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Current Problems in Financial Reporting and Internal Controls

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The broad professional interests of financial executives provides me the opportunity to bring together in one talk a number of themes relating to financial reporting. Corporate financial executives have a vital role in shaping the progress made in financial reporting, both through their individual corporate efforts and through the FEI. Moreover, private sector initiatives in effective financial reporting contribute importantly to enhancing investor confidence, and will have significant implications for the nature and extent of future governmental regulation in a number of financial reporting and disclosure areas.

In this connection, I would like to discuss with you today some major current accounting developments and some methods of improving management's reporting of financial information. I would also like to touch briefly on a few of the implications which the Foreign Corrupt Practices Act will have for financial executives.

1. The FASB's Conceptual Framework Project

I would like first to discuss the ongoing examination of the accounting profession's theoretical foundations -- the FASB's conceptual framework project. I want to urge you as financial executives to give this project your

strongest support. Important new concepts are already emerging from the framework which are impacting financial reporting. It is important to integrate these concepts, as they will play an increasing role in financial reporting in the years ahead.

The conceptual framework must be -- as I think the FASB recognizes -- much more than merely an attempt to catalog the premises and assumptions which are implicit in accounting as it exists today. The project must rather constitute an exercise in leadership -- an effort to create a set of principles which can serve as a goal, a visionary guide, for the profession to work toward as it develops and refines disclosure principles and methodologies. It is a safe prediction that, during the coming decades, the economic, political, and technological changes in this country and the world -- and their impact on the nature and methods of American business -- will be enormous. Accountants and financial managers must have a conceptual framework sufficiently flexible and broad to accomodate those developments.

A. <u>The scope of the conceptual framework</u>

In order to attain these lofty objectives, the project must address and resolve several crucial issues.

The first is assuring that the conceptual framework has sufficient scope. In December 1977, the Board issued an exposure draft of its "Statement of Financial Accounting Concepts" which spells out the Board's view of the scope of financial reporting objectives and of the elements of financial statements. This proposed statement is particularly important to the future direction of financial reporting in the United States, and I want to take a moment to review some of its highlights.

First, the Board has not limited its scope to financial statements, but rather has -- wisely in my view -- elected to define its task in terms of financial reporting in general. That premise, if reflected in the Board's final product, will bring the accounting profession closer into step with the needs and expectations of the users of financial information and with the realities of the way business must communicate in a complex and sophisticated economy. Second, and just as significantly, the exposure draft reflects the philosophy that financial information is not simply a record of past occurrences, but is equally of value in enabling users to assess the future.

Again, that principle is one which harmonizes with the realities of modern financial reporting.

Both of these concepts are responsive to shortcomings which numerous critics have attributed to our present system of financial reporting. Until very recently, the focus of financial disclosure has been much too heavily on accounting questions within the context of traditional financial systems. Unfortunately, the approach has tended to be "all or nothing." That is, information not perceived as being part of historical cost financial statements has frequently been regarded as wholly outside the discipline of accounting and has thus received inadequate attention, regardless of its utility, from accountants and financial executives alike. And, correspondingly, disclosures which users have demanded and which are "financial" in nature -- such as segment information and geographic operating data -- have been forced into the mold of the financial statement, even where the information involved does not fall squarely within traditional financial statement concepts.

The Board's recognition that the accountant's domain can extend to disclosures outside the four corners of the balance sheet or income statement will alleviate the

anomalies and misunderstanding which the "all-or-nothing" approach has engendered. The broader area of financial reporting is an appropriate frame of reference within which to grapple with conceptual problems, and the FASB'S recognition that the financial statements are only one element in the complex of financial disclosure is a positive sign. For example, it provides management with the opportunity to distinguish between measurable results typically presented in financial statements and other information which may be equally meaningful to users, but less precise. Further, this expanded perspective should also encourage the auditor to lend the credibility of his independent expertise to useful, but non-traditional, data of this nature.

B. "Soft" Information

For these reasons, individual financial managers must be sensitive to the implications of the broad philosophy marked out in the FASB's exposure draft. Implementation of that philosophy would, in my view, help pave the way for rational responses to a number of difficult issues. Consider, for example, the need for the model to recognize and support types of disclosure which are sometimes labeled, perhaps disparagingly, as "soft" information. The inclusion of such

disclosures in financial reports is a trend which the Commission has favored in recent years, and the FASB conceptual framework project appears to be the logical stepping-stone for consideration of the overall issues which these kinds of disclosure requirements raise.

The Board's formulation of the proposed objectives of financial reporting, which I mentioned a moment ago, strongly suggests the need to bring forward-looking and other "soft" information under the conceptual framework umbrella. For example, the exposure draft states that "financial reporting should provide information to help investors and creditors assess the amounts, timing and uncertainty of prospective net cash flows." This precept, which is one endorsement of the need for forward-looking and soft information, is not new. Nonetheless, I place considerable importance on it because I recognize and share the view that cash flow is an especially important tool in evaluation an enterprise -- more important perhaps than the commonly employed concept of earnings per share. Resistance on the part of the business community and others to providing this sort of forward-looking information -- and the auditor's unwillingness to be identified with it -- has, however,

been substantial. The Board's statement should help to heighten understanding of the importance of this type of disclosure and to confirm its legitimacy as a disclosure objective.

Traditionally, information which is difficult to verify is often disseminated only with great reluctance or to a relatively small number of users. Hopefully, the conceptual framework will help to change this attitude. In any event, in my view, both the disclosures which management provides and the responsibilities which independent auditors assume must increasingly focus on soft information if the objectives of financial reporting, as the FASB has articulated them, are to be fully met.

Let me give some examples. First, the conceptual framework project must address squarely the need for financial reporting to mirror economic reality in an era in which annual inflation of six percent or more has been the norm. This is not a theoretical or abstract need. Explicit recognition of the impact of inflation contributes to the capacity to interpret the economic future of individual companies. In the aggregate, it impacts directly on the capital formation process and on political and

societal attitudes and expectations about the continued effectiveness of the private enterprise system and its ability to finance our future.

I do not mean to suggest, however, that accounting based on historical costs must or should be discarded nor that the new methodology necessary to bring financial reporting closer to an economic picture of business operations should be agreed upon as part of the conceptual framework. On the contrary, I visualize the process of developing the reporting techniques necessary to implement the goals of the conceptual framework statement as an evolutionary process which may span many years. I have some serious reservations about the kinds of judgmental or subjective decisions which would be injected into financial reporting by a "current cost" system. Thus, while cost-based financial statements will probably continue to be the center-piece, the financial disclosure system should expand to accomodate other types of information as well. If the FASB's project does not result in a framework within which financial reporting can come to grips with economic realities in an economy characterized by significant inflation, then -- regardless of its

other attributes -- the project will bear a very heavy burden of self-justification.

I have in the past spoken on the reasons why I believe that the failure to reflect the diminishing purchasing power of the dollar causes reported profits to be systematically distorted upward. For present purposes, suffice it to say that traditional income statements tend to suggest that many firms are generating adequate funds to satisfy their investment demands when, in fact, they are eroding their capital. This problem is an important and serious one, which highlights the economic and behavioral impact of our accounting system. Consideration of the need to stimulate capital formation does not necessarily lead to the conclusion that historical cost should be discarded in favor of conversion to an accounting system premised purely on current cost assumptions. Such a choice becomes important only if one thinks of financial information as limited to that contained in financial statements -- rather than as a system of financial disclosures which is broader than, but includes, traditional financial statements.

C. ASR 190

The FASB has announced its intention to issue an exposure draft this year proposing supplemental

disclosures of the effects of changing prices on a business enterprise. This area of financial reporting is one where the private sector, primarily the FASB, should play the leading role in establishing reporting standards. Thus, while the Commission did adopt a replacement cost rule in ASR 190, it did not in any way preempt the FASB by so doing. In ASR 190 itself the Commission specifically stated that it "does not believe its new requirements prejudge any conclusions which may arise from the FASB's study of the conceptual framework of financial statements." That release further stated that "experimentation with replacement cost information . . . will materially assist the FASB in its study . . . ." The Board's resources and expertise place it in the best position to develop such standards. It deserves your strong support as it works on developing these supplemental disclosures, as well as on all other aspects of the Conceptual Framework project. The FEI should also play a constructive, leadership role in this area -- by working for example, on development of industry alternatives to ASR 190. Your experience, expertise, and interest in this area are substantial, and your

contribution can be very important in shaping the ultimate resolution of this issue.

The Commission's basic policy is to rely on the private sector for leadership in establishing and improving accounting principles and standards. When the FASB has completed its deliberations on measurement principles, it may then be appropriate for the Commission, as an alternative to the present disclosure requirements, to revise its replacement cost rule to permit experimentation with the supplementary disclosure for which the FASB is likely to call. Ultimately, if the FASB's concept framework works for SEC reporting, as we hope it will, the Commission may decide to rescind the rule entirely. In any event, further action by the Commission will be influenced by our experience with alternative disclosures, the success of which will depend on the response of individual companies and of groups such as the FEI in taking an active, leadership role in their development and implementation.

2. Oil and Gas Accounting

No discussion of financial reporting at this time would be complete without reference to the Commission's recent action in regard to oil and

gas accounting. In the recent Commission proceeding on accounting practices for oil and gas producers, the Commission was confronted with an industry whose unique operations and economic environment indicated a need to depart from traditional measurement concepts and with a specific mandate from Congress to assure the existence of a reliable energy data base. The Commission's action exemplifies the role which supplemental disclosure can play in redressing the failures of traditional accounting concepts.

The most significant economic event in the exploration, development, and production of oil and gas is the discovery of proved reserves. Yet, traditional accounting methods have not allowed such discoveries to be recognized in recording the assets or earnings of oil and gas producers. Proved reserves of oil and gas constitute the most important asset for most of these companies. Indeed, traditional methods for accounting for the costs of oil and gas exploration bear little, if any, relation to the value of the product, whereas any meaningful assessment of past activities and future prospects of an oil and gas producer requires information about the value of its reserves. Accordingly, the Commission was led to the conclusion that an accounting method

which recognizes the value of proved oil and gas reserves as assets would result in more meaningful presentation of the economic resources and the earning power of oil and gas producers.

The development of this "reserve recognition accounting" will not be an easy task. Commentators on the Commission's action have been quick to point out the many problems which must be overcome. One of the most significant questions is whether estimates of reserve values can be made sufficiently reliable to incorporate these values in basic financial statements. Estimates of reserve quantities are necessarily imprecise, and are subject to subsequent revisions as additional information is obtained.

The need to make assumptions as to prices, costs and timing of production adds further to the subjectivity of this information. After several years of experience with reporting such data, however, it can be expected that meaningful trends and patterns will emerge from which evaluations can be made. As I indicated, moreover, a substantial effort will be required to define and develop measurement techniques for this kind of information.

The development of reserve recognition accounting does not presage a trend to the use of value accounting in other areas. It is, rather, a response under specific circumstances to the degree of failure of certain accounting principles to recognize what is important to investors.

Nor do the conclusions reached in this proceeding represent a change in the Commission's policy toward the FASB. The oil and gas accounting project of the Commission has been unique in many ways, including the impact of the requirements of the Energy Policy and Conservation Act of 1975. We reaffirm our strong support of the FASB expressed in the July report to Congress on accounting and auditing matters; however, the Commission's relationship with the FASB must allow for occasional differing judgments on issues in view of the responsibilities and independence of each body. The Commission would welcome further initiatives or participation by the FASB in the continuing efforts relating to financial reporting for oil and gas producing activities. If the FASB should decide to take the initiative in this regard, the degree of future involvement by the Commission would likely be diminshed.

3. Improving Investor Understanding of Financial Data

I would now like to turn to the matter of improving management explanation of financial information. As the accounting profession, the business community and the Commission endeavor to identify and provide meaningful financial information, we have all become acutely aware of the need to provide investors with a clear understanding of both the significance and the limitations of this information.

A. Management Discussion and Analysis

Of major importance to the usefulness of reported financial information is management's explanation and interpretation. Unfortunately, the "management discussion and analysis" which accompanies operating summaries too often is approached very mechanically, resulting in little more than simplistic boilerplate. For some time, the Commission has been concerned with the problem of how to make the management discussion and analysis a meaningful vehicle for communicating useful information. Some believe that the Commission's existing guides for the preparation of the management discussion and analysis, which employ certain numerical tests to

determine the matters to be discussed, are a major source of the problem. The Commission is considering rule changes in this area and recently requested public comment on the revised Form 10-K format recommended by the SEC's Advisory Committee on Corporate Disclosure, which includes significantly different requirements for analytical discussion by management. _/ These proposed requirements emphasize the obligation of management to decide what factors may have a material impact on the business and should be discussed, rather than establishing rigid numerical formulas.

Regardless of the format, the usefulness of analytic information will ultimately depend upon management's commitment to use this tool to communicate meaningfully to investors. Analytic information has not in the past been available and the blame rests largely with management. It is up to you to encourage experimentation with this mode of disclosure. Many of you should be embarrassed by the superficiality of the discussion and analysis which is now provided to shareholders by management.

_/ See Securities Exchange Act Release No. 34-15068 [FR], August 16, 1978.

There is an important principle here involving the relationship between the private sector and government regulation that repeats itself often and leads to increasingly prescriptive regulations. You understand far better than anyone else what would constitute meaningful analytic disclosure for your company, and the responsibility for that disclosure is yours. If your response is not meaningful, you are inviting further, more specific and detailed government regulation. The choice and the consequences are yours to determine.

b. The Management Report

A second but presently less common disclosure vehicle designed to improve communication with users of financial information is the "Management Report."

Although a few companies have included some form of management report in their annual reports to shareholders for some time, this disclosure vehicle did not receive wide attention before the Cohen Commission recommended that companies include with their financial statements a report that acknowledges management's responsibilities with respect to financial information. One of the major initiatives in response to the Cohen Commission's recommendation

has been the FEI's endorsement of that recommendation and its issuance, in June, 1978, of guidelines for preparation of management reports. The FEI's prompt and thoughtful action is commendable. I believe appropriate use of management reports will substantially improve communication of financial information to investors and shareholders. Moreover, in addition to clarifying the respective roles of management and the independent auditor, management reports should improve the understanding users of financial statements have regarding management's responsibilities with respect to accounting and financial reporting. Such reports will better prepare users to evaluate both management performance and the usefulness of reported financial information.

I do have certain concerns regarding management reports, however. They should not be used as a means of simply impressing users with management's wisdom and benevolence. They are financial disclosure vehicles, and not public relations gimmicks.

Because of these concerns, as well as the concern that many companies will not voluntarily adopt recommendations for a management report, the Commission's staff

is considering whether it should recommend Commission action. In my view, it would be premature for the Commission even to propose rules requiring comprehensive management reports before obtaining the benefit of private sector efforts in this area. However, it is an issue which the Commission must continue to study. Based on the progress made, we will determine whether rule-making is needed and if so, what kind. If we do go the rule-making route, we will want to benefit from the experience of the FEI in the approach which is ultimately taken.

4. The Foreign Corrupt Practices Act

One of the items suggested by both the Cohen Commission and FEI for inclusion in the management report is an assessment of the adequacy of the company's system of internal accounting control. This matter has received far more attention than other aspects of the management report, in large part as a result of the enactment in December, 1977 of the Foreign Corrupt Practices Act.

While the Foreign Corrupt Practices Act provided an additional dimension to the consideration of internal accounting control, the establishment and maintenance of sound controls has always

been an important responsibility of management. Congress reaffirmed that an adequate system of internal accounting control is a necessary component of management's ability to provide shareholders and investors with reliable financial information on a timely basis.

Reporting requirements for an issuer's internal accounting controls are presently under active consideration by the Commission's staff. While the nature and content of auditor involvement are major issues in this review, it seems to me that management, and not the auditor, should originate information regarding the company's system of internal accounting control. I see the auditor's role as evaluating management's presentation of such information, rather than generating it.

As you know, the objectives of internal accounting control specified in the Foreign Corrupt Practices Act were taken directly from the auditor's professional standards. In light of this, a major concern to issuers in assessing the adequacy of their control systems has been how criteria initially formulated to assist the auditor in determining the scope of his audit should be transformed into standards against which

issuers can measure their internal accounting control systems. I am pleased to note that a committee of the AICPA recently issued a Tentative Report, containing recommendations designed to provide guidance to companies in evaluating whether their internal accounting control systems satisfy the requirements of the Foreign Corrupt Practices Act. I believe that the work of this committee will be very useful to corporate managements.

The Foreign Corrupt Practices Act gives the Commission broad responsibilities in the establishment and oversight of internal accounting controls. However, we would very much prefer, once again, to rely on private sector initiatives in this area, such as the work being done by the AICPA's Special Advisory Committee on Internal Accounting Control. In the last analysis, however, adequate control systems are not the auditor's responsibility or the Commission's. The statute places the responsibility for controls on corporate management. The input which the FEI can provide from the client's standpoint, accordingly, would be extremely valuable.

Several quotes from the Special Advisory Committee's Tentative Report will help put the respective roles

of management intiative and regulation into perspective. In its Report, the Committee noted that "the internal accounting control environment established by management has a significant impact on the selection and effectiveness of a company's accounting control procedures and techniques . . . [I]t is important to recognize that a poor internal accounting control environment would make some control procedures inoperative for all intents and purposes because, for example, individuals would hesitate to challenge a management override of a specific control procedure." Further on, the Report notes that "the wide range in the size of the over 10,000 publicly-held companies in the United States, in their operating style, in the complexity of their transactions, in the diversity of their products and services, and in the geographical dispersion of their operations clearly makes it impossible to ennumerate specific controls that will answer every question and meet all of the needs of all companies." From these two statements, one must conclude that the responsibility for what constitutes a substantive internal control system must rest on management and on its integrity and commitment. Efforts to regulate

on the subject would, of necessity, be either overly general or overly restrictive, and not likely to be very helpful, on balance. Here again is an area for initiative on the part of corporate management, rather than extensive regulation on the part of government.

I want to suggest some factors which I hope you will consider in the evolving dialogue on internal controls. I have spoken repeatedly of the importance of the audit committee in the context of corporate accountability in general. The effectively functioning audit committee takes on an enhanced importance, moreover, in the process of compliance with the Foreign Corrupt Practices Act. In this regard, the FEI can and should play a significant role in assuring that audit committees do function in an effective manner.

I might add, parenthetically, that many newly-appointed audit committees apparently feel under some pressure to appoint a Big-8 firm as outside auditor. I do not believe that this trend is warranted. There are many smaller audit firms which have excellent, well-deserved reputations and are quite capable of providing quality audits to most American corporations. It would be unfortunate if the increasing use of

audit committees led public companies to ignore highly-talented auditors, because of a misperception that "bigger" is always "better." Size is not necessarily correlated to quality.

One factor to be considered by companies seeking assurance that they are in compliance with the Foreign corrupt Practices Act, and with high standards of corporate accountability in general, is the effective use of their internal audit staffs. Recently, there has been an increased emphasis on using internal auditors to do "operational audits" -- that is, reviews which stress management efficiency and program evaluation. While operational auditing is now and will continue to be a legitimate and important internal audit function, I believe that more stress should be placed on the traditional internal audit functions related to internal controls, information systems and compliance with corporate policies and procedures. In this regard, I think it is appropriate to note that, in establishing the first widely-accepted standards for internal auditing, the Institute of Internal Auditors placed particular focus on these traditional internal audit roles.

Even where the internal auditor is performing these traditional functions, an appropriate corporate framework must exist to enable him properly to do his job. Internal auditors are, by the very nature of their work, placed in a somewhat schizophrenic position. It is essential that the internal auditor maintain independence in relation to the activities subject to audit. The realities of corporate operations, however, also dictate that he serve management in fulfilling its particular repsonsibilities. This dual role will at times put the internal auditor under conflicting pressures which may detract from his ability adequately to perform either one.

To help make these dual responsibilities work in favor of your company, you should assure that the director of internal auditing is primarily responsible to someone in management with sufficient authority not only to provide independence, but also to insure that all elements of the organization cooperate with the internal audit staff. The appropriate executive to oversee the work of the internal audit staff will, of course, vary from company to company. If that executive is the chief financial officer or chief accounting officer, however, as is

currently often the case, I do foresee substantial conflicting pressures inevitably being placed on the internal auditor. In order to relieve these pressures, the internal audit staff should not, except under the most unusual circumstances, report to either of these officers. Nevertheless, the oversight executive should be at a level high enough in top management to minimize the risk of pressure to prevent issuance of a critical report or to impede access to the audit committee or Board. His authority also should be sufficient that reports are accorded appropriate attention by those in a position to act on the recommendations of the internal auditors.

Access to and oversight by an independent audit committee, of course, can significantly strengthen the independence of the internal staff and help to focus their work.

Conclusion

The reporting issues I have touched on so briefly today will occupy the attention of all of us for quite some time. Your reactions to my comments here, and to the Commission's actions in this area in general, would be of great value to me, and I urge you to let me know your thoughts.

As financial managers, you have the leading role in the resolution of financial reporting issues. As the agency the Congress has charged with enforcing the federal securities laws, the Commission likewise has a stake in the outcome. Hopefully, working together, we can strike the proper balance between private sector initiatives and Commission action in the area of financial reporting and internal controls. Through a dynamic in which the private sector takes the initiative, I look forward to a significant increase in the meaningfulness of financial information available to shareholders and investors. This will be a development for which the Commission, the accounting profession, and the business community will all be able to claim credit.

Thank you.