weight, spending and taking put everything in writing."

Here is an indication that a perpetual inventory system should be used. In addition, the last phrase may be interpreted as a requirement that accounts for all revenue and expenses be maintained.

The Bible does not provide much information regarding how financial reports should be prepared or how the accounting system should be set up, but it does discuss the motivation for financial reporting. In particular, the Bible points out that financial accounting is necessary to avoid fraud, to monitor agents and to reduce conflicts over resources. Today, of course, we place great emphasis on the idea that accounting exists to provide information to investors. The economy, in biblical times, did not have diffused ownership that required that accounting serve this function. Even though the Bible does not deal with the information objective of accounting, the other accounting objectives discussed still exist today.

### Internal control

The Bible provides an extensive discussion of internal control. That is not surprising since large amounts of cash were used and control was necessary. The Bible discusses limited access to assets, separation of duties, dual custody of liquid assets and the rationale for internal control in a very modern way.

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<sup>1</sup>All biblical references are from the *Jerusalem Bible*, edited by Alexander Jones (New York: Doubleday & Co., 1966).