

“THE CURRENT ACCOUNTING AGENDA OF THE S.E.C.”

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Chairman

Good afternoon, ladies and gentlemen. I am Paul Kay, from the Bank of New York, and on my left is Meyra Green from Credit Lyonnais. We would like to welcome you today on behalf of the Junior Analysts Committee. We are honored today to have John C. Burton, Chief Accountant of the Securities and Exchange Commission, here to speak on the current accounting issues of the S.E.C.

Professor Burton received a B.A. from Haverford College and a Ph.D. from Columbia University. He taught at Columbia's Graduate School of Business Administration for ten years. Those of us who were fortunate enough to have had him as a professor can attest to his ability to focus on those key issues at the interface of accounting and finance as well as his fair-mindedness, his patience, and his excellent sense of humor. Without further ado, it is my pleasure to introduce Professor Burton.

John C. Burton

Thank you, Paul. It is always a pleasure to be introduced by a former student. I usually look in my grade folder to see if I should smile and be complimented or whether I should have forgotten. But I am confident that in your case, there is no problem. It's a pleasure to be here in front of the Security Analysts. I was just telling Paul that this room has some memories. When I was a small boy my father used to occasionally take me to lunch at the Bankers' Club and it was generally in this room. In those days it seemed grander somehow. But in those days I was not trying to look around a pillar at someone, which probably contributes to that. In those days I also did not have any need to start my talks with a disclaimer. In fact, in those days I usually didn't give any talks, and when I did, people didn't listen, particularly my father. But now I have the privilege of starting all talks with a mutual disclaimer. The Securities and Exchange Commission, as a matter of solemn policy, takes no responsibility whatsoever for the musings of its missionaries, and accordingly my remarks are my own. My views may occasionally coincide with the Commission and the colleagues on my staff, but the correlation coefficient is by no means one. I do not know what the Beta is, but that is a different thing. I guess it would be fair to say that those who pay close attention to me like high Beta stocks

I thought today I would talk a little on responsibilities of analysts and then move into SEC activities which are, I think, giving analysts more responsibilities. If I were to summarize the responsibility of analysts in one word, I would say that it is increasing. There is no question about the fact that the role of the analyst is increasingly important in today's investment environment. Analysts are called upon to evaluate more complex sets of data, dealing with more complex businesses, and in an economy that is far more complicated than it used to be.

Analytical Skills in a Complex Environment

I spent this afternoon at a meeting of the Financial Accounting Standards Advisory Council and I heard two lawyers speak on the subject of accounting and they urged greater simplicity, which is one of the ironies of all times. Nevertheless, they said what we really want is accounting once again to be as simple as it was in the days when we studied accounting.

For accounting to tell the story simply, completely, without complications, and hopefully without the use of footnotes and simply a careful reflection of economic reality in easily understandable terms which everyone can use. This, I think, is reflective of what everyone wants from accountants and, of course, is reflective of what can not be given when the world is complex. If accountants seek to give a simple answer, they are more likely to mislead than if they try to express the realities and complexities as they actually exist. Accordingly, in the real world, we are not going to get simpler financial statements. We are not going to get simpler answers and easy handles. We are going to get more complex data, more complex interrelationships, more difficult analytical tasks.

This means that analysts will have to approach their tasks with greater professionalism, with greater specific skills in understanding financial information as well as specific skills in understanding the economic phenomena that affect companies in our environment. I do not think that there is any question, as we look ahead, that the need for greater professionalism will represent both a burden and an opportunity. It is a burden because one has to go beyond common sense. This does not mean that one should ignore or depart from common sense. It means that one must have an understanding of the data to which common sense can be applied. It will provide greater opportunities because there will be an edge for the analyst who is well trained and who will take the time for the study of corporate activity. I think it appropriate for there to be such an edge. Some people have suggested that this is not consistent with the concept of fairness in the market place. I believe that it is totally consistent. The person who devotes more effort and has more technical skill should be able to develop a better understanding and presumably that will lead to better investment performance.

In looking at this increased professionalism and the analyst's role, there are clearly two parts of it. The first is the necessity for developing an understanding in depth of corporate activities, or what the company is doing, what its prospects are, what its financial statements mean, how this fits in with the economy as a whole. This is part of the process of understanding a company and understanding it in depth.

Then once the analyst understands the company, the second stage of analysis is trying to determine how the market will evaluate the company. This is a separate, though not totally separable-- but fundamentally a separate task. The person who really understands the company probably will see over a period of time how the market appraises what is going on. There are some people who have historically been very good at understanding developments within companies and within industries, but because they have been so committed to them have not been able to recognize the leads and lags that take place in the market place. So what may be good advice for the long run may not be good advice for the short run. Analysts have to be able to do both, although sometimes these may be roles that different individuals will play.

Let's turn now from the role of analysts to the role of the SEC. I will try to describe the current activities of the SEC in the area of disclosure, and I want to give some flavor of what we are likely to do in the future. As I look at SEC activities in the area of disclosure I can identify what I would describe as five thrusts in our activities. Let me describe them.

Continuous Disclosure

The first is a move in the direction of continuous disclosure. Continuous disclosure does not mean the recording or the publication of every transaction but it is rather, in part, the state of mind. It recognizes that public disclosure is a major part of the responsibility of the financial and operating management of companies. Therefore, they must be in a position to recognize their public reporting responsibilities as events occur that are significant.

One of the elements of continuous disclosure that we have recently adopted is the requirement for more comprehensive interim financial reports. Starting with the first quarter of 1976, all registrants will be required to file substantially expanded 10-Q reports, 45 days after the end of the quarter. Starting in the end of May, 1976, we will begin seeing 10-Q statements which will include a full set of financial statements, although without the detailed notes, and in somewhat summarized form. You will see the balance sheet, income statement, and funds statements for each quarter. You will also see a management's analysis of operations in which management is being asked to compare the current quarter with the same quarter of the prior year, and to set forth those elements which are most important in understanding changes. This management analysis taken together with financial statements, we think, will help people better understand the causes of quarterly fluctuations.

By moving in this direction we do not suggest or believe that greater emphasis should be placed on the three month period. Rather we believe that more comprehensive disclosures will make it less likely that users will look for a simple handle like an earnings per share figure and will be faced with the obligation of trying to dig in and understand what happened. We recognize that as time periods become shorter, the number of estimates that have to be made must increase and the imprecision of the data must also increase. We do not think that this is bad. In fact, by requiring more information, we are helping people to have data which may aid them in understanding the extent to which imprecision may exist. In addition, by putting the responsibility on management for explaining the reasons for changes in their quarterly results, we are, it seems to me, putting an appropriate burden on them to highlight those areas which are most important in the quarter.

We have not made any requirement that these expanded 10-Q reports lead to expanded quarterly reports to shareholders, although we believe that this is likely to occur. There is no requirement that the quarterly report to shareholders need be more comprehensive or include any of this data. Our understanding is that at least a majority of companies intend to move in that direction, and of course many did toward the end of last year after we adopted our rules.

Auditor of Record

A second thrust, probably of less direct importance to you, is what we call the auditor or record concept. This is the concept that the auditor of the year end financial statements is also the auditor of the company. As such, he has a responsibility, as yet not legally defined, for all public financial reporting by that company. He has an obligation to stay current as to what is going on and to stay current as to what kind of information is being issued by his client. In

developing this concept we have not aimed at a quarterly audit. I do not think that a quarterly audit would meet the cost/benefit test.

In many respects, what we are trying to achieve is a changing reference in state of mind on the part of the auditor. It is generally recognized that the auditor has some continuing obligations throughout the year. To encourage this explicitly, we have placed certain responsibilities on the auditors of larger companies to review interim results at least at the end of the year in connection with their audit of financial statements. While we have permitted that the related footnote can be unaudited, we have said that there are certain responsibilities for review of the data and we have accepted the standards of review set out by the AICPA in this regard. We believe, and have been advised, that in many cases this means the auditor is performing this review on a timely basis throughout the year even though he is not necessarily reporting thereon.

Differential Disclosure

The third thrust that I would like to identify is differential disclosure. This is one that has received quite a bit of publicity over the years, over the past two or three years, anyway. It represents an explicit recognition on the part of the Commission that there are users of financial statements with different degrees of sophistication, different degrees of commitment in terms of use and different amounts of training and that it is not appropriate to say that a single set of financial data aimed at the "average investor" will be sufficient for all these users of financial statements. Therefore we have said that while it is important that there be certain information aimed at the "average investor," it is also important that there be information that is primarily of concern to the analyst and the sophisticated investor. We believe that this is both equal and consistent with our responsibilities under the securities laws. As we look at the trading markets today, we find that an overwhelming amount of the transactions that determine price are based on the actions of institutions, and presumably are based on the analytical efforts of professionals.

Impact of Inflation

The fourth major thrust is the development of improved disclosure of the impact of inflation and changing prices on a particular company. As you may be aware, we proposed last August certain rules which would require companies to present information covering the current replacement cost of inventories and productive capacity at the end of the year and disclosure of cost of sales and depreciation for the year, computed on the basis of current replacement cost. We think that this information is not a magical potion which will enable analysts to find true income, but rather we see it as additional information which will be of value in trying to understand what is going on in a company. Current replacement cost gives some measure of current economics, not a perfect measure, but it gives us a better measure than historical cost. As an analyst tries to evaluate earning power, which is basically replaceable earning capacity, current replacement cost data will be of assistance in trying to assess what might be expected to continue on in the future. Therefore this data will be helpful in understanding what is happening, what has happened, and will be useful in making more informed predictions of what will happen.

It may interest you to know that we received about forty favorable letters of comment on this proposal including a letter from the Financial Analysts Federation which expressed the belief

that this information would be of interest and use to investors. I think that letter will prove to be of great assistance in the Commission's evaluation of this project.

I believe that the Commission will adopt these rules, perhaps close to the end of this month, applicable to year end 1976 financial statements.¹ I believe that the rules will apply primarily to large companies, at least initially, and will provide for these data to be presented in an unaudited fashion, but as part of the financial statements. It would be my prediction that we would initially only require them in the 10-K reports of these companies, although we would encourage companies to make this disclosure elsewhere. Perhaps we will require only generalized replacement cost data in shareholder reports. We recognize that initially these data will not be perfectly comparable among companies, that they will be imprecise, that there will be a great many estimates that go into their preparation. We have been urged by many different people not to require publication of these data for just such reasons. I personally am confident that analysts will be able to understand the deficiencies as will other users of these data and will not use them irresponsibly.

Initially there will be quite a lot of disclosure because companies will be explaining how they prepared the data and what they believe the data means. I hope that you will use it and I hope that you will supply us with input on how you are using it. Furthermore, I hope that you will indicate to us examples of those data which are particularly useful and those that are not, so that we can continue to review this process to determine whether it is something of general value.

Cooperation with the Financial Accounting Standards Board

The fifth trust of SEC disclosure activities, broadly defined, is our policy of trying to improve accounting information and measurement through cooperation with the Financial Accounting Standards Board. We strongly support the efforts of the Standards Board to develop improved accounting measurement. We think that they are doing a good job. While everyone from time to time believes that they are not moving fast enough, particularly on the subject that may be close to one person's heart, I think on the whole their record is pretty impressive. They have a tough job and I think they are talented, determined to do it well, and we cooperate with them on a continuing basis and are confident of their success.

What might be new initiatives, which would either be variations on these or additional thrusts? I think as we look ahead there is nothing that is imminent in the sense of proposals that are about to emerge in the next month or two. But there are at least three areas which I would like to touch upon that my staff is actively working on at the present time, or that the staffs of other divisions of the Commission are working on and which may emerge for comment in the year ahead.

¹ On March 23, 1976, the Commission issued Accounting Series Release No. 190, "Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data." Also released on that date were Staff Accounting Bulletin No. 7 which provides interpretations of ASR 190, and Release No. 5696 which proposes that persons disclosing current replacement cost information would not be deemed to have made an "untrue statement of a material fact . . .etc."

Disclosures of Uncertainties

One of these, an important one, and probably the most difficult to deal with, is improved disclosure of uncertainties. We have tried to deal with this in a generic sense in Accounting Series Release No. 166, which spoke of the impact of uncertainties on financial reporting. We have also tried to deal with it more specifically both in rule making and in terms of our administrative activities particularly with REITs and with financial institutions.

One of the basic problems with the accounting model is that it uses single values. It reports only one number which rests somewhere within a probability distribution and in order to understand it one must have some understanding as to what the probability distribution looks like. Up to this point we have not been terribly successful in getting good descriptions of probability distributions. We have gotten quite a few lawyers who have learned to write risk factor language which goes into most prospectuses. These say "We are a small company in a large industry;" "We are subject to the alarms and excursions that are associated with competition;" "Management may not remain with the company. If they remain with the company they may become less effective." There are a variety of these caviats which appear as "Risk Factors" in prospectuses. But disclosure of uncertainties comes down to saying, for example, that when you picked a figure for the reserve for doubtful accounts, you picked one that is conservative or liberal. There is a need to describe the dimensions of these uncertainties. We have not had any success in this regard at all. I wish that I could tell you that I have a series of about five really good ideas which are about to emerge that will resolve this need. I don't have these ideas, but they are an area that we are concerned with, and we hope that we can do a little more than is being done today.

Liquidity

Another area where we are doing some work is improved disclosure of liquidity. As we move into economic recovery liquidity problems are less severe, however, I do think that improvements are needed because at the present time financial statements are sort of a mish-mash. There are some elements which are still liquidity oriented, based upon the way in which financial statements were prepared in the nineteenth century when they were primarily prepared for bank creditors who were only interested in liquidity. There are other dimensions of financial statements which are prepared on a stewardship basis, and then they are all jumbled together. As a result, the devices which should perhaps be showing something about liquidity, for example balance sheet classification of assets, are not doing so. The funds statement is not a very well developed device at this point. This is particularly true in some industries and some situations. Bank funds statements are a classic example of data for its own sake, but data which provides no significant information. There are some other industries in which this is the case as well. It seems to me tht we have to give some thought to ways in which liquidity problems can be disclosed. In the final analysis of course, one looks at cash forecasts. But it may be that we can do something short of that, that will be of assistance to investors in understanding potential problem areas.

Future Oriented Disclosures

The third area, one in which we already have had some initiatives, is what I call future oriented disclosure. That is a broad subject of which forecasts is only one element. As you are no doubt all aware, the Commission resolved in a set of proposals all the problems associated with the projections of economic performance. The only difficulty is, all those people that we were helping by this resolution have not yet become convinced that we have found the right way. In fact, their protests have been so strong that even we are beginning to have seeds of doubt that we have found the right way. This matter is being looked at again. I think it is very likely that sometime in the next six to eight months we will put out for comment additional or revised proposals on projections.²

When I speak of future oriented disclosure, I speak of more than forecasts. It may be, for example, that we should beef up the section on Management's Analysis of the Summary of Operations. We now say if there are any facts known to management that make historical results not indicative of what may be expected in the future, such facts should be disclosed. Perhaps we should be asking management to do more in explaining the past in a future oriented sense, indicating changes in conditions today that may have an effect on the future. Our replacement cost rules are of that nature and we might be explicit in that regard. Then, of course, in addition there are various techniques by which you can get better breakdowns, classifications of historical information, that will help in the predictive process.

Advisory Committee on Corporate Disclosure

Now I have touched upon a number of SEC activities and I have not yet mentioned a very major one, which is our new study of disclosure and the disclosure framework. As you may know, Commissioner Sommer is chairing an advisory committee which he will continue to head after April 1st, as an outsider, not as a commissioner. The advisory committee is taking a look at the whole framework of disclosure. We expect that the advisory committee will help us to better understand the costs and benefits of our disclosure rules within the framework of the total disclosure system which exists in our society today. We are not, in this study, looking to have either less disclosure or more disclosure, but better and more relevant disclosure. None of us knows what conclusions might be reached, but over the next year we are going to be devoting substantial resources to this program. We think that we will emerge with a report--again not with the ultimate answer, but with some recommendations and conclusions--which will at least be a meaningful contribution to disclosure policy.

Conclusion

In conclusion, we think that all the Commission's movements in the area of disclosure indicate that it is likely that the role and importance of analysts will increase. Intelligent and well-trained users of financial data will have an edge. This is not inconsistent with fairness to investors, and is consistent with substantial growth in your profession, despite the end of fixed commission rates. This edge must be based on insights and on ability to make economic and

² On April 27, 1976, the Commission issued Release 33-5699 which withdraws previously proposed rules related to projections of future economic performance (Release 33-5581), and proposes guides which are considered to be broader and less restrictive than the previous proposal.

behavioral forecasts, not on inside information. The day when the best analyst was the one with the pipeline to the company is, I think, over, even though contact with the company is an important part of understanding. It is probably arguable today that you learn more by talking to the company's competition than you do by talking to company itself, simply because companies are becoming more aware of the problems of inside information and the liabilities that may exist as a result of distributing it. So, I see analysts playing a more important role in our capital market--a more important role in terms of the process of the effective allocation of capital--and I hope that the SEC can be responsive to their needs and to their obligations.

If any of you have any questions, heckles, harassments that you would like to subject me to, I would be pleased to respond.

Question: Does FASB 8, which deals with foreign currency translation, create volatility? Will the Commission do anything about it?

Answer: In the first place, I have serious doubts as to whether or not an accounting method appropriately disclosed as to its impact will result in substantial volatility in the marketplaces. It certainly will result in volatility of reported net income, as any process which puts the impact of a change into one period as opposed to averaging it has the effects of changing the volatility of income. I believe that analysts and other users of financial information will be able to absorb this, understand it, and take it into account in the process of evaluation.

It seems to me that one of the fundamental approaches that the Standards Board is taking, and has taken in a number of different statements up to this point, is that the role of accounting should be "tell it like it is, let the chips fall where they may," and to move away from averaging devices which spread effects over a period of time.

Now this is not an approach that has been terribly popular with management, because if there is one thing that managements like it is the ability to manage earnings, average their ups and downs, put a little away for a bad day, take a little back on that bad day. These are techniques that have been around for a long time. Managements are particularly unhappy when they are faced with the possibility of volatility in earnings as a result of an effects that they cannot control. This is the case of foreign exchange fluctuations where earnings can be substantially impacted because of changes at various points of time. The FASB is the best organization to appraise and to make a judgment about the propriety of reflecting these impacts currently. The various managements that feel highly aggrieved about FASB 8 did call these problems to FASB's attention prior to the Exposure Draft. They pointed to the problems which were in the Discussion Memorandum. After the Exposure Draft they once again pointed to the problems. They indicated "Here are the difficulties." "You are inserting a certain element of substantial volatility into earnings." "You are requiring, for example, the adjustment of debt, which is a large dollar amount, to flow into one period." These points were all made to the Standards Board and the Standards Board considered them within the framework of its due process and concluded that the approach that they took was the best approach. They are, of course, hearing today from a lot of people who are unhappy with this.

We too are hearing from people who are unhappy with the effects of FASB 8. We have said to companies and their auditors that if they believe they have a set of unusual factual circumstances that the Board did not consider which they conclude make the financial statements misleading, then their auditors can use the “203 Opinion” that says, “If following the rules creates a misleading financial statement, you can do something else.” As yet we have not found any auditors who are willing to reach that conclusion. I do not anticipate the Commission taking any action on this. We spent a few days with the Standards Board on this particular project after the Exposure Draft and before the final statement and it is, I think, clear that they thought through the issues. Whether they reached the same answer that I would have reached is not germane. In fact, I have not reached an answer. It is one that whoever argues last is the one that I am persuaded by the most. I think that it is quite apparent that the activities of the Standards Board are going to move in the direction of greater volatility of earnings, and accordingly analysts are going to have an increasing responsibility to go beyond the single figures and to look at the earning power and to make judgments as to whether gains or losses resulting from exchange translations should be factored into earning power or excluded.

Question: Could you require further disclosure on how the foreign exchange translation was calculated?

Answer: We think about that. We have not had anyone, at this point, come to us and identify disclosure deficiencies. All we have heard is that the number is wrong. But we have not heard arguments along those lines. To the extent that people can articulate what is is that they think will be useful, where the problems are, we would listen. We listen to analysts. They don’t speak very often, at least to us, but when comments come in, we pay a lot of attention to them. You are a significant user group.

Question: Would you consider requiring companies to send 10-Q reports to anyone who asked for them?

Answer: We would consider it. Whether we would do it, is another question. There are some possible legal impediments with respect to what authority we have. The authority that we have in connection with the 10-K is tied into the proxy rules. It is less clear that we can tie in quarterly reports. In fact, we do not even require quarterly reports to be sent to shareholders. That is a Stock Exchange requirement. So I think that we are sympathetic and if there seems to be a substantial demand we might look carefully at the law to find out what authority it might give us that we have not focused upon, that we can use as a vehicle to achieve this. I suppose that there is always rule 10b5, which might be interpreted to say that it is a false and misleading device, scheme, artifice to defraud or whatever not to send out 10-Q’s to anyone who asked for them. But that is stretching it a little bit. If it gets to be a problem, if companies really say, “Well, too bad, you will just have to subscribe to Leasco,” we may have to do something about it. Most companies will make them available to people.

Question: Is it not preferable to look at averages for financial institutions rather than at the source and applications of funds, which reveals only changes between two statement dates, since average figures can be quite different from year end figures?

Answer: I would agree that at the present time the funds statements reflect net changes. It would seem to me that over periods as long as a year for lending institutions it might be worth looking at average loans, average new commitments, things of this sort. In our Guides 3 and 61, which are out for comment, we have called for a lot of average daily balance type of data. But that is different really than average new commitments or average new money lent, which, I think, is one of the things that should be considered.

Question: Do you believe that the accounting profession is moving fast enough in developing new regulations?

Answer: That is a good question. I have a lot of faith in the accounting profession. I think that over the past five years they have changed dramatically. They have recognized a set of responsibilities and have committed resources to fulfill these responsibilities. At the same time they are facing more demands. As we look at the year ahead, I think that it is clear that there will be some congressional inquiry into the structure of the accounting profession. There will probably be an inquiry into the way that accounting principles are set. I hope that the accounting profession will come out well. I think that they have a good story to tell if they can tell it. I am fundamentally optimistic about the accounting profession, and about its willingness to step forward more than it has in the past. Sometimes it has not stepped forward as far or as fast as I would have liked, but I think that it is moving.

Question: Do you believe that there will be further disclosure on certain contingent liabilities, particularly supply contracts, and would this disclosure be in the financial statements or in footnotes?

Answer: I think that in terms of contingent liabilities associated with long term supply contracts and commitments of this sort, it is pretty clear that our requirements contemplate disclosure at the present time. Of course, there are questions as to what are the routine normal course of business contracts as opposed to those contracts that are of such significance that they need to be spelled out in detail. I think that FASB 5, while it says that if you cannot make an estimate you do not have to accrue a liability, does at the same time indicate that you do have to make disclosure. One of the results of the arguments that have occurred in this past year between lawyers and CPA's has been to focus attention on the area of contingencies. I think that disclosures are likely to get better. They will probably not cover everything. I think disclosure will take more the form of footnotes rather than flowing through the income statement. There again the FASB seems to be saying that we should be applying greater objectivity to the numbers that go into the balance sheet and the income statement. They have to be more auditable. They have to be less controllable. The move is away from averaging. The move is in the direction closer to cash. These are all things that go to the fact that we should not be looking in the direction of softer data in the face of the financial statements, but presumably better disclosure of uncertainties in the footnotes, in Management Analysis and in other places.

Chairman: Mr. Burton, on behalf of the Junior Analysts Committee, I would like to thank you for coming to speak before us this afternoon.