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Financial Reporting and Investor Protection

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by
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[Introductory note: Michael H. Sutton was appointed Chief Accountant of the U.S. Securities and Exchange Commission in June 1995. Prior to his appointment, Mr. Sutton was the senior accounting and auditing technical partner in the firm of Deloitte & Touche LLP. Previously, he led the firm's national accounting research and consultation group and served as a client services partner in the firm's Detroit and Atlanta offices.

Mr. Sutton was a member of the Emerging Issues Task Force of the Financial Accounting Standards Board (FASB) from 1987 to May 1995, and served on the FASB's Financial Accounting Standards Advisory Council from 1983 to 1986. He was chairman of the FASB Committee to Review the Emerging Issues Task Force and vice chairman of the Special Committee on Financial Reporting of the American Institute of Certified Public Accountants (AICPA). He also served on the AICPA's Accounting Standards Executive Committee from 1980 to 1983.

Mr. Sutton is a graduate of the University of Tennessee. He received a B.S. in accounting in 1962 and an M.S. in accounting in 1963.]

INTRODUCTION

Looking back over the last decade, we have seen dramatic political and economic change worldwide -- change that has created major new demands for capital and opportunities for investors. It has been a time in which U.S. capital markets have been enormously successful in attracting investors and raising low-cost capital for businesses at home and around the world.

It also has been a time characterized by calls for financial reporting to respond to an ever-broadening range of expectations. As we address those calls, I urge that we keep in focus the fundamental objectives of financial reporting and its critical role in serving the interests of investors, a focus that has been a hallmark of capital markets in the United States.

In my remarks tonight, I will attempt to sharpen that focus and discuss financial reporting in the context of the Commission's role of protecting investors. In that context, financial reporting that seeks to provide credible, decision-useful information, regardless of the range of investment objectives, helps protect investors by enabling them to make more informed decisions.

THE COMMISSION'S ROLE IN FINANCIAL REPORTING

The origins of the Securities and Exchange Commission are familiar to this audience. It was born in the wake of the greatest financial disaster the U.S. has ever experienced, the stock market crash of October 1929. Substantial investment holdings became worthless in a matter of minutes, hours, and days, and investors and the public lost confidence in the fairness of the U.S. securities markets.

One of the serious weaknesses in the system recognized at the time was that financial reporting to investors lacked credibility. In response, the Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934, which created the Commission and granted to it the authority to establish accounting principles for public companies and to prescribe the form and content of financial statements filed with the Commission. Those laws, and related rules and regulations subsequently adopted by the Commission, mandate initial and continuing disclosures that companies must make if their securities are sold to or traded by the U.S. investing public. The goal was to restore investor confidence by promoting full and fair disclosure and preventing misleading or incomplete disclosure.

Practically since its inception, the Commission has looked to the private sector to provide leadership in establishing and improving accounting principles used by public companies. The Commission's willingness to look to the private sector, however, has been with the understanding that the Commission will oversee the process and, if necessary, exercise its statutory authority to supplement, override, or otherwise amend private sector standards.

From the outset, and particularly since the formation of the Financial Accounting Standards Board in 1973, this partnership with the private sector has been exceptionally successful. It has fostered accounting and disclosure that has served well the interests of both the investing public and the companies they own.

ACCOUNTING AND INVESTOR PROTECTION

Today, however, there are so many calls for financial reporting to respond to one concern or another that, I fear, the primary goal of providing credible, decision-useful information to investors sometimes gets drowned in the clutter.

The staff often hears, for example, that accounting should reflect the intent of business decisions, and almost daily we encounter requests to accept or encourage in accounting treatment that will not deter some form of business or capital market activity that is argued to be highly desirable. This includes assertions that, if a particular accounting treatment is not allowed, it will not be possible to pursue a desired transaction or strategy. Those arguments, however, have another side. What may be "good" for selling shareholders in a particular circumstance may not be good for the buying shareholders.

Similar pleas also are heard in the context of the accounting standard-setting process. We have heard, for example, that the FASB's proposed accounting for derivatives will cause companies to forego available risk management tools and, as a result, cause those companies to be exposed to greater market risk.

When I hear this argument, I am reminded of the Board's project on accounting for health care benefits a few years ago that led to Statement 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions.* In the final stages of developing that standard, some affected interests predicted that the new accounting would cause companies to abandon their health care plans and cause countless citizens to be without much-needed benefits. That didn't happen, and I think with hindsight, most now agree that, to the contrary, improvements in the accounting brought needed attention to and consideration of the real issue, the costs of health care. With every important standard-setting project, some will object strongly to change and predict dire consequences if change is made.

To the trained ear, some of the concerns we hear today about the dire consequences of more transparent accounting are so extreme that they lack any sense of balance or acceptance of the important role of financial reporting in serving the needs of investors and our capital markets. Some are so far removed from a rational cause-and-effect relationship that they might be compared to outcries against a 55-mile-per-hour speed limit because the opponents fear that imposing such a limit could cause millions of people to be late for work.

I see nothing in the Board's derivatives accounting proposal that supports the argument that the new accounting would deter companies from engaging in the risk management activities they deem appropriate or that would be in the interests of the public owners. The new model would, however, provide investors with much-needed information about those activities and their impacts on the financial statements.

Sometimes, regulators that have diverse public policy responsibilities look at financial reporting through different eyes. Regulators of financial institutions, for example, may focus on "safety and soundness," and that focus may suggest certain biases in how transactions and events should be portrayed or what public disclosures would be considered desirable. As another example, regulators of public utilities may have policy priorities for assuring adequate supplies of energy to consumers at a reasonable cost.

Clearly, these are important public policy objectives, but they should not supplant or compromise the essential goal of financial reporting to public investors -- providing reliable, decision-useful information to shareholders and prospective shareholders. Accounting and disclosure should have no other public policy objectives than to provide the best possible financial reporting to investors that will serve as a sound basis for investment decisions. To accomplish those objectives, financial reporting must portray economic transactions and events, and economic performance, in a neutral way, without slanting the results to favor any one economic interest.

We should be wary of arguments that accounting will make or break a deal, or create or destroy a particular market, or advantage or disadvantage a particular economic interest. While accounting can be an important factor in some decisions, accounting that masks or fails to capture meaningful information for the benefit of all investors is not sound and puts investors at risk. The goal of enhancing the ability of accounting to express the story of an enterprise's financial performance in a meaningful, accurate, and consistent way for the benefit and protection of investors must remain clearly in focus.

CREDIBILITY AND INVESTOR CONFIDENCE

To accomplish the goal of protecting investors, financial reporting also must maintain a high standard of credibility. Many factors go into maintaining credibility, but one of the essential elements is independence -- certainly, independence in the process by which accounting standards are established, but, equally importantly, independence in the application and enforcement of those standards. The auditing profession, as an independent overseer of compliance with financial reporting standards, plays a crucial role in preserving the integrity of financial reporting.

The Commission's concern for the independence of the auditing function really is quite basic and straightforward. The essential public purpose of the independent audit is to build trust and confidence in our capital markets by providing comfort to investors that the information they receive from companies can be trusted to reveal what should be revealed. The Commission's perspective reflects a fundamental, underlying belief that the success of our markets, the deepest and most liquid in the world, rests on maintaining and enhancing investor confidence.

Investment decisions made in a vacuum are gambles. Informed investment decisions require decision-useful financial information, and highly reliable information is more useful to investors than information of uncertain believability. By adding credibility to the information provided by companies coming into capital markets, the auditing profession supports more informed investment decisions and, thereby, protects investors.

Maintaining investor confidence in the independence of the audit process is a more complex issue and one that gives rise to perplexing new questions for the Commission and the auditing profession with each passing year. It is an issue that has many dimensions. It is critical, of course, that information provided to investors be, in fact, reliable. But what investors believe about the reliability of the information is just as important, and therein lies the more difficult challenge.

You may be aware that the Commission and the AICPA worked together to create a new Independence Standards Board, an independent, private-sector body that is charged with addressing auditor independence issues and establishing appropriate standards for auditors of public companies. The goal is to preserve and strengthen confidence in the independent audit; the challenge to the Board is to address the difficult issues that have emerged from an increasingly complex business and professional environment. As the trends toward expanding services by the accounting profession and mergers and restructurings of accounting firms continue, the need for effective standards and guidance becomes more intense.

THE ROLE OF INTERNATIONAL ACCOUNTING STANDARDS

Another difficult challenge facing financial reporting today is the desire for more international harmony in accounting standards. As businesses needing capital and investors seeking opportunities have broadened their horizons beyond national markets, the call for more common standards to encourage efficient cross-border capital flows has been growing. Here, again, as we attempt to address these calls, we must keep our focus on the critical importance of protecting investors and maintaining investor confidence.

For the past several years, the International Organization of Securities Commissions (IOSCO), of which the SEC is a member, has been working with the International Accounting Standards Committee (IASC) on a project to develop a core set of accounting standards that could become a framework for financial reporting in cross-border securities offerings. Because the Commission will need to assess the acceptability of the core standards for use in U.S. markets, the SEC staff has been active in following the IASC project. For example, SEC staff members have attended IASC steering committee and Board meetings as IOSCO observers, and the SEC staff has provided detailed written comments on proposed standards.

Tonight, I will not comment on the status of the IASC project, or the prospects for the timing or success of the project, except to point out that the Commission's participation does not mean that it is obliged to accept the resulting product. Rather, it reflects a commitment to the goal of improving financial reporting in capital markets around the world and an undertaking to support the IASC's initiative with timely input. As has been stated many times, the acceptability of IASC standards for filings in the U.S. will be decided after the project is completed, with appropriate public input, and based on the substance of those standards and the degree to which they meet the needs and expectations of U.S. investors and capital markets.

Instead, I will comment briefly on some of the tensions that underlie the international harmonization process. At times, some of the debate and dialogue is seen as provincial bickering over whether "my way is better than your way." What underlies much of this tension, however, is much broader than preferences in accounting theory and, in some respects, reflects historical and cultural differences in the development of financial reporting and capital markets.

Recently, a financial officer at a major European industrial company commented on his perception of U.S. accounting standards and the Commission's registration and listing requirements. He said, "People at the SEC...have their rules, and when something does not comply exactly, then it's unacceptable. You may be very healthy financially, but they can't judge that unless it is set out in a particular way."

This statement suggests that, at times, the Commission may be perceived to be slavishly bound to a fixed set of rules and resistant to other points of view. It also suggests, I fear, that there may be some misunderstanding about our perspectives and our motives. Yes, we do seek rigorous interpretation and application of high quality accounting and disclosure rules. But, we do so because we believe that comparable and transparent reporting, reporting that allows individual and institutional investors to make their own evaluation of a company's financial health, protects the interests of U.S. investors.

In U.S. capital markets, investor protection is achieved not through a system of merit regulation that allows only companies that are judged to be "healthy" to offer their securities, but by a system of market regulation that seeks to assure that all who seek access to U.S. markets provide to investors transparent portrayals of the risks and opportunities involved. Underlying that approach is a strong belief that the success of U.S. capital markets is due in large measure to the high quality of the accounting and disclosure standards used by U.S. public companies.

In the final analysis, I believe that even those who view U.S. standards as being too rigid or too demanding, or as imposing too many reporting obligations on management, also recognize that there is a reason why U.S. accounting and disclosure has evolved differently from that in other countries -- and a reason for its attractiveness to capital market regulators. While other financial reporting regimes have been developed in environments that are oriented to the interests of creditors or tax policy, the U.S. system has been shaped to meet the needs of investors and capital markets. It is this orientation that differentiates the U.S. financial reporting system from those developed in many other countries.

The U.S. accounting and disclosure system supports -- indeed, makes possible -- the deep and far-reaching tradition of participation by individual investors in U.S. capital markets. The willingness of individual households to invest in stocks and bonds creates a much larger pool of investor funds in the U.S. than anywhere else in the world. As the process of harmonizing financial reporting continues, the desire to increase the access of foreign registrants to U.S. markets should not be allowed to take priority over the interests of U.S. investors.

CONCLUSION

In closing, let me emphasize the essential role that financial reporting plays in making our capital markets the most efficient and most trusted in the world. While the challenges of change and innovation surely will continue, constant and consistent nurturing of the fundamentals of our success -- decision-useful and credible financial reporting for the benefit and protection of investors -- must remain our constant priority.

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