# The Changing Face of Financial Reporting

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October 14, 1975

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## The Basic Standard

In a rapidly changing world such as we have today the standard by which financial reporting must be judged cannot imply static goals; rather, it must serve as a constantly moving target which must be pursued.

The basic standard may be articulated as follows: Financial reporting must reliably communicate the results of business activities to various interested parties on a timely basis.

This standard has several elements, the implications of which are significant in trying to develop a reporting structure that will meet the needs of users of the reports. A careful analysis of the various components of this standard will indicate some of the problems of achieving it in today's world. The implications of these elements are significant in trying to develop a reporting structure that will meet the needs of the users of the reports.

## Various Interested Parties

The standard first indicates that reporting must communicate to various interested parties. This leads to an analysis of who are the users of financial information. Broadly it can be said that financial information is used principally by economic decision makers. The first group of economic decision makers with interest in financial information are the managers of a business. Since this group can control the information which they receive on the basis of their perceived needs, however, it is not necessary to give them primary consideration in the development of a framework for public financial reporting. Nevertheless, it is important to recognize that to the extent public reporting requires information not felt to be needed internally, the incremental cost of developing these data are likely to be higher and the resistance of managements to reporting it will similarly increase.

Even if our concern is primarily with decision makers external to the business firm, we find many different types with legitimate interests. In the first place there are investors making decisions for their own account either as an owner or a lender of capital to an enterprise. This is the group to which the disclosure framework of the securities laws has traditionally been addressed, but it certainly does not comprise the whole market for data.

In recent years the needs of fiduciaries who are investors on behalf of others has become increasingly important as the role of investing institutions, both in the trading market and in the process of capital formation in this country, has expanded. The investment decisions of fiduciaries carry a burden of responsibility which differ from decisions made by many of those who invest for their own account, since fiduciaries have a direct responsibility to their clients and must bear the risk of being called legally to account if they fail to exercise it.

Other potential users in addition to users who are concerned with investments must also be considered. Macroeconomic decision makers, including both the executive and legislative branches of government, must be viewed as users of this information. To the extent that the business community wishes to communicate effectively to this group, and it is essential that they do so, the financial reporting system of business must contemplate the needs of such policy makers. We cannot have, for example a system of accounting which overstates economic earnings, and expect government personnel to recognize this and adjust for it in determining tax policies and in evaluating the adequacy of profits for purposes of capital formation.

Finally, of course, there are specialized interests that must be considered in developing a reporting framework. While every possible user of information cannot be identified and satisfied within conventional financial reporting, significant users should be considered. Employees are certainly one such group. Business must be concerned how it communicates its activities to its employees as individuals and to its employees organizations.

Another group which the Commission has recently been directed by a court to consider is environmentalists. Hearings have been held on the subject of whether the Commission should require certain data in regard to environmental protection and employee safety and employment policy as part of its disclosure system. While it is easy to see how reaction to all possible highly specialized information needs could unduly clutter a reporting system, needs of significant groups cannot be lightly overlooked if the system is to achieve its objective. In a recent release, the Commission proposed rules which would make available to investors information regarding the extent to which corporations have failed to satisfy environmental standards under federal law.

As we look at these varying types of interested parties it is evident that the different types have different information needs. Furthermore, some decision makers with similar objectives may perceive their information needs differently. We have discovered, for example, that there are many different approaches to investment decision making. Some believe that financial analysis of corporate results is a vital tool which plays a major role in selecting good investments. Others view this as much less important and have adopted investment approaches varying from those based upon market indicators to those which contemplate communication with the occult (if that is different from market indicators.)

In addition, there are broad differences in the training and capacity of decision makers and substantial variations in the time they have available or wish to devote to studying economic information. Some revel in detail while others abhor it.

The Commission has attempted to take at least a first step in the direction of meeting diverse needs by articulating a policy of differential disclosure under which varying levels of summarization are presented in different documents so that users can find information consistent with their perceived needs.

The Communication Process

The second major element of the standard is that reporting must communicate. The process of communication is not well understood or simple. Even the mechanical problem of getting public information to users is a major one when users are dispersed and data channels are limited. A magnificent short wave transmitter is not of much use unless there are radios around.

Beyond this, the problem of how to structure the communication so that it can be received by a user is a major one. Even if you have transmitters and radio receivers, the receiver will not be of much use if a foreign language is being used.

In summary then, we must have a good transmitter, good receivers and programs that people can understand. To achieve this, both the preparer and the users of financial reports must have a common frame of reference. This means that the education of users is critical and it has been a matter that has been too long neglected in financial reporting. The low repute in which analysts are held in the accounting world is depressing but justified at least in part. A substantial portion of them are not adequately trained to use the accounting information which is available.

Measuring the Results of Business Activities

The third element of the standard is that reporting must communicate "the results of business activities." While this sounds simple, it has certainly not proven so in the development of accounting principles.

Three basic characteristics of business activities are that they are continuous, usually complex and that decisions regarding them are based primarily on expectations. As we contrast this with the characteristics of the accounting model which deals with discrete periods, is simplisticly based on a simple trading enterprise for which it was initially developed, and which has traditionally down graded expectations, it is not surprising that measurement problems arise.

While a model cannot be expected to describe perfectly the reality which it represents, on the other hand it is hard to believe that its parameters could be so antithetical to reality as is the case with accounting today.

Reliability

A fourth element of the standard requires that reporting communicate "reliably." This implies the absence of bias and the absence of error together with some congruence between the reporting and the business reality. It suggests the need for adequate controls over the reporting process and for the application of professional expertise and detachment in the reporting environment.

Timeliness

Finally the standard suggests that reporting must meet the test of being timely. If reporting is to be useful, it must occur in time to enable a decision maker to utilize it in reaching sound decisions. While prompt after the fact reporting may achieve this goal in many cases, in some circumstances this objective may necessitate reporting prior to an event, based upon expectations. In all circumstances, it implies reporting promptly so that users can access current activities before they become irrelevant.

Changes in the Reporting Environment

If the financial reporting environment is going to move towards this standard, and I believe it essential that it do so; a number of significant changes in the face of reporting are likely to take place. These will not suddenly appear but should come about through an evolutionary process.

A Continuous Reporting Framework

First, it seems inevitable that there will be a move toward a continuous reporting framework for public financial reporting. Continuous reporting does not mean that every transaction will be publicly reported when it occurs but rather it implies the development of a reporting attitude. Management must think of its public reporting responsibilities throughout the year and not simply when annual or quarterly statements are due.

One element of this will be more frequent and more comprehensive reports covering shorter periods. As shorter periods are reported, the nature of the business continuum should become more apparent. The objective of such reporting is not to report the short period as such but better communication of the business continuum. In such reporting, imprecision must be recognized. The shorter the period, the more it will be necessary to make estimates and to recognize that exactitude is not needed to assure accuracy.

The Commission has recently taken a significant step in this direction by its broad expansion of Form 10-Q which will require registrants to file income statements, balance sheets and source and application of funds statements quarterly rather than simply to product the abbreviated income data which was previously required.

In addition to more frequent and more comprehensive reports, this new framework of continuous reporting will require a greater focus on key periods in the case of a seasonal or cyclical business. Where a growing season or a selling season is key to operating results, disclosure of relevant facts during that period should not await particular calendar dates. Any data which may reflect a significant change in trend should be reported promptly. In some industries this is done today.  Automobile sales, for example are reported for ten day periods and these data are of consideration importance to economic and financial analysts.

Continuous reporting also implies prompt reporting of significant or unusual events outside the normal course of business.  While it is sometimes difficult to define what is significant or unusual, it is important that such attempts be made.  The Commission in early 1973 adopted a reporting requirement associated with Form 8-K which requires companies to make full and complete disclosure of material unusual charges and credits to income on a timely basis and to associate their independent public accountants with the accounting procedures followed in connection with these items.

A significant element of a continuous reporting framework requires that data be reported within the context of an appropriate perspective.  This suggests the need for a forecasting system. I have little doubt that forecasting will be an integral part of financial reporting within 10 years, even though the Commission has no plans to mandate it in the near future.  We have issued proposed rules which we had hoped would contribute to the orderly development of the forecasting area but which seem to have aroused substantial criticism which suggest that these rules may prove to be counter productive.  This is an area that will require careful consideration before any final Commission action is taken.

It should be emphasized, however, that much of the discussion about forecasting seems to have focused on the wrong elements.  The purpose of forecasting in a reporting system is not to tell users what next year’s earnings per share will be, but rather to provide better information about operations.  An ongoing forecasting system will set current period results in better perspective based upon management expectations.  Such an ongoing forecasting system may in fact eliminate the need for some interim data as long as business results do not change expectations.  A forecasting system as part of the total financial reporting package will be of great value in enabling investors to understand why results deviate from forecasts.  This analysis will make historical reporting far more meaningful.

The requirement that data be reported within the context of an appropriate perspective also suggests the need for a system which offers an alternative to historical costs. The proposals of the Commission that financial statements be supplemented with replacement cost data, and the proposal of the Financial Accounting Standards Board for financial reporting in units of general purchasing power are movements in this direction.

Improvements in Communication Technology

A second major change that may be expected in financial reporting will be the development of improvements in communication technology. Systems must be developed to get data more efficiently into the hands of those who need it. As a first step, some means must be found of achieving more channels of communication. Traditionally the two channels that have existed are the financial press which provides for general communication between preparers of information and all users, and direct channels where the preparer communicates directly to specific users. We need to find additional channels whereby specialized users can be reached more readily with information that is of particular relevance to their needs. At the same time, there needs to be developed some system whereby various parties are given reasonable safeguards against liabilities which may arise from any selective distribution of financial information in the absence of legal protective provisions.

Improvements in communication technology should also include better receivers of information. This would suggest improved education for users of financial information and perhaps development of increased professionalization in the use of data. The Financial Analysts Federation is now beginning the process of developing professional standards for that group and this is a significant step forward.

Development of Various Levels of Detail

Another major change in financial reporting will be the development of reporting at various levels of detail rather than an emphasis on a single set of data for all. Inevitably as financial reporting evolves in the direction of this standard there will have to be much more data publicly available. When a multi-million dollar entity operates for 12 months with thousands of employees and many different business activities, one cannot expect to describe it in a few pages for someone who is interested in developing an understanding in depth of its operations.

At the same time as we see multiple levels of detail, there will also be an obligation placed upon preparers of data for better and more analytical summaries of the key factors in business performance to meet the needs of investors who do not wish to or are unable to perform detailed analysis on highly complex financial data. The Commission took an initial step in this regard in requiring management's analysis of the summary of earnings, and it seems likely that this type of obligation will increasingly be placed upon management.

## Broader Role for Public Accountants

Another major change which is occurring and seems likely to continue is the greater involvement of independent public accountants in financial reporting. Auditors are partners in the reporting process with public responsibility to assure an appropriate result. They will increasingly be viewed as "auditors of record" with some continuing responsibility for all public financial reporting of their clients. This seems a logical correlary to the idea of continuous reporting.

It should be emphasized that auditors are not and should be viewed as policemen conducting adversary audits. The auditor serves as a detached professional whose reporting expertise is of value both to the reporting company and to the users of information. The basic auditing approach must continue to be based on the assumption of good faith on the part of all since to assume otherwise is to suggest the total destruction of the entire underpinning of our current business system.

The Commission has recently adopted rules which we believe will encourage the development of the concept of auditor of record and the continuing involvement of the auditor in financial reporting. Our new rules require association of the auditor on a retrospective basis with certain limited quarterly data which will be included in an unaudited footnote in audited annual financial statements. We believe this requirement will encourage management to involve public accountants on an ongoing basis and we hope that it will lead the accounting profession to view the audit as a continuous obligation rather than an annual exercise.

I should reemphasize that this limited auditor involvement is not primarily designed to catch gross abuse, but rather to improve interim reporting. We feel that it will encourage greater attention to the measurement principles involved in quaterly reporting and will result in improved disclosure and analysis of quarterly results. In addition, it should reduce the likelihood of undetected error and it will create a greater behavioral incentive for management to produce meaningful quarterly reports. This is not to suggest that management today does not do a conscientious job but rather to recognize the fact that most of us do a little better and are a little more careful when someone is reviewing our work. The procedures that will be established do not constitute an audit and are not designed to catch intentional misrepresentations or other frauds.

The new rules, therefore, are part of a changing audit approach. They should lead to increased audit knowledge about the company, a more analytical and continuous audit and ultimately a situation in which the auditor will view his job as auditing the company not just the financial statements. It should follow that the auditor must feel some responsibility for the entire financial reporting system of his client of which annual financial statements are only one output. This approach should not increase audit fact-finding work. There should be no increase in the observation of inventories, the confirmation of receivables, the counting of petty cash. Rather, it will increase the amount of analytical auditing work and probably increase the auditor's alertness to problems.

Ultimately, this may mean that the auditors' reporting responsibility will be increased as well. The President of the American Institute of Certified Public Accountants has recently suggested that auditors may some day become interpreters of financial statements for investors.

The process of increasing auditor involvement will be an evolutionary one, not one mandated overnight by the Commission, although we are willing to encourage the process as our recently adopted rules should do. Our new rules, however, do not in themselves require continuous involvement and and the development of such an approach will ultimately depend upon the willingness of the accounting profession to move in this direction.

## Summary

A careful analysis of the demands of society suggests that a substantially changing face of financial reporting will be one of the realities that all involved in the process must recognize. Investors and other consumers of information will see their needs met with more information more effectively communicated. Hopefully, the result of these changes will be a more efficient capital market where scarce resources are allocated to their most productive use.