

The Evolution of Reporting and Auditing:
From Periodic to Continuous

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An examination of the disclosure environment today indicates that a steady change is taking place. The philosophy of disclosure is moving in the direction of continuous timely reporting, rather than the emphasis on reporting the results of a single calendar inspired time period. This is reflective of the fact that business is inherently a continuum, rather than being done in a series of discrete segments. While there may be some crop-oriented businesses where one period is substantially independent from the next, this is certainly the exception in terms of companies whose shares are traded in the public market place.

Obviously, by continuous reporting I do not mean to suggest that every time Macy's rings up a sale they should call their friendly analyst. Rather, I am talking about a reporting attitude on the part of corporations that public reporting is one of the responsibilities which a management must keep in mind throughout a year and not just at year end. This is consistent with the approach taken by Louis Loss in his draft of a new securities code which implies that you register companies, not securities.

To say that reporting is moving in the direction of becoming continuous is not to suggest that the calendar should be done away with on an absolute basis. Periodic reports for relatively short periods defined by the calendar may still be the best approach for reflecting a business continuum. But it should be clear that the objective of such reporting is the adequate reporting of the continuum, not of the short period as an end in itself.

It does not require sophistication or accounting skill to know that the results of short time periods are less precise than those of long, because of the relative importance of arbitrary accounting assumptions that must be made and a recognition of the fact that the company does not wish to devote the time to achieve precision on a frequent basis.

While quarterly or other short periodic reports may be a useful approach to giving information about a business continuum, it should not be the only approach considered. Under some circumstances, for example, it may be highly desirable to report on periods other than the quarter within the year, depending upon the nature of the business cycle of a particular firm. In the case of a department store, it may be useful to report on a monthly basis during the Christmas

quarter in which traditionally the largest part of the year's business is done. In addition, there may be a reporting obligation which arises when a change in trend is perceived within a calendar period such as a quarter.

It may also be desirable to encourage the reporting of very limited data on a very frequent basis. This would normally represent sales data and is already done in certain industries. The recent substantial attention being focused on automobile sales is a case in point.

Finally, it is clear that there should be reporting of significant events on a timely basis when they occur. There are numerous difficulties in defining significance and for that reason the Commission has left a considerable amount of latitude in its current reporting form (Form 8-K) for companies to disclose any significant events which they wish to call to the attention of the public. In addition, the Commission, in Accounting Series Release No. 138, mandated disclosure on a timely basis of any material unusual charges and credits made to income with substantial details.

Another approach to reporting a business continuum may be related to the well-known management technique of exception reporting. If companies make regular forecasts of their results, it may be that interim historical reporting should only occur at times when a change in expectations arises. In essence, a company could allow a forecast to stand as long as it is consistent with the results being achieved. This might also include a system of variance analysis where variations between an actual and forecast are regularly reported and explained.

I do not mean to suggest that the Commission has made any determination that it should mandate either forecasts or different reporting periods other than those based on the calendar. I do believe, however, that the evolution of the reporting environment indicates a change in outlook which corporations and auditors must be fully aware of.

In discussing the need for frequent public reporting, one of the problems that cannot be ignored is the physical problem of getting information public. While a large corporation with a significant announcement seldom has any difficulty in getting access to the media, the same can certainly not be said for the medium-size or smaller public corporation whose doings are not as

newsworthy. In addition, regular mailings to all stockholders result both in substantial costs and time delays which may have to be avoided. It may well be that some "filing" mechanism should be developed to let companies make "public" disclosure through the vehicle of a filing and perhaps with concurrent publication of something resembling a legal notice in very abbreviated form. Such filing could be with the New York Stock Exchange or the National Association of Securities Dealers or, of course, it could be with the Commission. It might be possible to have the organization with whom the data were filed publish a daily list of at least the names of companies who made filings so that an analyst or other interested party could quickly avail himself of the information if he wished to do so. The Commission attempts to do this in a small way by including information on filings in its Daily News Digest and this may be a starting point.

With this general background, let me turn to the Commission's recent specific proposal for improved interim reporting. Our proposal had three components. The first would amend Form 10-Q to require full income statements, balance sheets and source and application of funds statements for each quarter. Footnotes would generally not be required except as necessary to make the statements not misleading, since users of the 10-Q's would be assumed to have access to annual notes.

Secondly, an amendment to Regulation S-X was proposed to require footnote disclosure of sales, gross profit, profit before extraordinary items and net income for each quarter during the year. The annual accounts, therefore, would include certain quarterly data designed to assist investors in putting the year in perspective. This would help in the perception of trends and it will help to illustrate patterns of seasonal variation which may be significant to investors in understanding the significance of annual results.

Finally, this second proposal, through the requirement for a footnote including quarterly data, would involve the independent auditor in the interim reporting process. As proposed, the rule would include this footnote in audited financial statements and, hence, the data therein would be audited as part of the statements.

Such a requirement is very different from requiring a separate audit of each interim period, since the data presented are highly abbreviated, the test of materiality will be different when the data are related to a year as a whole and the fundamental lack of precision in quarterly results must be also taken into account. In proposing the rule, the Commission emphasized that it was not proposing audited interim financial statements.

In auditing this note, the auditor will have the advantage of hindsight in regard to estimates and, hence, some of the most difficult and time consuming audit steps will not be necessary for interim periods.

We are now working with the Auditing Standards Executive Committee of the AICPA to develop standards for auditor involvement. We are doing this because we are not prepared to cast the auditor out onto uncharted seas when he begins the process of examining statements with this new responsibility. Neither are we prepared to see procedures devised which will expose corporations to substantial audit cost increases. We recognize that there will be additional costs, but some of the estimates being proposed at the present time seem unrealistic. At the time when the rule is finally adopted, some specific standards and procedures will be set forth either by the AICPA Committee, by the Commission or by both.

While I believe that the Commission has concluded that some significant auditor involvement interim reporting should be mandated, I would certainly not believe that the specific proposal is cast in stone. Our discussions with the Auditing Standards Executive Committee and our analysis of comments may well lead us to judge that an alternative approach would be preferable and we may, therefore, involve auditors in a different way.

Early reactions to our proposal have not been uniformly enthusiastic. While analysts and other users of statements have largely applauded, corporations have indicated concern about cost and auditors have indicated concern about cost and liability. Among the proposals, auditor involvement is clearly the most controversial. A number of comments indicated a failure to perceive the objectives for the proposal of auditor involvement. They suggest that we are proposing the requirement for auditor involvement because we have discovered a few abuses and

are tarring everyone with the same brush. They ask why many should pay for the sins of the few and suggest that if our objective is to prevent abuse, a far more effective and less costly way of achieving this objective is to undertake a vigorous enforcement program where those who misbehave are called to task.

While it is true that we have found abuses and dealt with them in enforcement actions, the avoidance of these abuses is not our primary purpose in proposing these rules or in mandating auditor involvement with interim reports. In order to clarify our objectives, I would like to try to articulate what it is we are trying to achieve.

In the first place, our proposals are designed to emphasize the continuous nature of the reporting process. We do not believe that we are in a situation where some reports should have a degree of reliability significantly different than others, even though there may be differences in the precision of specific accounting estimates. It has been empirically demonstrated that interim reports have just as great an effect on the market place as do annual statements and, accordingly, it is important that they do not produce a misleading picture. While there may be some benefit in having precise estimates made once a year, the basic reliability of all data must be maintained.

Second, the objective of auditor involvement is primarily to involve the professional accountant's reporting skills in the interim reporting process. Independent public accountants are the professional experts of the reporting world. Their expertise and diversity of experience, if involved in the interim reporting process, should improve the quality of this reporting. This is not so much achieved through finding errors as it is in improving the systems of reporting being used and applying timely judgments to difficult accounting problems.

In addition, the involvement of auditors will lead the profession to devote more attention to the measurement problems associated with interim results. Prior to the issuance of Accounting Principles Board Opinion No. 28 in 1973, there was nothing in the authoritative literature that dealt with interim reporting principles. APB 28 is only a start. It includes many ambiguities and inconsistencies, although it is a significant step forward. Public accountants and standard setters do not really have a full grasp of the communication problems associated with

interim reporting since they have not involved themselves in it. I think there is little doubt that as they become more deeply involved, the principles of measurement and reporting applicable to interim periods will be substantially improved.

Finally, an additional objective of our proposals is to change the auditor's outlook on auditing from one of auditing financial statements to that of auditing the company. The Commission suggested this in Accounting Series Release No. 165 where it introduced for the first time the "auditor of record" concept in an official statement. Basically, this concept is one that ties the auditor to the company rather than to particular financial statements. While the auditor is "on the books" he must recognize a responsibility to be involved with all aspects of the company's public financial reporting.

Historically, the auditor has tended to look at an audit engagement as a discrete task aimed at rendering an opinion on a particular set of financial statements. The professional literature clearly identifies this as the objective of his work.

Investing, however, is a continuous process. Investors are in the market place on a day-to-day basis making investment decisions based upon available information. The development of a reporting framework that emphasizes the continuous disclosure of information is a response to this fact.

As the auditor adjusts his approach to auditing to take this into account, he must, it seems to me, look upon his responsibility as encompassing his client's public reporting system as a whole. Financial statements for a year are merely one output of the system. While it may be appropriate periodically to make specific examination of asset valuations and other specific accounting problem areas and thus render an opinion on specific financial statements, this should not be the first objective. As long as the auditor is "on the books," he should be involved in a continuing process of examining the reporting system.

This does not necessarily imply more fact-finding audit work. It rather suggests a different focus to the audit. Even though fact finding may not increase, the amount of analytical work which is the responsibility of the auditor probably will. In addition, the auditor's reporting

responsibility may grow. It is difficult to predict exactly how this evolution will take place, but the trend is clearly evident.

I see this process as an evolutionary one rather than one that will be mandated overnight by the Commission. Certainly, our current proposals do not in themselves require such an approach. The essence of continuing involvement is something which will require a development of conventional relationships on the part of both auditor and client which probably cannot be legislated by rule. Even today, there are many auditor-client relationships which reflect, in effect, a continuous involvement of the auditor in public financial reporting. While these are the exception, they are by no means unique. The increasing use of audit committees of boards of directors and the increasing responsibility placed upon outside directors are likely to be significant forces in accelerating the trend.

It is apparent that there are significant problems of standards and responsibilities which must be dealt with as the auditor moves in this direction. In today's litigious world, the auditor would be imprudent not to be concerned about problems of responsibility and liability which may arise. At the same time, it would be disastrous if the fear of liability caused the auditor to resist a development which has the potential for substantially increasing the quality of public financial reporting and the quality of audit services that can be rendered to a client. Where an auditor is present on a regular basis, he can provide substantially more effective service to his client and his audit should be substantially improved. While this better service will not be without cost, it seems likely that its principal impact will be to spread audit work throughout the year rather than increasing its absolute amount. Review work done on a quarterly basis, for example, should reduce work done at year end.

The Commission strongly supports the accounting profession as an essential element in the structure of financial reporting. If the profession is prepared to see its function evolve and develop, its potential for positive social contribution is enormous. We look forward to working with it as a partner in achieving our objective of an improved capital market system.