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John C. Burton

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Corporate Financial Reporting: Ethical and Other Problems

A SYMPOSIUM

Corporate Financial Reporting: Ethical and Other Problems

Corporate Financial Reporting:

Ethical and Other Problems

A SYMPOSIUM

Sponsored by:

American Institute of Certified
Public Accountants
Financial Analysts Federation
Financial Executives Institute
Robert Morris Associates

Edited by:

John C. Burton, CPA, Ph.D.

Seaview Country Club
Absecon, New Jersey
November 17-19, 1971

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On behalf of the four sponsoring organizations

Preface

If excellence in financial reporting is to be maintained in the United States, one of the necessary ingredients is communication and coordination among the groups involved in preparing, using, and regulating financial information. Such communication must take place on a continuing informal basis as well as within an organized framework.

Recognition of this need led to a symposium which was organized and held in the fall of 1968 at Seaview, New Jersey, under the sponsorship of the four professional groups most concerned with financial reporting: the American Institute of CPAs, the Financial Analysts Federation, the Financial Executives Institute and the Robert Morris Associates. Its objective was to foster both organized and continuing informal contacts among members of these groups with the intent of improving the reporting process. The papers and proceedings of this symposium were published in 1969 under the title *Corporate Financial Reporting: Conflicts and Challenges.*

The groups and participants at the time felt that the meeting was successful in this respect, and in the years since this meeting continuing benefits have been felt. The Accounting Principles Board, for example, has broadened its consultations at an earlier stage in its decision-making process. A financial analyst has been included in its membership. There has been an increased number of joint panels and discussions at the meetings of the four sponsoring organizations, and there has been some coordination of research effort. Beyond this, personal relationships established at Seaview have been the basis for continuing informal contacts and conversations.

It would be presumptuous indeed to assert that all of the items mentioned above were the result solely of the first symposium, since many might have occurred in any case, and others required much work by many people subsequent to Seaview. Nevertheless, that meeting can be identified as a significant event in the developing cooperation among the organizations involved.

One specific outcome was the development into a continuing organization of the Symposium Steering Committee, which had originally been established to organize and supervise the first meeting. This group of eleven men, comprised of the chief professional staff members of the four organizations, held meetings every four months and served as a means by which the organizations could keep up-to-date on the activities of others and could plan various joint efforts.

In the fall of 1970, this group concluded that a second symposium should be held. A number of topics were considered and after concurrence on the part of all the groups, the topic of ethics in financial reporting was agreed upon. The Steering Committee spent many hours in the development of the program and the selection of paper and case preparers and of discussion leaders. The editor, who served as committee chairman, is deeply grateful for the invaluable help of all members of this group, both in this specific respect and for the continuing application of common sense and intellectual rigor in the process of bringing the proceedings to this form.

While all members of the Steering Committee were deeply involved in the symposium, a special note must be made of the efforts of Michael Pinto of the AICPA who coordinated the entire program and took responsibility for the hundreds of details which had to be attended to. He was aided in making physical arrangements at Seaview by Douglas Heath of the AICPA. These two men deserve the credit for the smoothness with which the meeting was handled.

In addition, Margaret Williams handled the many problems associated with the distribution of materials to participants as well as the typing of the final manuscript, and Marie Bareille of the publications staff of the AICPA showed talent and patience in dealing with a frequently delinquent editor. Without these many effective efforts, the end result would not have been possible.

Readers of these proceedings will feel on many occasions a sense of frustration resulting from the brevity with which some of the subjects discussed are covered. This is due primarily to the limited time available at the Symposium and to the fact that participants rightfully assumed considerable experience and expertise in their audience. Those readers with an interest in sharing the background of the participants and in studying the area of financial reporting in greater depth are referred to the professional journals of the sponsoring organizations: *The Journal of Accountancy,* the *Financial Analysts Journal,* the *Financial Executive* and *The Journal of Commercial Bank Lending.* Many of the subjects considered at the Symposium have been discussed at much greater length in these productive sources.

The editor must also express his own personal appreciation to the Steering Committee for their continued willingness to involve him in exciting professional activities of this sort and for their judicious application of both needling and encouragement to urge him to greater efforts.

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Graduate School of Business
Columbia University

Corporate Financial Reporting: Ethical and Other Problems

Symposium Participants

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DALE Y. FREED, Robert Morris Associates
CHARLES C. HORNBOSTEL, Financial Executives Institute
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ROBERT O. CARLSON, Public Relations Society of America
JAMES DON EDWARDS, University of Minnesota
ROBERT L. GRINAKER, University of Houston
DAVID F. HAWKINS, Harvard University
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American Institute of Certified Public Accountants

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LeRoy Layton, Main Lafrentz & Co.
Arnold I. Levine, J. K. Lasser & Company
Gordon L. Murray, Haskins & Sells
Walter J. Oliphant, Arthur Andersen & Co.
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Wallace E. Olson, Alexander Grant & Company
Stanley J. Scott, Alford, Meroney and Company
Palmer Tang, Touche Ross & Co.
Frank T. Weston, Arthur Young & Company

Financial Analysts Federation

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George S. Bissell, Massachusetts Financial Services, Inc.
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Marilyn Brown, Burnham & Co.
Arthur K. Carlson, Irving Trust Company
Robert G. Ellis, Investors Diversified Services, Inc.
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Robert T. Morgan, Wood, Gundy Securities, Ltd.
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C. Reed Parker, Duff, Anderson & Clark, Inc.
Thomas C. Pryor, White, Weld & Co.
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Charles T. McGarraugh, Northwestern National Bank
Harry S. Meily, Security Pacific National Bank
Dan W. Mitchell, Old National Bank
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Introduction

Accurate and reliable information is the cornerstone upon which an economically effective capital market is built. If such a market is to allocate capital resources among competing claimants, there must be adequate data to appraise the utility of capital in various enterprises, and there must be confidence on the part of investors and lenders that the data is accurately prepared and presented in good faith by the seekers of capital.

Corporate financial reporting in the United States is almost certainly the best in the world. Most corporate financial officers have grown up in a climate where full and fair disclosure is normal good business practice, and the reports of an overwhelming majority of publicly held corporations reflect a conscientious effort to tell the corporate story "like it is," at least within the framework of the conventional accounting model.

Despite this generally commendable record, a number of situations have arisen in recent years which give evidence of less-than-good-faith reporting, and these cases have received notoriety far out of proportion to their number. Similarly, there have been cases of less than totally professional practice in the auditing and analytical use of financial information which have been brought to public attention.

In addition, there have been criticisms of the basic accounting model and its application in some circumstances where it was not felt to describe business activities adequately, and there have been several suggestions that the historical accounting approach did not present sufficient information on which to base investment decisions.

In the light of these challenges, the four principal organizations professionally involved in corporate financial reporting concluded that a discussion of ethics in reporting would serve a useful purpose in identifying the relevant issues in this changing area and in considering them jointly.

Accordingly, leading members of the American Institute of Certified Public Accountants, the Financial Analysts Federation, the Financial Executives Institute, and the Robert Morris Associates gathered at the Seaview Country Club, Absecon, New Jersey, in mid-November for a two-day symposium. Also present were representatives of the Securities and Exchange Commission, the New York Stock Exchange, and the legal profession.

Three years ago, the same four organizations sponsored the first Seaview

symposium on conflicts and challenges in corporate financial reporting, and from that meeting came significantly improved communication among the groups.

Objectives of the Symposium

The second symposium, like the first, was not designed to produce any legislative result. No formal group report was contemplated or issued, nor should this edited transcript be viewed as a report of group conclusions. The objective of the program was to provide a forum where ideas about ethics in reporting could be discussed, and new ideas for the improved performance of the reporting process could germinate. In this connection, a number of background papers were prepared which were read by the participants in advance of the meeting. The symposium itself, after a keynote address by Dr. Clarence Walton, president of The Catholic University of America, was entirely devoted to discussion under the leadership of five discussion leaders drawn from academic ranks. Reflecting this emphasis, the volume begins with an edited transcript of the discussions, rather than with the papers. Since the papers served as background for all aspects of the meeting, it was not practical to associate specific discussions with specific papers. The meeting itself was not organized by papers, but by topics, and this approach is reflected herein. The valuable contribution of the papers was in laying ideas on the table and stimulating the thinking of the participants.

The transcript of the discussions ran to 460 pages which indicated, at least, that participants talked about ten per cent faster than at the previous symposium. The editor's task was made more difficult by the tendency of various issues to come up at various times during the two days, and accordingly a chronological organization of the discussions was impractical. In this report, therefore, the editor attempted to gather together, under major topical headings, discussions which took place at different times. In so doing, comments frequently had to be eliminated to avoid repetition, and some had to be edited to place them in context. In no case, however, was the occasionally fertile imagination of the editor used to create comments that did not exist. Only in the introduction to each section is the editorial prerogative of comment exercised.

A part of each day's discussions was devoted to consideration of a case. These two cases were written for the symposium by Professors Robert Grinaker and David Hawkins, who also led the case discussions. While these cases contributed significantly to the insights of the participants by testing their ideas against certain specific factual situations, it did not seem desirable to reproduce the transcript of the case discussions as such. Certain segments of these discussions dealt with general principles, and these are included in appropriate sections of the edited transcript. The responses to the specific situations were summarized by the editor and accompany the text of the cases.

Keynote Remarks

The stage for the discussions was challengingly set by Dr. Clarence Walton in his keynote remarks. He developed the changing philosophical views of the role of the corporation and its management in society, starting with the representationalist view which held that the management represented the stockholders and was responsible to them alone; this was the historical and legal view of the entity. In contrast, he identified the trusteeship concept which implies that a corporation holds a franchise from society and that management must therefore take a view of a larger universe that transcends stockholder interests. This latter concept, which he perceived as dominant today, has implications for both business and reporting decisions, and these were considered frequently in the discussions at the symposium.

Within this framework he also identified the essential criteria of an ethical system. These included freedom of choice, the assumption of rationality, a system of sanctions so that rewards and punishments are attached to ethical effort, and a monitoring system with the ability to exercise sanctions. These criteria also were returned to frequently in the consideration of the ethical system associated with financial reporting.

Responsibility for Reports

The first substantive ethical issue to be considered by the group was the possible conflict of interest between the decision-making role of management and the financial reporting role. In two of the background papers, authors had suggested that there was an ethical problem arising from this joint role that management plays since it could not impartially report on its own achievements. The possibility of an outside "public reporter" was considered, and the public accountant was generally felt to be the most likely to fill this role if it developed. A substantial majority of the group, however, felt that the responsibility for reporting on corporate activities should remain with management, subject to the review of the independent auditor as to the fairness of the financial statements. This conclusion was based on the ground that management reporting had largely worked well, that an outside reporter could not possibly be as fully aware of the activities of the business as could management, and that even the establishment of the public accountant as public reporter would not assure the absence of ethical conflict due to the fee relationship existing between the auditor and the corporation.

Most participants seemed to agree that altering the basic structure of responsibility for reporting would represent an overreaction, and perhaps an ineffective one, to the small number of cases in which unethical and misleading reporting had occurred. Such a solution would require a definition of who was responsible for a firm's information system and what legal responsibilities would fall on the public reporter—both difficult problems. Substantial addi-

tional reporting expense would also probably be incurred if this responsibility were turned over to an outside party, and considerable doubt was expressed as to whether any benefits gained would warrant this cost.

While there were still a few participants who believed that auditors would not have to expand their work substantially to become public reporters and that their independent professional outlook would significantly improve the quality of reporting, the majority seemed to feel that a more modest change in the outside auditor's responsibility would mend the few situations where reports failed to reflect the reality of the firm's activities. The suggestion was made that if the auditor accepted responsibility for and attested to the fairness of financial reports rather than simply their conformity with generally accepted accounting principles, most of the dramatic cases of using an accounting formula to misstate results would be eliminated.

"Fairness" and Accounting Principles

The suggestion that auditors be made responsible for fairness of statements as well as conformity to generally accepted accounting principles led to a discussion of both the definition of fairness and the definition of accounting principles. Here a major controversy arose. One part of the group essentially harked back to Dr. Walton's hypothesis that an ethical system required a dimension of freedom to be operative. From this, it was argued that the rigorous and detailed definition of accounting principles would tend to eliminate ethics from the reporting process and lead to "letter-of-the-law" reporting which would not reflect the realities of the business in some cases. This group seemed to prefer to define fairness in terms of professional judgment about the adequacy of reports in reflecting economic reality, and by implication to prefer a common law approach whereby accounting propriety would be defined through a series of case decisions about appropriate accounting under various factual situations, as compared to the Roman law approach in which a fixed code of principles would be developed with the intent of solving problems in advance through detailed proscription.

On the other hand, a significant group argued that when fairness is isolated from generally accepted accounting principles, one has nothing; without defined principles, fairness becomes a purely subjective term, not amenable either to analysis or enforcement. This group argued that the route to improved reporting was a more comprehensive and specific definition of accounting principles which would then represent fairness as generally agreed upon by an authoritative professional body.

After considerable discussion, a consensus seemed to emerge that brought together these views. It was generally felt that the definition of acceptable accounting principles was a step toward fairness of presentation, and that the comparability of various statements which resulted was part of that fairness. At the same time, it seemed to be felt by most participants that a total definition of accounting principles that would meet subjective ethical canons of

fairness was not possible due to the diversity of situations existing in the economic world. It seemed that while such a step as the definition of accounting principles by industry might be useful, there remained an overall criterion of fairness which could be applied on a common-sense basis by a professional accountant which could not be totally supplanted by any institutional or legislative means. Thus, the idea that auditors express an opinion on such overall fairness as well as conformity with established principles retained substantial support. At the same time, there was general agreement that the process of definition taking place in the Accounting Principles Board should be continued.

Timeliness and Interim Reports

This discussion led to consideration of the timeliness of disclosure and the extent to which reliance on a public reporter or increased responsibility for public accountants would delay corporate reports to the public. Financial managers felt that the potential for delay was considerable if outsiders were to have either primary or audit responsibility for interim reports. Analysts emphasized the need for reliability in quarterly reports and felt that auditors should be associated with them in some fashion even if a full audit opinion were not included. They felt, and the auditors present seemed to agree, that the acceptance of some audit responsibility for interim reports should not require large amounts of additional audit work or any substantial delay in the publication of results. No clear consensus was reached in this area.

Published Forecasts and Financial Reporting

Another major subject considered at some length in the symposium was whether or not the publication of historical financial statements constituted sufficient financial disclosure by corporations. In this connection, the group addressed itself to the comment of one of the paper preparers that one principal objective of good corporate reporting to the financial community is the minimization of surprise. There seemed to be fairly general agreement with this proposition, and its implementation led to a discussion of the role of published forecasts in financial reporting.

This topic had been discussed at the first Seaview symposium, and at that time there seemed general distrust of the whole idea. In three years a significant change in viewpoint could be detected. Among the participants, the analysts seemed generally in agreement that public forecasting was an idea whose time had come, while corporate executives, although not agreeing that regular published forecasts were the right answer, did concur that financial management had a responsibility to avoid surprises and that the publication of explicit forecasts might be one of the ways of meeting this responsibil-

ity. Several executives, however, preferred the approach of giving assistance to analysts so that their forecasts were not too far away from reality as currently perceived by the corporation.

There was considerable debate as to the appropriate form for forecasted financial data. Some people seemed to advocate a full set of projected financial statements for a period of time into the future, while others suggested a more general forecast of a range of earnings per share and the identification of the crucial events which management anticipated would occur in subsequent periods.

There was considerable dismay expressed over the potential legal liabilities that might accrue in any scheme requiring the publication of explicit forecasts as a regular part of financial reporting. In this connection, Commissioner James Needham of the Securities and Exchange Commission commented that the Commission was re-thinking its historical opposition to the publication of forecasts in registration statements and other published documents. He also indicated that he recognized that consideration of the problems of liability was an important part of the re-thinking of this and other proposed adjustments in financial reporting.

There was some discussion as well regarding the role of the auditor in corporate forecasts, and the British experience was referred to in which the auditor does associate himself with forecasts but does not take responsibility for the assumptions on which they are based. Auditors indicated that they were thinking seriously about their possible role in this area, but there seemed to be no strong sentiment among the group that an auditor's attestation would add significantly to the reliability of a forecast.

While it was apparent from the discussion that total agreement was far from being achieved on the subject of published forecasts, there was considerably greater feeling in favor of some form of forecasting than had existed three years before. In considering appropriate steps to take to build on the discussion at Seaview, there was general agreement that one logical step was to pursue the forecasting issue in a systematic fashion at a subsequent meeting of representatives of the four sponsoring organizations. Such a meeting might be charged with the responsibility of developing recommendations for the SEC and the public as to the forms public forecasting might take and the risks associated with it, including the problems of competitive disadvantage, legal liability, and behavioral constraints on management which were touched on at the symposium.

Development of Increased Professionalism

The papers and the discussions at Seaview also urged the development of increased professionalism both in the preparation and use of financial reports. It was agreed that professional competence in both areas was an important part of the ethical system covering financial reporting, since the basic

qualities of honesty and integrity must be placed in an appropriate setting if they are to be operationally effective.

In this connection, it was noted that the AICPA Code of Ethics requires members to adhere to technical standards and a proposed revision of it greatly expands these requirements. The current codes of ethics of the Financial Analysts Federation and the Robert Morris Associates tend to emphasize relationships among members rather than professional competence. It was felt that all three codes might well be supplemented to include definitions of professional objectives and some statements that would define the parameters of competence in each professional area. In addition, standards of performance in the demonstration of competence might be articulated in the codes so that an inadequate effort could be identified and criticized.

It was also observed that at this time the Financial Executives Institute did not have a published code of ethics, although representatives of that organization said that one was under consideration. The feeling was expressed that the FEI and the other groups might well consider the development of an ethical code covering all corporate reporting which would be promulgated both to the professionals in the area and to the chief executive officers of corporations who are ultimately responsible for the reports of their enterprises. This code would not replace the codes of individual organizations since they have more than one purpose and specialized interest to consider, but it would blend their joint professional competence in the reporting process.

A Surveillance System

A final area related to professionalism that received considerable attention was suggested by the keynote speaker's reference to the need for sanctions and a monitoring system in connection with any ethical system. The group discussed at some length the need for additional surveillance over ethical practice in financial reporting. Concern was expressed that the temptation to indulge in unethical conduct tended to be inversely related to corporate size and success, and it was felt that any surveillance system would have to include the entire range of public reporting corporations. On the user side, examples of unprofessional use of financial reports would also be difficult to detect.

There was also considerable discussion related to the distinction between ethical and legal standards for defining good practice in the reporting sphere. Some participants felt that only through the development of legal standards and enforcement through the legal process could sound ethical practice be satisfactorily achieved. They pointed out that once ethical standards became norms they would be applied by the courts and would become part of the legal structure of the reporting environment. Recent cases and decisions have supported the view that where professional standards lag behind public expectations, the latter may serve as the basis for determining both legal liability

and ethical judgments as to what represents the proper course of action.

Those who declined to rely solely upon legal sanctions and the regulatory surveillance system now in existence indicated that they felt a need for an institutional vehicle by which users of financial statements could complain about what they consider to be unethical practice. It was agreed that the accounting profession's institution of practice review had not been effective in this area and several analysts believed that there should be some means by which reports that met technical standards, but not ethical standards of completeness and economic accuracy, could be brought to the public's attention. The Financial Analysts Federation's current procedure of presenting an award to good annual reports was seen as a step in the right direction, but a need was also felt for applying sanctions to inadequate reporting as well. Symposium participants seemed sympathetic to this idea, but there were no concrete suggestions for the institutionalization of a complaint mechanism, such as a review body or a professional ombudsman. It was pointed out that at the present time many such reporting deficiencies are brought to the attention of the public through the press, particularly by a few reporters who regularly mention accounting matters in their columns.

Suggestions for the Future

At the conclusion of the symposium, there was general agreement among the participants that it had been successful in achieving its objectives. Several suggestions were made for the continuation of the communication process among groups. One of these advocated the creation of a Council on Corporate Reporting constituted of four to six representatives of each of the sponsoring organizations which would meet on a continuing basis to discuss general and specific issues and to make recommendations. Another suggestion was for more frequent symposiums devoted to more specific topics. The consideration of these and other ideas was left to the Symposium Steering Committee for the development of recommendations as to further activities.

Commissioner Needham gave the symposium a charge for future action when he indicated a general recognition of a desire for change in financial reporting and the need for the organizations both to define their respective roles in the process of change and to commit themselves to assume responsibility for a higher level of conduct in day-to-day business affairs. He urged the groups not to wait two or three years for their next symposium, and stated the interest of the SEC in specific recommendations that might arise from this or other joint efforts, since he felt that the private sector really has a better capacity than government for dealing with problems of the sort discussed at Seaview.

As was apparent from the objectives of the symposium, its success must be measured not in terms of the specific output but in terms of what follows. The final measure of value must await continuing steps for the structuring of continuity and change in corporate financial reporting.

1

Symposium Discussions

Responsibility for Reports

Management has traditionally had the principal legal and ethical responsibility for reports on the activities of the business which it controls. There have been some observers, including Professor Douglas Hayes in his paper, who have raised the question as to whether this arrangement creates an ethical problem of conflict of interest between the responsibility for operating a business and that of reporting on its activities.

In the discussions that follow, it is clear that this ethical problem is not solved, but at the same time, there are major questions as to the competence of others to serve as public reporters without the depth of background and knowledge of the business which management possesses. In addition, it is pointed out that the conflict of interest problem is not really solved by having public accountants, paid by management, as reporters, and other alternatives are not readily available.

While disagreements remain, there seems to be a consensus that the system of reporting by management, attestation by auditors, and analyses by analysts has not worked badly except in a very limited number of cases. It seems to be felt that if auditors were to attest to something beyond concurrence with a formula called generally accepted accounting principles, and if analysts could improve and perhaps institutionalize their surveillance over the reporting process to bring to light dubious practices, the present basic system of responsibilities might prove better than any reasonable alternative in view at this time.

Discussion

DISCUSSION LEADER: It has been suggested in one paper that there is a basic conflict of interest between management's responsibilities for operating the business and its responsibility for reporting thereon. First we have to consider whether this is a basic conflict, and if so, then we must look to whether it should be resolved by changing the basic responsibility for reporting.

ANALYST: I don't think there is any question whatsoever but that the conflict exists. Doug Hayes has cited some reasons for it in his paper. In the final analysis, one of the basic missions of management is to minimize the cost of capital. Where there are alternative reporting methods available, they have the responsibility to select the one which would be most favorably re-

ceived by investors and creditors and hence facilitiate the attraction of both debt and equity capital.

If they do not do this, they are not performing the function that their shareholders have appointed them to. I don't see any way around this kind of a conflict of interest, because there will be times when managements are forced to choose between public responsibility and shareholder responsibility at a point where these two are in conflict.

FINANCIAL EXECUTIVE: I wonder if this conflict is really so clear. I think that most companies report in a responsible way because they have found that in the long run this kind of reporting is just plain good business. It is better business than looking for the highest short-term presentation: "Fast-buck" shenanigans don't pay off.

DISCUSSION LEADER: Is it sufficient to rely on managements, some of whose interests are intensely short-run, to be guided by such long-run considerations? Wouldn't it be safer simply to assign reporting responsibility to some outside party?

FINANCIAL EXECUTIVE: I doubt that anybody outside a company is able to write an annual report or to adequately tell the investing public what the problems of that company are, or what progress it is making. No one else can do it.

As close as the public accountant might be—and they are often very close—I don't think that he could tell the "story" of the company. They now attest to the financial statements, and that is their responsibility.

ANALYST: I would judge that more annual reports are written by outsiders than by insiders. This is what the existence of the financial public relations industry is based on. I would question whether management is the only one that can tell the "story."

FINANCIAL EXECUTIVE: I think you have to be more definitive when you say that the annual report is prepared by an outsider. The president's letter is prepared, generally speaking, by the chief executive. When you get into the theme of the report, there may be assistance from a public relations firm.

FINANCIAL EXECUTIVE: Isn't the real question who is the provider of the factual input? Having an outsider dress up your language for you so that it communicates better doesn't change the fact input that you are dealing with in the first place.

FINANCIAL EXECUTIVE: In a good many fields of endeavor in this world, ghost-writers are used—not the least in politics. Whether a person is sufficiently articulate in the written word to put a series of letters and words together better than someone else has nothing to do with responsibility for the content. Whether the financial public relations field is flourishing, therefore, has nothing to do with the responsibility for the written word in the annual report.

The content, the thrust, the theme, the disclosures are the responsibility of management, regardless of whether a PR firm is used or not; that is the important thing. I also do not think there is any way the responsibility for

words of the report can be divorced from the financial statements; judgments as to what is significant must be reflected in both.

DISCUSSION LEADER: Perhaps the public reporter should report, and then let the management explain what it perceives to be most significant. In this way you will have a set of financial data which is presented by a public reporter who identifies these as the best that can be presented in his professional, external, independent judgment, but management will retain responsibility for interpretation.

FINANCIAL EXECUTIVE: Right now the management presents the data; the accountant testifies as to its acceptability; and then the financial analyst interprets it. He criticizes, condemns, and does everything else in the course of either accepting or not accepting what the management says. To put the public accountant between the financial analyst and the management of the company is to make everyone's task harder.

FINANCIAL EXECUTIVE: My first reaction is certainly negative, but I'm willing to explore how you would do this. How far would you have a third party's responsibility go? Would he be responsible for maintaining the underlying data that you are going to use to report to the public?

There are decisions made all through the year that have to go through the books. Does he have to run all the accounting departments in the country? And, if he reports to the public, who, then, is going to audit his work? Are we going to have a reporting group and auditors to audit the auditors? Where do we stop?

DISCUSSION LEADER: I don't want to take the position of an advocate since my mind is not made up on the desirability of third-party reporting, but let me offer a hypothesis as to how it might go.

Today, the auditor has responsibility for reviewing the adequacy of his client's information system and internal controls. As a public reporter, he would not change this part of his role. The basic data would still be maintained by the corporation, and the auditor would have to satisfy himself that the output of the system is mechanically accurate. Then the public reporter would use this basic data to report on the operations of the firm. Perhaps the public accountant will be the public reporter, or perhaps this role should be assigned to chartered financial analysts, to a totally new cadre of experts, or to a public accountant different than the one who audits the information system.

CPA: One financial executive implied that all management reports are complete, but I think history will show that many management reports are *in*complete.

Who is going to be the monitor of those management reports that lack real, substantive content? I think this is a serious issue.

FINANCIAL EXECUTIVE: I think, in general, reports from management are basically complete. It is an unusual organization that does not want to report completely.

Let me turn to another question which would arise if we asked auditors to expand their function. Suppose we have a plant coming on stream and we report this in our annual report. What could our public accountants do to improve disclosure about the capabilities of that particular plant? Do they have as much competence as management to evaluate the benefit of that particular new plant, what its capacity is and what its effect will be on our organization?

CPA: I agree that the public reporter might have to do a lot more work than we do now, but auditors are today evaluating your company's conclusions in writing off start-up costs and estimating the life of the plant and setting unit-of-production statistics.

There would be some extension of the work, certainly, and possibly a lot more subjective decisions, but I don't think it's as hard as you make it out to be. It would be a fascinating task.

Financial Executive: I would submit that the public accountant is not competent to talk about the quality and the capabilities of the management, because the public accountant, by definition, has had his education, his training, in a relatively narrow field of the business endeavor, and there is no reason to think that a man who has been thus schooled is competent to evaluate a marketing executive, or a manufacturing executive, or a chief executive. Perhaps he can evaluate the financial officer, but beyond that field I don't think the public accountant has competence.

CPA: That's why it's going to take us ten years to do it.

Financial Executive: I don't know who is going to pay that bill to make you competent.

Financial Executive: I think that most companies today give their public accountants an opportunity to review the president's letter and the text of the report, comment on it, and recommend changes. So there is much joint effort on the part of management and their public accounting firm in the reporting process. There is a lot more cooperation than conflict.

Analyst: Since so much of this is already being done, it shouldn't be much of an adjustment for the proxy rules to be changed to make the accountants responsible for everything in the annual report.

Financial Executive: I would say that there is an overwhelming gap between the knowledge of the public accountant about the financial statements and about future projects and nonaccounting items in the body of the report. Some of them, perhaps, would lend themselves to certification, but the basic nature of what management says in the body of the report about what is going on in the business is quite far removed from the historical financial statements. My company, for one, would not like to pay the bill for having an accountant familiarize himself sufficiently with our business so that he could certify the annual report.

CPA: CPAs are having enough trouble with the current attest function. I don't think we should worry about extending what we are doing. What we must do is to see what ethical constraints can be added or improved upon in

what we are already doing. We have not reached any kind of perfection in our current role. How can we push forward to try to attest to the competency of management or the quality of the products they are producing?

FINANCIAL EXECUTIVE: I agree. If the accountant is to be required to be responsible for the complete annual report and for reporting on management, the expertise required of him is going to include the fields of engineering, sales, purchasing, and many others. Even beyond the need for such expertise, we cannot hope that the accountant could be sufficiently acquainted with everything that goes on from day to day. To do this job, he would have to be an overall expert in every field, and he would have to take part in day-to-day operations as they occur. I don't think it's possible.

CPA: I have two comments. First, I reject the suggestion that CPAs are simply experts in accounting and accounting principles and not aware of the business as a whole. We have to be—and we are—involved in the general economic aspects of the business as they relate to the background of what's being developed in the financial statements. Without that background, you can't do a good job of auditing in the first place.

On the other hand, I agree that CPAs are not generally equipped to come in and be appraisers of management, outside of the financial area where we have constant exposure. There is nobody who can be all things to all people. We and management have different roles to fill, but we can contribute to each other.

CPA: It seems obvious to me that the auditor is not in a position to express opinions about the quality of the management, as such, in the present circumstances; it also seems that the input for the financial report has to come from management in the first instance.

This does not solve the question of responsibility, but I think this question would lose much of its significance if the auditor accepted the responsibility of expressing an opinion on the fairness of the financial statements. If, in fact, he puts himself on the line for the fairness of the statements, I think the public is getting what is needed.

CPA: One middle ground might be to have the accountants assume primary responsibility for only that portion of the report which relates to the application of accounting principles. The responsibility for underlying data and other facts and assertions would remain as at present.

FINANCIAL EXECUTIVE: Implicit in many of the remarks that have gone before us is that there is no conflict on the part of the public accountants like the conflict that management has. But the fee relationship is a very fundamental conflict here. How do we eliminate conflicts of interest by merely transferring this responsibility to the public accountant?

BANKER: As a user of financial statements, I would like to feel that I can continue to look to the management of the company to tell me what is going on, and that I could believe what he said after having worked with him over a period of time and judged his character. I would prefer to be able to talk to him and not have to feel that I had to go to the accountant to get the facts

about the company, its projections, how it was going to operate, and what its game plan was.

I think the accountants certainly have a very important role to play, but I think we are downgrading the competence and the integrity of management when we talk about the auditors as the principal reporters of corporate results.

BANKER: In one way, what we are saying is that we are going to implement a very complicated and cumbersome system of review to isolate a very small amount of unethical conduct. Since whatever individuals that assume this responsibility will also be human beings, there undoubtedly will still be some of them who do not achieve ethical perfection. And so you haven't solved the problem. Indeed, you have made it worse.

DISCUSSION LEADER: I sense from this discussion that there is some concern about the conflict of interests that exists when management reports on its own activities, particularly because those relatively few cases where management does not report properly assume an importance that is out of proportion to their numbers. On the other hand, there is no agreement that designating an auditor or anyone else as a public reporter would solve the problem. There seems a greater inclination to stay with the present system of basic responsibilities while perhaps increasing that of the auditor to include as part of his report an opinion on overall fairness of presentation as well as congruence with generally accepted accounting principles.

Fairness in Financial Reporting

Throughout the symposium, there was continued discussion of the concept of fairness in financial reporting. Several issues were discussed in this regard.

In the first place, a number of the participants were clearly concerned with the thrust of recent court decisions which established a principle of fairness as taking precedence over generally accepted practice when the two came into conflict. One part of the group felt that the appropriate response to these cases was to increase the degree of definition of accounting principles, while others felt that it would be better to assign to management and the auditors a responsibility for fairness above the simple application of rules.

From this, the group was led to a general discussion of whether codification of rules led to greater fairness or whether it might hamper the application of ethical canons of fairness by encouraging a letter-of-the-law kind of thinking. The problem of developing standards for fairness in a general sense was identified, as were the difficulties of applying fairness to new business situations where there was little experience with the realities of the business situation.

It was noted that the courts and regulatory agencies might make law out of the ethical concept of fairness through case decisions, and it was suggested that perhaps the corporate, analytical, and accounting communities should establish some means by which reporting fairness could be appraised before the fact on a case-by-case basis.

The discussion indicates the difficulty which participants feel exists in the definition and application of an ethical standard of fairness, but at the same time, a feeling seems to emerge that something more than specifically defined accounting procedures is needed.

Discussion

DISCUSSION LEADER: A number of recent legal cases have raised questions about the adequacy of financial statements, even though they were presented in conformity with generally accepted accounting principles. Does this mean we should look beyond general acceptability as defined by the Accounting Principles Board in evaluating both the legal and ethical responsibility of accountants and financial executives?

CPA: I would like to ask a question of one of the lawyers present. In the *Continental Vending* case that has brought the problem of liability most conspicuously before us, the key question was one of disclosure rather than one of accounting principles, and our rules on disclosure are simply that the financial statements shall adequately disclose all necessary information; that's a fairly subjective determination.

My question is whether, if we were dealing with a matter of principle—that is, whether an asset should be carried at cost, or cost or market, or whether amortization should be over a certain period—would the jury have felt as free to come to a conclusion in opposition to the professional posture on the subject?

ATTORNEY: What you are asking is whether you would have had the same result if you had a rule that was clearly set forth. I would rather doubt it in that case; but by the same token, I think it's implicit in the case that if the evidence is that the application of a fixed rule would result in something less than fair disclosure, you might end up with the same result.

There is another recent case where it appeared that there had been adequate compliance with generally accepted accounting principles, but nevertheless the court felt that the statement of one long-term investment was misleading because it was carried at a once written down figure from the cost of the asset. The court felt that, in view of the circumstances that existed at the time of the publication of the financial statements, it should have been written down again.

Therefore, I don't think you can say as a flat statement that if there is a clear-cut rule which is the basis upon which an item is carried on the balance sheet or income statement, the rule automatically relieves the possibility of liability, if it can be shown that it is not consistent with a fair presentation.

From these decisions there has been created a general overlay of fairness which indicates that you have to look past accounting principles and accounting rules to find out whether fairness is served.

CPA: Would you then discard the terminology "generally accepted accounting principles"?

ATTORNEY: No, I think there has to be something like that, whatever you call it. There have to be guidelines, and the effort of the APB, of course, is to narrow those guidelines, make them more precise.

Whether the precision of the rule-making effort will ever result in a situation where you can apply the rules and not be concerned about this overview of fairness, I don't know; but I would think there would always have to be some guidelines as a starting point.

The principle laid down in the *Continental Vending* case was that defined principles are useful tools. The Court said that a presumption of fair presentation is created if you have complied with generally accepted accounting principles, but it's not a conclusive presumption in every case.

CPA: I am concerned with this idea of separating fairness from generally accepted accounting principles. It seems to me that we ought to be con-

cerned with making the rules covering accounting principles fair. If the rules are fair, the application of the rules is going to result in something that is fair, and if it doesn't in some circumstances, we will change the rules and learn to make the rules better. But this vague notion of fairness seems to me to be rather frightening.

ATTORNEY: My concern is whether you ever can get the generally accepted accounting principles defined with such precision and in such detail that you never have to be concerned whether the application of those rules would result in a fair presentation.

The standard form of certificate speaks of "fairly stated in accordance with generally accepted accounting principles." I think what the Court was doing in the *Continental Vending* case was going beyond this and saying that it had to represent two assurances: first, that generally accepted accounting principles were followed, and second, that the auditor had made an independent determination of fairness. The CPA was not home free with only the first assurance, despite the fact that there was a strong presumption that the matter was fairly stated.

CPA: I think it is very disturbing to the profession if that language holds up, because it's a whole new ball game.

FINANCIAL EXECUTIVE: I'd like to make an observation on this point of separating accounting principles from the question of fairness. I think that all managements take a stand regarding the fairness of their presentation when they publish financial statements, and in that sense management is way ahead of the accountants with respect to taking a position and having a willingness to accept responsibility for fairness.

CPA: Let me ask a question about that comment. Suppose there is a large item of goodwill required under generally accepted accounting principles which management personally believes shouldn't be on the balance sheet at all. You still have to put it on the balance sheet.

FINANCIAL EXECUTIVE: You are stating that responsible corporate management will publish what they believe to be misleading financial statements, and I can't accept that.

CPA: But take the situation I have cited. If this particular management happened to feel the presentation was unfair, and yet it was required under generally accepted accounting principles, what will they say about it?

FINANCIAL EXECUTIVE: They can say a lot about it. They can say that they are publishing financial statements that are not a fair presentation of the condition of their company, but their auditors require them to do so.

CPA: Turning to the practical question of whether it would have a beneficial effect if fairness and generally accepted accounting principles were two separate things that the accounting profession had to deal with, I believe it would have a salutary effect, even though it would be bad from a liability standpoint.

If anyone has to take the blame for not keeping in bounds the "go-go boys" or those who used accounting gimmicks which don't reflect business

reality but are within the confines of generally accepted accounting principles, I believe it has to be the accounting profession. We were in a position to do something about the problem, and we should have done so. I don't think any set of rules, no matter how broadly based or how finely written, are going to absolve our profession from calling a spade a spade when generally accepted accounting principles are used to create profits not produced by business operations.

CPA: My favorite solution to this problem is that generally accepted accounting principle number one should be that the financial statements be fair and not misleading. This would widen our liability, but it would increase the value of our service.

FINANCIAL EXECUTIVE: I would like to pursue this question of how any increase in legal liability can be created by reason of the separation of the two concepts. I think the management of the corporation does represent that the statements are a fair presentation, and also that they are in accord with generally accepted accounting principles. Since management is already responsible for that, I don't see why liability is increased by making such a statement explicitly.

ATTORNEY: I think that question leads us to a consideration of the distinction between ethics and law, and what's happening to that distinction. When you move an ethical responsibility into a sanction system, you have ceased to have an ethical principle. You now have a legal duty for neglect of which somebody can suffer detriment or harm.

Historically, it has been found that ethical standards are really inadequate protection for society, with the result that more of the things that have been regarded as ethical principles and responsibilities have become sanctioned by law and become legal responsibilities.

The "fairness" that we have been talking about is a good example. "Fair" isn't a legal category. "Fair" is an ethical category; yet *legal* responsibilities are now being attached to a failure to be fair.

You have the same thing in the case of the constitution of the National Association of Securities Dealers. It says that the members shall conduct themselves in accordance with just and equitable principles of trade. Well, just and equitable principles of trade to me is an ethical concept, and yet people are being put out of the securities business because they are not complying with just and equitable principles of trade.

CPA: Isn't "fairness" a terribly difficult standard to apply? Take the oil industry, for example; some oil companies show oil reserves in their statements and others do not. Some companies use a full costing approach for their producing property while others use the individual well or lease as their property unit. Companies in both these categories honestly feel that they are being fair. Is it possible for both to be fair when significantly different statements result?

CPA: It boils down to the fact that when you isolate fairness from generally accepted accounting principles, you have absolutely no standards

whatever. There is absolutely no such thing as a standard of fairness in accounting apart from generally accepted accounting principles. Without generally accepted accounting principles you are cut adrift in any attempt to determine fairness. That's purely a subjective term when you remove it from the accounting sphere which is what's being attempted here. I don't think you have such a thing as an isolated standard of fairness.

ANALYST: It may be difficult to define what fairness is, but I believe it is possible to look at some situations and conclude that the presentation is not fair. Let me cite an example of a real, live company, the Allis-Chalmers Company.

During 1970 the management of the company generally let it be known in the financial community that the earnings would be $1.50 a share. Came September and the third quarter report, they were still letting the $1.50 sit out there, but they did mention in the third quarter report that there would be an accounting change made when the annual report came along, and it would affect the earnings by about $.09 a share.

Nothing more happened until mid-December. In mid-December, the Chief Executive Officer had an interview with the press and said: "I know we have been talking about that $1.50 a share and we're terribly sorry—it's not going to work out that way. It's going to be $1.20 a share."

So he corrected his forecast in plenty of time, and nothing more happened, and in the early February before statements for the year were released a three-plus million share transaction in Allis-Chalmers stock took place on the New York Stock Exchange, at a price of 17 or 18 a share.

Three or four or five days later the annual statement was released to the press. What do you suppose the earnings were? The earnings per share were exactly $1.20, with four accounting changes raising the earnings by $.41 a share.

If you looked at each one of those accounting changes, they were perfectly respectable. You could agree with each one of them. They were appropriate. They put in a computer out in the finance subsidiary, so now you could account on an individual account basis. Fine!

The Hydroturbine Division had never previously got around to putting in accounting for long-term contracts on a percentage-of-completion basis like the competitors did. Great!

But what happened to that company and its stock and the credibility of its management? The stock dropped below 12. Was the statement "fair"? It was certainly acceptable. That's real life.

DISCUSSION LEADER: This seems to lead us to the question of whether the specific definition of accounting principles does lead in some respects to unethical reporting by giving a shield behind which people who wish to be unethical can be so, meeting the letter of the law, but not the spirit.

Does this situation exist? Is this something that will become more dangerous if the Accounting Principles Board follows along its way of specifying, in increasing detail, what accounting principles are?

ANALYST: I think that the earlier discussions have indicated that you can stay within generally accepted principles and still be somewhat unethical.

Without trying to place blame, I think there has been a lowering of ethics in the accounting-reporting area coming about as a result of the "performance" orientation of the mid-sixties, forced partly by money managers and partly by the public.

The accounting profession has not come up with any real standards that solve this problem, nor have the financial analysts or the financial executives.

I think that there is a real conflict of interest built into different goals and needs of managements, accountants, and perhaps even of analysts that requires some standards beyond accounting principles to bring the level up to where it was before people started using creative accounting and reporting to enhance stock values.

CPA: There has been some movement in that direction through the establishment of audit committees, which is a very sound move. That isn't the whole answer, and it needs improvement because even audit committees in some cases do not really understand what their function should most appropriately be.

FINANCIAL EXECUTIVE: I think it can be said that the credibility of corporate reporting has been damaged by events of the last few years, and this has had a detrimental effect both on business and the accounting profession. Perhaps our biggest problems in reporting have occurred in three relatively new situations which have come into being within the last five years—franchising, leasing, and land development.

When these companies and divisions sprang to life, the corporations themselves were not prepared to handle the accounting problems they created; neither were the public accounting profession, the SEC, or the Wall Street analysts. As a result we have had some very unusual financial and analytical reports, and some price/earnings ratios have gone out of line.

This development put a stigma on all reports and has come back to plague the companies, their auditors, and the analysts.

ANALYST: Doesn't this demonstrate the shortcomings of trying to write specific rules and regulations? There were and could be no rules and regulations sufficient to deal with these new businesses prior to the time they first had to report to the public.

If the accountants had been asked to attest to the fairness of these statements, perhaps they would have come up with a different set of standards a lot earlier.

DISCUSSION LEADER: Now we come back to the CPA who said: "What is fairness if it's not defined?"

CPA: I think that when the innovative situation arises, we *do* start with the basic fairness, but it's a matter of opinion what fairness in a given situation is.

As a profession, we have to react more quickly to such situations, and we are moving in that direction with the APB interpretations that are being

issued, as well as with greater rapidity in the issuance of Opinions. Even though we may start with fairness, the fact is that opinions will differ as to what fairness is in any situation, and we can't take a broad principle such as fairness and think it's going to work effectively in reporting, because it won't.

PROFESSOR: Rather than defining accounting principles in general, shouldn't we think about establishing a body that will respond to particular situations as they arise, either upon the application of interested parties or on that body's own initiative? If fairness is a subjective judgment, shouldn't a body of really independent professionals make that judgment based on the facts of a particular case rather than leaving the judgment to the management or the auditors in the case where no specified principles exist? This is an alternative to attempting to codify everything at once.

FINANCIAL EXECUTIVE: I'd like to point out one thing that I think is apropos and that particularly applies to these new situations. Charges of unfair presentation and implications of unethical presentation frequently are made in retrospect. They have to do with situations that had no precedent, such as land development companies. In the beginning a lot of these land development companies were presenting these sales when there was only a two per cent down payment.

If, in fact, most of these purchases had been completed, this accounting would have been an accepted practice today, but because many of them are not, it has turned out to be unacceptable. Today most companies do not report sales unless a seven or nine per cent down payment is received.

Now we look back and say management might be called unethical or unfair, but perhaps they really believed they had made sales, and they felt that they were reporting properly. What guidance did they have beyond their own convictions or expectations?

FINANCIAL EXECUTIVE: I'd like to throw a question at the analysts about their own performance in dealing with such companies. There were substantial companies with a record of growth which carried a normal price/earnings ratio at that time. Then we had franchising companies and leasing companies and land development companies; they were carrying exorbitant P/E ratios and were still being underwritten by substantial firms and recommended by many analysts. How can you put a 60, 70, 80 P/E ratio on a situation that may not have ever shown any cash inflow at all, but a prospective income over the next three, four, or five years? These are the situations that reflect on the ethics, integrity, and professional judgment of everyone involved.

ANALYST: You look at what is reported, and see a growth curve that looks like one side of the Matterhorn. The companies had sales, earnings, and a beautiful growth rate. The earnings statement looks respectable, and a lot of people haven't recognized the problem that's really involved in recognition of income and expense. That is how the multiples happen.

ANALYST: There were a number of analysts who went through the reports of such companies and saw that it was quite evident that what you were

reading was pure fiction, because if you looked at the amounts of money actually flowing into and out of the company there was a net outflow. And a lot of analysts didn't recommend such companies.

ANALYST: This is a very hot potato, really. What should you do about those companies whose reports you have read which you feel are "bad" from a reporting sense? Not that their statements do not fall under the umbrella of general acceptability, but where earnings are raised in the accounting department rather than by operations.

Should the analyst write a report on such a company indicating that they are using something which is proper according to the principles but improper according to the intent? This is a very difficult thing, because analysts don't get much credit for writing memos which tear apart a company. Perhaps we should view ourselves as being in the education business, and such reports are a fulfillment of that part of our responsibility.

PROFESSOR: Even when reports are written which raise the issue that something in the accounting statements doesn't look right, the question normally raised by the writer of this report is whether other people will notice the deficiency and thus affect the market price.

In other words, the analyst is taking the very cynical view that if a problem is well enough hidden it is OK. He's not dealing with a normative concept as to whether this company is indeed following practices which should be recommended for permanent investment, but he's taking a purely pragmatic course: Will the thing work or not?

The analyst should do a much better job here. He should tell what is going on and recognize that it reflects upon the potentials of the company, because any company that does not level with their investing public should be viewed with extreme caution. If analysts merely ask whether the company can get away with it, their reports are as unethical as those of the company.

ANALYST: Perhaps what is really needed in these cases is an early warning system by which a review function is established to perceive danger areas in accounting, analyze them, and then disseminate the information.

ANALYST: I think it is clear that a lot of the consuming public of financial statements is unaware of the possible unreliability of generally accepted accounting principles in some situations. Perhaps one solution to this ethical problem would be to follow the practice that certain government agencies have adopted in required labeling practice. Perhaps the accountant's statement should include the warning: "Undiscriminating acceptance of generally accepted accounting principles may be injurious to your financial health." I am only being partly facetious!

ANALYST: New problems are always coming along one after another, and I believe that when we are in a new or uncharted area, a lot of these problems would be solved if we simply determined, when in doubt, to take the conservative side in reporting.

Managements of companies in development situations in order to get more capital have a natural bias to be optimistic, and it seems to me that the

accountant should therefore take the more conservative side, whatever that may be in a particular case. This wouldn't solve all problems, but many of them wouldn't develop to the extent that they have.

FINANCIAL EXECUTIVE: And yet a company is criticized if it holds earnings back for a future period by setting up reserves through one technique or another. So we're damned if we are conservative, and we're damned if we're not.

ATTORNEY: I would suggest that one of the problems here is that disclosure isn't carried far enough, and that a little bit more can go a long way. One of the things that the FEI has recently proposed is that where there are choices of the application of accounting principles, the alternatives be set forth. That, I think, is a very significant extension of disclosure.

It seems to me that the format of financial statements has become ritualized; an extension of disclosure would go a long way toward solving our problem. At the present time, we live with a narrow set of standards for the information that goes into the financial statements. Perhaps we shouldn't even be satisfied with a simple income statement and balance sheet for a given period.

At the present time, the accounting profession is left in a weak position when confronted by strong client pressure. As long as there are a multiplicity of accounting principles, as long as it is permissible to make changes by some standard—and the recent tightening of that standard is a major advance—the auditor is in a very difficult spot which I don't envy. His client says, "We don't have to do it the way we did it last year. We can do it this way."

And what does the auditor say? If it's a generally accepted accounting principle, he says: "Yes, you're right, you can do it that way. Now, of course from the standpoint of consistency I'll have to say you have made a change; but, yes, you can do it."

So if the client runs through three or four of these changes, what does the auditor do? The only thing he can say is that each one of these individually is a generally accepted accounting principle, "Taking them together, you distort the results, and it's an unfair presentation, and I quit." And that's a damned hard thing to do, because the auditor is not in a position where he is relying upon anything more objective than his own instinctive fairness, which, as I think everybody agrees, is a very difficult standard to go by.

This problem, of course, doesn't just relate to changes but also to the selection of new principles when new operations are started. The profession has recently taken steps which make it tougher to make changes and to improve disclosure. But a relatively small additional advance would improve the situation further, and you should strive for it. You could then say to the client: "Go ahead and do it, but the rules of my profession require that I tell the public in a very obvious way that if you had used a different principle, here is how the results would look, or if you had done it the way you did it last year, your earnings would only be so-and-so."

If the auditor did something like that he would take away a lot of the

benefits that management thinks accrue to it by opting for principles that are most favorable. If you set up a standard by which there is disclosure in addition to that appearing in the footnotes and the opinion today, you have taken a very simple but a very significant stride in the direction of making it very tough for management to manage earnings in the fashion in which they have been capable of doing.

COMMISSIONER NEEDHAM: I think we have to put this matter in perspective. Let me tell you what our experience is.

We have 8,000 issuers filing with us every year a variety of documents, and if 50 out of 8,000 present an accounting problem, it's a lot. If the problems were of the magnitude that some writers would have us believe, the whole mechanism of the Securities Act would break down.

I do feel that we recognized at the Commission that as more people talked about the conflict between auditor and client, it seemed to become truer and truer just by the repetition. The amendments we made to Form 8K were designed to create an atmosphere for discussion of very difficult accounting problems, and at the same time, to retain an atmosphere of independence for the accountant and to give him some firmness in dealing with his clients by requiring disclosure if his engagement were terminated over an accounting dispute.

But on the other hand, this new requirement of notifying us when an issuer changes accountants imposes additional responsibilities on the outside auditor, and we definitely had that in mind as well; he must be thoroughly familiar with what his decision is and the subject matter that he is dealing with. When he says "No," he had better know what he is talking about; otherwise, another accounting firm could come in there, making him look rather silly, and I think his professional reputation would be damaged.

One other point that needs to be made in the area of fairness and accounting principles is the importance of intent. What is management trying to do? Is there the intent to defraud? It is difficult, but you have got to measure intent. It's somewhat misleading to be looking for a cookbook list for ethical behavior. You're just not going to get it. Our lawyers wouldn't put up with it; they like to have flexibility, and I think I do too. Just because it's not written down that "thou shalt not" do something, it does not mean it's not a violation of the Securities Act. We feel we have flexibility, and we use it.

CPA: This whole discussion of fairness arises in part from the use of that word in the auditor's report. Historically, the certificate used to say that the statements were correct. Since it was impossible to say that absolute accuracy had been achieved, the words "present fairly" were substituted which was thought to mean "reasonably correct." Absolute concepts of fairness were not really thought about when the word was inserted into the standard report.

There has been considerable discussion about changing the report to increase the emphasis on fairness as a concept in itself, but we are troubled

by the practical and legal problems of doing so. If there are no guidelines on fairness, every individual CPA will be applying his individual judgment in each case, and the result will be utter chaos, in no way in the public interest.

FINANCIAL EXECUTIVE: When we are talking about fairness and ethics, we must remember that we are talking about something which is relative to our times. Fairness in financial reporting is fairness in terms of what people expect us to report, but it could be held in a later day that one of the things we should be taking into consideration, for instance, is the amount of money the corporation is spending for antipollution devices or for contributions to various organizations.

In other words, fairness today is fairness as we see it. Tomorrow's guidelines may indicate that we have been totally unfair today. Whatever we do in terms of fairness or ethics is based on what society today expects and is willing to tolerate.

We have all been talking in an environment here according to our own understanding of law and our own understanding of ethics, but twenty years from now somebody reading back and looking over this record may think how antiquated we really were.

ANALYST: Relative to that point, it should be added that we are not just talking about those items that are certified by the auditors. We're talking in many instances about other segments of reports; and, as an analyst, I have found more trouble there than I have in the areas that are certified. Fairness appeals to me, if we can define it, and even, perhaps, if we can't, but it must apply to the entire reporting process, not just the accounting section.

CPA: I concur with most of these remarks and comments. I think we need to build on what we have, but I think it's more important that we understand what we have on which to build. We should move toward fairness even if it is a moving target, but in doing so, we have to first make certain we understand the present.

DISCUSSION LEADER: If I were to try to piece together a "sense-of-the-meeting" on this subject, I believe I perceive on the one hand feeling that fairness is a standard which can be applied over and above defined accounting principles despite the difficulties which arise in making the concept operational. There is a sense that auditors should be able to attest that statements are in congruence with reasonable perceived business realities as well as with generally accepted accounting principles, even though the former may be hard to prescribe before the fact in general terms.

On the other hand, there is a feeling that increased efforts at definition of accounting principles and increased disclosure requirements will play a major role in improving financial reporting, and that these efforts should be encouraged and supported.

In other words, both fairness and defined accounting principles are necessary but not sufficient conditions to assure reporting excellence. We must combine the two.

Interim Reporting

Part of ethical reporting behavior relates to the timeliness of reports being issued. Relevant data published too late to be of value is no better than inaccurate reporting since both can lead to uninformed investment decisions.

The traditional reporting period is the year, but since the investment process is a continuous one, annual financial reports do not provide sufficiently timely data. The New York Stock Exchange and recently the SEC have therefore required companies to report quarterly earnings figures. In addition, the SEC requires more frequent reports of any material happening.

In the following discussions, the extent to which corporations have interim reporting responsibilities and the nature of these reports is considered. In addition, the role of public accountants in such reporting, both presently and prospectively, is discussed.

Discussion

DISCUSSION LEADER: In recent years, greater emphasis has been placed upon interim reports. Perhaps we should therefore turn our attention to the responsibility for these reports and the form they should take.

STOCK EXCHANGE REPRESENTATIVE: The stock exchange was the first body to require quarterly reports. This was done in our listing agreements. The recent SEC actions have strengthened these requirements primarily by applying them to other companies and by expanding the information requirements somewhat. Our listing agreements also require that stock exchange companies will issue quarterly reports on the same basis as annual reports and will set forth therein any unusual nonrecurring items and any change in accounting principles.

ANALYST: The requirements of both the stock exchange and the SEC are beneficial and necessary. We are applying evolving standards to interim reports, and we must recognize that. Some years ago an interim statement almost by definition was thought of as a first approximation, while the annual report was the precise figure. Today we are in the process of moving to the point where each quarterly report has equal validity with any other quarterly or annual report. Investors are rightly or wrongly placing increasing reliance on interim reports, and I believe more attention must be paid to this form of disclosure.

CPA: Let me ask a general question. Are the present sanctions that are imposed on interim statements adequate?

ATTORNEY: Although I know of only one case, I believe that Rule 10b-5 has within it ample grounds for adequate sanctions on interim statements. Remedies can be well developed by the SEC under 10b-5; and additionally, you can have class actions on behalf of all shareholders who engaged in securities transactions during the period that the misleading information was in the marketplace. I think that the sanctions are there. The Commission has power, as they have demonstrated, to bring action, suspend trading if necessary, and do a number of things.

What should disturb accountants is the problem of reporting interim statements and all the complexities of accounting for various items on an interim basis. The question of materiality takes on great significance in this area as do the problems of special charges, accounting changes, and income taxes to the proper interim period.

My guess would be that the courts will be reasonably sympathetic if it appears that honest judgments were made, but many problems are difficult.

ANALYST: May I ask about the responsibilities of the auditor for interim statements? What does he consider his professional obligations and his ethical obligations with respect to such statements, which, obviously, he is not prepared to certify? Should he, as a matter of routine, screen interim reports prior to issuance because of the depth of his knowledge about the company which would alert him to anything unusual, even though he has not gone through the steps which would permit him to certify?

Is he under any professional responsibility to do this? What are his obligations if the interim report is released without his seeing it previously, and there is something in that report which alarms him because of his knowledge or the general corporate situation. Should he speak out immediately? And, if so, to whom?

CPA: Suppose that something is part of an arrangement that the company's banker had been deeply involved in, and he knows the report is misleading as does a leading financial analyst who has visited the company recently. Should they speak out publicly? And if they shouldn't, why should the auditor?

CPA: I think the auditor should interject himself, but I don't think he can interject himself beyond the management level. He should tackle management uninvited if he sees reports going out which might be misleading or which might get the company in trouble. In general, I don't think he has any obligation or right to go beyond management at that point. It would depend upon the situation.

BANKER: I would say that the banker shouldn't go further than that. If a banker sees interim reports that are wrong, he should immediately confront management, but I don't think he should publish a *Wall Street Journal* article on it.

ANALYST: Suppose that whatever happened in the interim occurred in

the third quarter statement, and it went unchallenged. What's the auditor's responsibility at the end of the year?

CPA: The fact that it was unchallenged makes no difference to the auditor's responsibility.

ANALYST: Suppose there was a footnote in the interim statement which would immediately lead a CPA to conclude that it was not published in accordance with generally accepted accounting principles. If the auditor goes to management which, in its turn, resists any change, is the auditor under any obligation to the public at large or to the stockholders to set them right when he knows that the information in the interim statement is misleading, and when he knows that he is going to be reporting on the year-end figures? Or does he have any obligation at year end to speak out on the quarterly report?

FINANCIAL EXECUTIVE: I don't really see how the auditor can be held accountable for interim results unless we go to the position that all interim results should be audited, because sooner or later the kind of situation that you described is going to lead to a direct confrontation between management and the auditor, and what seems like a simple position, or a simple set of facts that the auditor was considering, turns out, in fact, to be quite complex; he is really not in a position to substantiate his opinion with respect to an interim statement without doing a comprehensive audit of the position of the company.

This leads me to the point of view that the question here on interim reporting is whether management has a responsibility to have its representations audited.

ANALYST: Even if an auditor is not asked to audit interims, if he has already been hired to do the year-end audit, and an interim comes to his attention of which he does not approve and which represents a departure from generally accepted accounting principles, then I think he has an ethical problem which may go beyond his relationship to management and extend to the stockholders and the investing public.

FINANCIAL EXECUTIVE: It seems to me that whether or not the auditors actually audit a quarterly report, the investor assumes that there is some degree of assurance that these reports have been reviewed or "blessed" by a CPA firm even though the certificate is not there, because the investor knows that they are going to be incorporated in a broader picture within six to nine, or maybe even three months, as part of an annual report.

FINANCIAL EXECUTIVE: I have a feeling that the instances in which an interim report may not follow accepted accounting principles are few and far between. Most companies consult with their auditors throughout the year. The auditors know what is going on, and they feel quite free to go to management if they are dissatisfied. I have trouble accepting the idea that management will disregard the opinion of the auditor during the year and face up to reality at year end. So I think we are almost making a mountain out of a molehill.

ANALYST: I don't find any satisfaction in the defense that because abuses are rare they can be excused. Numerically, they may not be very frequent, but they occur when there are problems, and the risks of loss on the part of the users of the financial statements typically are much greater in those cases where the relatively rare abuses take place.

If you want to improve the ethical standards that are applied in these cases, it seems that there has to be a third-party sanction system of some type that forces changes.

CPA: Why shouldn't there be some type of certificate from management to accompany the quarterly report in which they explicitly state that the statements are prepared consistently with past statements and with what will be done in the annual statement?

BANKER: Doesn't the fact that they publicize the quarterly report in effect do this?

CPA: Then it would put management to no trouble to sign a certifying statement of some sort. Signing an explicit statement might also encourage management to think even more carefully about its interim reporting practices.

BANKER: As a minimum, shouldn't the SEC require companies to file copies of their quarterly reports to stockholders with the Commission so that they can be compared with quarterly 10-Q filings?

SEC REPRESENTATIVE: At the present time, companies are permitted to use published figures as part of their filings. It would be an easy amendment to adopt to require filing of published reports, though I hope it wouldn't be necessary.

ANALYST: Aren't there companies that just publish quarterlies in the newspaper without sending a release to shareholders?

STOCK EXCHANGE REPRESENTATIVE: There is no stock exchange requirement that anything be sent to shareholders. The only requirement is publication in the news media. As yet, we haven't felt that it was appropriate to require companies to spend this money, although we encourage it.

ANALYST: I think the question of whether a company publishes a report, sends it to the shareholders, or simply sends the information to the SEC, but doesn't give it to the shareholders in the annual report is an ethical question. It seems to me that the shareholders ought to be the number one constituency of all the constituencies that the company ought to be interested in keeping informed. They are the people who have put money in the business.

DISCUSSION LEADER: It seems apparent that interim reporting is a subject of increasing concern to all parties represented and that some significant issues as to both the ethics and the responsibilities associated with such reports remain to be settled. Perhaps some systematic research is called for to articulate the problems and suggest solutions.

Forecasting

The subject of forecasting was one which received considerable attention at the symposium. This subject was brought up at the first symposium three years ago; there was some interest on the part of analysts, but active opposition by financial executives and little enthusiasm from other groups. The tone of the discussion was set by the executive who said, "I am petrified at the thought."

In 1971, there was still considerable disagreement, but perceptible movement toward the view that the time had come for serious consideration of the topic. There were even a few executives who viewed with favor the idea of public forecasts in one form or another, although the majority was still in the other corner. There was clear evidence both from the remarks of an SEC representative at the meeting and from a speech given in New York by the chairman of the SEC that the regulatory approach to forecast disclosure was changing and that most of the participants seemed to want to pursue the various ways of implementing public forecasts even if they were not ready to take the step of endorsing such forecasts as desirable.

The background paper by R. Gene Brown and the critique of that paper by George Bissell were available to participants, and it was clear that the subject had been carefully thought about by many before the discussion started.

As is obvious from the discussion which follows, no consensus was achieved, and strong pro-and-con feelings remain. The subject is one currently being exposed to substantial research efforts; perhaps when these are complete, more light will be available by which to appraise the arguments advanced.

Discussion

DISCUSSION LEADER: Forecasting is an area where there are few facts available—which makes me feel uncomfortable—and I judge from papers and comments that others share this feeling. Although the waters are uncharted, there are clearly many who wish to move ahead, and this is why the problem is before us.

The paper and critique present a number of basic issues which we can discuss in turn.

First is the issue as to whether forecasting really can be considered financial reporting. If reporting is defined as relating to events that have already transpired, then forecasting is the antonym of reporting. I think however, that Gene Brown refutes this very well when he says that for most users the financial reports are mainly useful as clues to the future. I am sure that most financial analysts and bank credit people would agree that they only regard financial reports as useful to the extent that they represent some sort of an indication as to the probabilities that may lie ahead for the company.

If we concede that forecasting is within the realm of financial reporting, we must then move to the question of who will be responsible for forecasts. Should there be, for example, any CPA responsibility? Should the Accounting Principles Board come out with some Opinions as to what the appropriate guidelines for forecasting are?

Related to this is the question of the format of forecasts. Should forecasts be put in the format of highly conjectural, generally stated ideas, such as, "This company is going to do better than last year," and end it right there? Or should the forecast be considerably more extended in information, including such matters as sales, earnings, and so forth, in a specific way? Or, alternatively, should there be some kind of estimated ranges for forecast data?

Gene Brown reports that there is very little literature or information on the ethical or behavioral questions involved in forecasting. We are exploring new ground here. We must consider the constraints on forecasts, and the advantages and disadvantages attached to them.

FINANCIAL EXECUTIVE: I think we have to accept the fact that forecasting is inseparable from financial reporting, for the simple reason that the very process of turning out a balance sheet or a current period income statement involves forecasting in the decisions made to defer costs and relate them to future periods.

DISCUSSION LEADER: While current accounting statements certainly involve forecasts, I think we are mostly concerned with the process of an extension of the forecasting process to the point of communicating specific estimates of future results. The question is how specific we should be.

ANALYST: I think when you go beyond the fairly general statements that managements often make, you open up a terrible Pandora's box if managements make forecasts. You have a major control problem. If reporting of past history isn't satisfactory, I don't know how you can begin to get to the point of forecasting the future.

DISCUSSION LEADER: This scares me as well. In my more cynical moments, I sometimes have trouble distinguishing between forecasting and touting. Aren't many forecasts essentially touting the stock of a company? Shouldn't there be ethical, legal, or professional constraints on this whole area? At best, aren't forecasts subject to a "credibility gap"?

ANALYST: I think the answer to that is more disclosure, not less disclosure. Historical information has not been sufficient to enable the analysts'

fraternity to appraise security values. We are going to have to focus attention on future developments, and appraise them more than we have in the past.

To do this, we will spend the next ten years trying to measure risk and express forecasts in probabilistic terms. To even begin this process, we are going to have to get more information about future developments than we have had to date from providers of financial information, and we are going to ask for probabilistic expectations as well as more general answers about corporate actions and intentions. The first stage in this process may be improved product-line reporting on both a historical and future-oriented basis, where the company comments in specific terms on the outlook for each product line as well as on its historical results.

FINANCIAL EXECUTIVE: What do you mean by comment on the future of each product line? Do you mean putting a number on it, forecasting what the sales are going to be, what the profits are going to be?

ANALYST: Yes. I think if one of the company's products happens to be computers, they are going to have to say what they expect to do in the computer market and why—in order to allow the analyst to consider their forecast and make a judgment as to how realistic it is, along with the forecasts of other companies comprising the industry.

FINANCIAL EXECUTIVE: There probably isn't a financial executive in the room who has not been burned by trying to predict the future a little bit. There also probably isn't a man here who hasn't dealt with analysts who come in and ask as many questions and get as much information as the financial executive can possibly give without giving them something that's privileged, and who then come up with an estimate that is about 100 per cent different than that of the financial executive himself.

ANALYST: The answer to that is to have the corporation give more information, not less.

FINANCIAL EXECUTIVE: There have been times when an analyst's estimates about our company's earnings were so optimistic that I thought they were simply touting our company to customers. In these cases, I did my best to talk them out of it; but this is a difficult spot for a corporate officer to be in. It wouldn't be good for my company to have somebody say that our earnings were going to increase by 70 or 80 per cent when that was absolutely wrong.

FINANCIAL EXECUTIVE: Actually, management may have to take on forecasting in self-defense, for the simple reason that if an analyst makes a projection which is unrealistic—even if management neither made nor agreed with the projection—management had better be in a position to say something.

FINANCIAL EXECUTIVE: I think we should focus on this point. What is the responsibility of corporate management to correct or guide reports of analysts when the management is convinced that an analyst's projection is haywire and that it does not reflect what the management can reasonably achieve?

ANALYST: I have one suggestion on this point. If the estimate is that irresponsible, I think very seriously that you would be doing the employer of that analyst a favor by calling him. That might correct the problem very quickly. While some of the damage might have been done, you are promptly involving the management of the firm concerned to take proper action to redress an irresponsible action that may have been committed. We could then investigate what went on and take any necessary action to redress any harm done.

FINANCIAL EXECUTIVE: Let me be a little more explicit in terms of exactly what we *do* do. Usually we will know what an analyst is going to come out with before the report comes out. When analysts come up to see us, one of the questions we always ask is what they are expecting for us this year. We make notes on it in the file and keep a formal file of these.

We have an internal rule that if an analyst is projecting a figure which is outside the ball park—and this is a subjective sort of thing—then we focus on that before he leaves. We don't forecast; we don't project. But what we do is tell him what everybody else in the Street has foreseen for us, and we try to get him to go back and re-do his work, to see if his number can approximate what the rest of the Street is expecting. We don't want someone to go off base. We do everything to make sure that the range of expectations on the Street are within the range of what *we* expect.

I don't know whether this is typical or not. I suspect it is. Are we acting ethically or not?

ANALYST: Wouldn't it be much more ethical to just say what that ball park range is? You wouldn't have to name a single figure. You might say, "We expect currently to earn somewhere between $1.75 and $2.00." That would be your present definition of the ball park. Release it to *The Wall Street Journal* and be done with this problem. And if your expectations change, release that change as well.

FINANCIAL EXECUTIVE: The reason we don't do that is that we don't think it is our business to do your work for you. We think you have the responsibility to measure your expectations.

ANALYST: Do you think we can serve the stockholder better on that score than you can? Can we know better than you what the ball park *should* be now; can we then tell the stockholder? I don't believe it. I think you can do a more honest job of communicating with your shareholders what you perceive to be most likely.

FINANCIAL EXECUTIVE: We perceive our responsibility to our stockholders differently from you; in our view you are asking us to do your work for you, and we won't do it. That's our position. If we do the forecasting, what is the analyst's role?

ANALYST: The analyst will then be analyzing and questioning the forecast. He will be looking at the supply-and-demand situation for the company's products, evaluating the gross national product projection, and generally working on the underlying fundamentals. In other words, he will do

much of what he does today, but he will be starting from a more informed position. And, of course, the final responsibility of relating the forecast to the value of the security remains with him.

ANALYST: I agree. You have to remember that there are times when there is something happening internally in your business that no one can know from the outside. All the external factors can be considered in calculating a range, but there may be some development in the company that requires a correction.

Let me give you an example in the stock market recently where a certain stock dropped significantly when the actual earnings increase was only about one-half of the very optimistic increase forecast. In that particular case, the analyst worked with a lot of detail. He was very well informed on the business. He made the best estimate he could. The management gave him about 25 minutes, and said nothing about the accuracy of his forecast. Then the earnings report came out, and the stock dropped. This management never talks to analysts, really.

I think management has to have some way of getting the story out and getting it corrected—pinning it down to a more reasonable range—particularly in cases where there are factors which even an astute analyst cannot perceive by study of the data available to him.

ANALYST: This comment introduces the ethical problem of the financial executive disseminating the appropriate information to his entire audience, rather than to just a few. It appears to me that if the corporate executive is willing to discuss the future prospects of his business in detail with a knowledgeable professional on the other side—whether or not he mentions any numbers—then he has some ethical responsibility to similarly inform the rest of his shareholders or possible shareholders in the investment community. The method could be a public forecast. And, once a forecast has been published, the corporate executive should feel more free to discuss details of corporate expectations without the insider information problem being present.

FINANCIAL EXECUTIVE: We'll give him all the historical information he needs. Then it is up to him to use it. We would have the SEC on our back if we started to tell him what we were going to make next year.

COMMISSIONER NEEDHAM: I wouldn't want this group to think that the historical position of the SEC with respect to forecasts is cast in cement. We have announced that we are going to conduct an in-depth study, and, as part of that, we are going to examine in the broadest context the question of what information an investor has to know in order to make an intelligent investment decision. We're also concerned about the availability of research to the investor.

If I may speak on behalf of the constituency that I represent—the investor—I really believe that he has a right to know the future prospects of a company in which he has invested or is about to invest. So I would repeat what I said at the outset; our historical position is not cast in cement.

Discussion Leader: You would, however, reserve the right to monitor the general accuracy—whether or not it was completely wild. Isn't that right? If I put myself in your shoes, representing the constituency of the investor, I would not want these forecasts to be misleading.

Commissioner Needham: We have Section 10b-5; I think that's about all the ethics necessary.

I would say that we have not reached the question of whether or not federal regulation would be needed in this area because we haven't decided where the disclosure would take place. If we were to decide that the disclosure were to take place in a prospectus, our position might be somewhat different than it would be if we were to decide to approach this through the proxy rule or require disclosure of this type in the annual statement.

So I can't answer your question. I don't know what requirements we would have with respect to the authenticity or whether the data presented would have to have an accountant's certificate.

I think, too, that it doesn't necessarily follow that forecasting would have to be as comprehensive as a historical statement. It might be more useful, or as useful, for forecasting to simply zero in on certain significant information such as technological changes within the industry, the development of international markets and competition, and similar data. There are other ways to accomplish disclosure without fitting it into what I already conceive as being the very rigid format of the income statement and balance sheet.

Analyst: I would hope that any step taken by the SEC would be permissive rather than mandatory in effect. I don't believe that companies should be forced into making public forecasts, although they should be able to do so if they want. If you force forecasts, you may open the way to abuses and legal liabilities. We have all known of cases where five-year forecasts were far off the mark; if they were required there might be a lot of misinformation floating around.

Financial Executive: Let me give an example. In 1966, the book publishing industry was growing at a very rapid rate. Some analysts were incredibly optimistic in their estimates of what was going to happen to our earnings. In 1967, government spending dried up, and instead of going up, earnings went down. Analysts then couldn't wait to sell the stock. If we had been forecasting three or four months before, we would have been as far out in left field as those analysts; we don't want to be in that position.

Financial Executive: I think it goes without saying that forecasting has become an integral part of corporate management, and it's an important tool today. As a matter of fact, in our company we make more decisions based on forecasts of results than we do on the actual results.

If you think about the ability to make forecasts, you would have to agree that the management team is the one best equipped to make a forecast, and that anyone else trying to look over its shoulder or second-guess it is at a disadvantage.

Now, it seems to me that perhaps the situation could be resolved by letting management make forecasts and publish them, but without saying more than, "We, the management, are making our corporate plans based on this expectation for next year, but we do not in any way assert that this will happen, though we will exert our best efforts to make it happen."

If something is put forward that way, I think people will respond with appropriate caution. They would still look to the analysts to evaluate that forecast, and to examine other sources of information about the company. If we put forecasts in this light and eliminate the need for people certifying forecasts which would give a false sense of security, we might be able to handle the publication of this data without too much trouble and without giving outsiders access to information that management feels might be detrimental to the corporation's interest.

FINANCIAL EXECUTIVE: I am pleased to hear such a statement since our corporation is about to issue a forecast on Monday, and I would not want to feel guilty of unethical conduct.

DISCUSSION LEADER: I'd like to ask what motivated your company to issue this forecast.

FINANCIAL EXECUTIVE: The decision was motivated by a desire of management to assist in the creation of an orderly market for a stock which has been very volatile. The disruptive influence of a particular interim report which is not representative of future prospects of the company leads to a very disorderly marketplace, which is undesirable in the view of management. We also felt that the security price would reflect its investment value—whatever that is—more accurately if our forecast were disclosed.

DISCUSSION LEADER: Is it your intention to report on how the forecast worked out?

FINANCIAL EXECUTIVE: I suspect we will be forced into it—at least in the president's letter that goes out with the annual report—should actual performance differ substantially from forecast performance.

BANKER: The late Marcus Nadler used to say, "If you are going to forecast, forecast frequently." Do you have any intentions of revising your annual forecast on an interim basis?

FINANCIAL EXECUTIVE: I think that anyone who publishes a forecast has a responsibility for disclosing promptly—not on a quarterly or semiannual or any other fixed basis—any new information that comes to light which would materially affect that forecast. If you made an annual forecast, and nothing happened between that time and the time you issued your next quarterly report, I believe that it would be prudent to reaffirm your faith in the forecast at that time.

BANKER: I have another question. Don't you feel that the publication of forecasts and the requirement to explain variations will lead to judicious understatement on the part of corporate officers?

FINANCIAL EXECUTIVE: This effect is certainly possible since the costs of overestimating are significantly higher than the costs of underestimating,

though I hope that various approaches such as publishing ranges rather than single figures will make those costs less significant. These questions seem to lead to a need for groups such as this one to undertake research in the area. At the present time we do see forecasts, but there are no guidelines as to what is ethical or desirable. We are in a permissive situation with no controls. There are many questions unanswered; we do not really know whether forecasts are beneficial or disruptive, whether they should be attested to or not, what form they should take.

CPA: I'm interested in the views of the other organizations on whether public accountants should be lending credibility and some sort of attestation to forecasting. A subcommittee of the AICPA's committee on auditing procedure is working on this project, with the possibility of issuing a statement on it, and I'm curious about opinions as to whether, on balance, the accountants can add enough credibility to forecasts to justify that effort.

ANALYST: I would say the first step would be to try it on the basis of the British system, to learn from the problems that they have had, and to see whether this can be done. And as you know, under their approach to the audit function of the forecast, the chartered accountant attests to the mechanical accuracy rather than to the commercial assumptions that underlie it.

FINANCIAL EXECUTIVE: I do believe that there does have to be some kind of surveillance over forecasts. The question is open as to whether or not this should be performed by the accounting profession, and I guess I would, for lack of a better alternative, say yes.

However, I would like to point out the difficulty and danger of embarking upon a program such as the British one. It is not unlikely that the case would arise where the auditor would find one or more assumptions which he believed to be inappropriate, either through basic disagreement on observations about the general economy or industry, or even when he might possess privileged information about a particular industry segment through having a variety of clients in that particular industry. He might not be in a position to accept the assumptions as stated; yet he is not asked to render an opinion on the assumptions, but only on the forecast based on those assumptions.

DISCUSSION LEADER: I have talked with a couple of British public accounting firms, both of whom have asserted that, while they do not attest to the assumptions, they now have a policy whereby, if they do not feel comfortable with them, they will not allow their name to be associated with a forecast based on such assumptions. This is a difficult position to be in, particularly if there is a merchant banker who is willing to lend his name to the assumptions, which in the British system is generally the case.

CPA: I think this issue represents a very real problem. If you are involved at all, and the assumptions are totally unrealistic, do you have an obligation to do anything about it? I think inevitably an auditor would be drawn into that position. But I think it's a problem that can be coped with by developing standards which would provide some guidance for what to do in such cases.

As far as research goes, we have a study nearing completion which is being conducted jointly by the English Institute, the Canadian Institute, and the American Institute—a comparative study of the attitudes, procedures, and practices in forecasting in the respective three countries.

The conclusions of that study are that we should move toward forecasting and should, basically, follow substantially the British practices at least for the time being. And we hope to have that published within a few months.

FINANCIAL EXECUTIVE: It would probably be of interest to add that the Financial Executives Research Foundation recently approved a full-scale research study on the subject of forecasts. The project is to begin at an early date, and the first phase is to be finished some time next summer.

STOCK EXCHANGE REPRESENTATIVE: Perhaps a reasonable way of starting this would be the pilot program approach. We found that to be a very successful way of trying something out, because the result is an attempt at *doing* rather than theorizing about the reasons that it can or can't be done. This could be done by a cross-section of corporations that are willing to participate.

ANALYST: I think we must recognize that while we are sitting around still discussing whether or not management should forecast, the SEC is considering going ahead. It seems to me that, if we are realistic, we must get to the point of recognizing that we are going to forecast and start considering how we do it. If we start discussing how we *do* forecast, it is possible that we will come up with some valid reasons to present to the SEC as to why it shouldn't be done. But as long as we simply say it shouldn't be done, we run the risk of having somebody else tell us that we *have* to as well as *how* to.

FINANCIAL EXECUTIVE: I agree. I think that each group in this Symposium has something to contribute to the others, as well as to the SEC, on this particular topic, and therefore it might be appropriate for some collection of talents from the four groups here to be brought together to prepare a recommendation on how forecasting should be done, if it is required or even permitted by the SEC.

I feel strongly that considerable thought and several disciplines should be brought to bear on any recommendations.

ATTORNEY: To round out the cast of people who are working with forecasts, the American Bar Association Committee on Federal Regulation of Securities has a subcommittee working on this question, with particular emphasis on the potential liabilities.

Beyond that, I would like to support the comment just made. I think a good precedent of the impact that the private sector can have on the public was in the line of the business-reporting area, in which the Commission was persuaded to forgo action until such time as there had been adequate study of the problems outside of the governmental area.

I like the idea of getting together–and quickly; then when hearings are held on it, as they seem likely to be, everyone is in a position to outline in a constructive fashion the manner in which this problem should be approached.

I also believe that when the subject is explored, there should be agreement that the place to start forecasts is not in registration statements, where the liability of the issuer is subject to no defenses. Due care is of no consequence to the liability of an issuer. Innovative reporting of this sort should start where penalties are not so enormous.

FINANCIAL EXECUTIVE: Before we get carried away with enthusiasm, I believe I should express my concern that I don't hear many protestations to the implied conclusion that we should drive full speed ahead toward forecasting. I think a part of the record of our discussions should be a question as to the propriety of that which seems to have gathered such momentum here. While this was discussed, I am not sure that the dissents have received sufficient weight. Let me add one additional problem which relates to published forecasts.

In general, I believe that making a forecast is not too difficult because, within our companies, we are constantly planning strategies to deal with uncertainties and we have alternative strategies to cope with these things as they evolve.

What distresses me is the necessity to reveal those strategies publicly in order to substantiate the forecast. If these strategies that form the assumptions that we discussed would have to be revealed and spelled out, they would be the subject of very specific questioning by analysts—and I would like to say that I don't think it's anybody's business to know what strategies management devises to achieve our program.

I won't even say that we don't reveal many of our strategies–we do. But the critical parts are those that relate to the competitive environment in which we work. The things that we reveal are generally the nonconfidential aspects of our competitive strategies. The confidential aspects of our competitive strategies we do not reveal, and I think it is improper to suggest that business managements should reveal such items. I question whether meaningful forecasting can be done without revealing precisely that.

DISCUSSION LEADER: It is clear that we have not achieved consensus on the subject of published forecasts, but at least we have most of the crucial issues out on the table. I am sure that the next few years will bring considerable research to bear on the topic, and perhaps the continuing progress outlined in our discussions will be the prologue to a more definitive solution to the problems of this area in the future.

Surveillance

Despite what is generally agreed to be a high level of technical and ethical behavior in corporate financial reporting in the United States, there have still developed in recent years a number of examples of conspicuous deficiencies in corporate reporting which have raised doubts in the minds of financial statement users about the total reporting environment. These deficiencies have been of several sorts. In a few cases, intentional misstatement has occurred, but more often the problems have arisen where reports are made in areas where limited reporting experience exists, where major uncertainties about the future are present, or where generally accepted accounting principles are unable to cope with complex economic realities. In addition, there have been cases where disclosure was felt to be inadequate.

At the present time, no systematic surveillance takes place over corporate reporting to identify problem areas and defective reporting practices or, for that matter, to applaud innovative approaches. The Securities and Exchange Commission has acted in conspicuous cases, but in many situations the problems cannot be defined as technical or legal deficiencies.

From the user viewpoint, there has also been a lack of surveillance over defective analytical reports. This might prove even more difficult to establish professionally since such a large percentage of analytical efforts are undertaken privately by bankers and institutional investors. Only the tip of the iceberg appears in published analytical reports.

There was considerable discussion of the role of various parties in surveying corporate reporting practices. It was not clear what group or groups should undertake such an effort or what sanctions, if any, should be applied. Nevertheless, a definite feeling emerged from the discussion that some professional effort should be undertaken in this area.

Discussion

Discussion Leader: It has been suggested that some professional surveillance of corporate reporting would be desirable. Is anything being done today? Should more be done?

Commissioner Needham: I would like to explain our enforcement program because I don't think it is generally understood. In the first place, we

know that we do not get every violator of the securities laws. We don't get every broker-dealer, every investment advisor, every mutual fund, every issuer, or every accountant that fails to fulfill his responsibility under the acts.

Secondly, we do not believe that we should have the primary responsibility for maintaining a high level of conduct in these areas. This belongs in the private sector. The SEC may have a gun behind the door, but we don't like to trot it out all the time because if we do we create an atmosphere of distrust on the part of investors—which in turn has an adverse effect on the capital markets.

We believe that we have the best capital markets in the world and the finest accounting and reporting standards of any country, and we want to retain that position. As we make changes to accomodate the needs and demands of the investing public, we want to be sure that we do so in an environment that doesn't jeopardize the existing system. This is why we never take action against an issuer or a professional without struggling over it and spending days in discussion.

We are therefore very happy to see a symposium of this sort develop in the private sector since it shows a recognition of the need for maintaining a high level of conduct. To the extent that this sector performs well, our activity becomes less—which is an acceptable solution.

Let me pose a question for the financial analysts in this regard. As you read a corporation's reports, suppose you react with a visceral feeling that the management of the company does not measure up to the standards of reporting to which you think businessmen generally should. What have you done as a group or individually to solve this problem? Do you adjust price/earnings ratios; or do you go to a market-maker, or in some way put pressure on the price of the stock? This is the kind of action the private sector can take effectively, and it doesn't bring in the heavy hand of the federal government.

ANALYST: I would like to answer the question from the institutions' point of view. Institutions account for a majority of trading on the New York Stock Exchange, so they are significant disciplinarians in terms of market effect. Each institution has a varying degree of internal research, and it also uses the outside Wall Street research in making its investment decisions. Investment ideas produced from that research must then be sold to the decision-making group in the organization.

When a negative idea recommending sale arises internally, the analyst can report directly to his superiors. The information is nonpublic, and a sale can be effected without any ramifications other than the corporation eventually noting that the shares have been sold, if they do watch that particular activity.

The problem for those in the brokerage community, however, is much greater because their recommendations are of a public nature, and the consequences are more far-reaching in respect to the analyst. His future contacts with that company might be jeopardized, which of course he does not want

to do, because this is part of his livelihood as a man who is gathering information, evaluating it, and passing it on to his clients.

Nevertheless, I think the market's reaction to reporting phenomena and to economic evaluations has quickened through the years. I think this is due to the increase in communications, to the increase in sophistication of those who are in the analytical profession, and to the sophistication and the size of the institutional market which addresses itself to these problems more quickly than the investing public at large.

It's my feeling that the price adjustments that seem appropriate do occur and occur more quickly than in the past. Those that have perceived the situation more quickly will leave the security first. Those who are less informed, or less capable of coming to an appropriate decision will, of course, linger on. Nevertheless, as that information becomes more broadly understood, there is, sooner or later, a correction in the marketplace.

As a system it is imperfect, but I don't know of any other which would be better.

ATTORNEY: One of the things that worries me about these remarks is the fact that the institutional investors get out of the market faster than the public investor because they can analyze these accounting principles better. I think that's a real problem.

ANALYST: That is not entirely true. I was involved in an incident in the last two years where we developed a piece of analysis which indicated that a company which was selling at around $45 a share had, in fact, no earnings. We informed our clients of this, and they laughed and refused to believe us; it took at least two weeks for that material to eventually sink in, and then the stock dropped sharply.

I should emphasize the very heavy responsibility which an analyst feels when he comes up with this kind of information. Others must have looked at the company and failed to perceive the realities of the situation. An analyst who publishes a report which is highly damaging to the price of the stock hurts a lot of people. It would be much better if company reports had not indicated the earnings in the first place or if their dubious quality had been immediately perceived.

ANALYST: I agree. The corporate report which is issued is the one that gets published through the media and included in the statistical manuals. This has a greater weight than anything you can say later to try to correct it. So it's extremely important to try to get the information on the right basis in the first place.

ANALYST: I wouldn't want you to leave the impression that there are no controls over brokerage analysts who publish their reports and face the difficult ethical and practical problems you point out. As institutional investors, we are major consumers of these reports, and it is true that we don't publish anything either for the benefit of the public or by way of critical observations with respect to the work that is done on the Street. That in no way implies, however, that we are not continuously evaluating their work "in house." I

think that some of the conversations that go on, both among ourselves with respect to the capabilities of certain of the analysts outside of our shop, and between ourselves and these analysts and their supervisors, have a continuing salutary effect on the quality of the analytical reporting that is done for institutions. While these controls are not visible, they are nonetheless effective.

ANALYST: There is a program, which is evolutionary in nature, that has been under way for some time—the Corporate Information Committee's program for making awards for excellence in reporting to the investing public. In this program we do not give awards for first, second, and third place. What we are doing is attempting to set standards of excellence in reporting to the investment community. We hope to have as many people as possible qualify for such awards.

We are moving along to the next step, which is a formalized program for informing those who do not qualify why they did not qualify. Most of them are finding out now anyhow because an analyst in their industry area tells them.

There have been a number of rejections of otherwise excellent performances both in annual reports and interim statements and other items where, wittingly or unwittingly, the report indicated something that may not have been accurate. In other words, there was perhaps a deceptive piece of information. When this occurs, one or more members of the subcommittee will object, or a member of the senior committee will raise the issue, and it will be reviewed. If the award is denied on this basis, the company will be informed. This is an element of surveillance and control. It is not fully developed at this stage, but it is growing.

ANALYST: I think that, as a group, analysts have done very little in terms of their complaints. In two years as chairman of the Accounting Policy Committee, I sent a number of cases to the practice review committee of the AICPA. There was next to no help from 13,000 other analysts. In the last year and a half, I don't know of any cases that the Committee as a whole has sent in.

I was never amused when the Committee would complain to the practice review committee, only to have the Corporate Information Committee give the same company an award for excellence in reporting.

What happens today, as a practical matter, is that the criticism of a particularly bad report is leaked to Alan Abelson of *Barron's* or Metz of *The New York Times.* It is easy to suggest that we write, but when major corporations threaten to sue, one's wife and partners get a little upset. I think we need a new mechanism.

CPA: There is a statement in Don Scott's paper that the role of the public in the enforcement process is limited, that publicity is the principal means of enforcement. So long as the marketplace uncritically accepts published earnings-per-share figures as the main performance indicator, adverse publicity on accounting practices of a particular company will have little effect as a deterrent.

I suggest that a year ago that was a true statement. Today it is no longer true, and the public is reacting quickly and violently. Abe Briloff's latest article on the question of accounting practices among the land development companies resulted in a writedown of something between $100 million and $200 million in the first two days in the securities of those companies. And in our stock-watch efforts, we have seen the effects of rumors of an article that might come out which might reflect on the accounting practices of a particular industry.

So the public has increasingly shown its distrust of both the companies and the way they report, and the accountants and the way they attest.

ATTORNEY: Perhaps the answer is to institutionalize Abe Briloff!

ANALYST: I think it should be mentioned that when analysts speak of accounting problems, we are not necessarily speaking of cases where current accounting norms are violated. We are more concerned with areas which I am not yet sure the accounting profession is even willing to recognize as problems. That is when the management of a company starts to work within generally accepted principles to adjust earnings per share in accordance with its wishes. There is plenty of leeway within generally accepted accounting principles to do this, and the accountant doesn't even realize that a problem is being presented.

COMMISSIONER NEEDHAM: The real question here is one of intent. The propriety of the reporting may depend in large part on whether there is an intention to mislead. It may be that firms have employed accounting practices which primarily serve their best purposes rather than those of investors. Perhaps as a result of this symposium, it will be concluded that the ethical standards imposed by the Commission are not quite high enough in terms of the audiences that are involved. Reexamination may be required both by the Commission and by the groups represented here.

CPA: I would like to put in a word for one control mechanism that we do have at the present time—the audit committee of the board of directors which meets with the outside auditors. The experience we have had with this has been excellent, if somewhat limited. We have found that outside directors on such committees have encouraged us to be extremely candid, and we have accomplished some things with management that we might not otherwise have been able to do.

FINANCIAL EXECUTIVE: I speak only from the limited experience of my company on this. We have had an audit committee for as long as I have been with the company, and I agree that it is an effective tool in helping to maintain the independence of our public accountants. We have our arguments with our public accountants, but there has never been any feeling that their services would be terminated if they didn't agree with our thinking.

We have honest disagreements of opinion which we settle one way or the other. Too many times I lose the argument because the auditor has the club in the final analysis, and we recognize it.

ANALYST: I am not sure that the audit committee improves the auditor's position. The audit committee, after all, represents the management point of view, and thus represents simply another problem for the auditor to overcome when disagreeing with management.

ANALYST: As readers of financial statements we see incident after incident that upsets us. We need some kind of mechanism other than Rule 10b-5 and other than a shareholders' derivative suit to dissent and, perhaps, to find out if our complaint is really justified. I think we need some kind of structural change that achieves this without a lawsuit. Don Scott in his paper points out that serious consideration should be given to the establishment of an accounting court, which is one possible solution.

ANALYST: I really can't quantify the number of problems, but I think that as analysts we have had substantial experience with situations we don't like. I don't think the AICPA practice review mechanism has done the job of satisfying our concerns.

COMMISSIONER NEEDHAM: I think you are right. We know we have this problem, but response is difficult. You have undoubtedly noticed that in the last few years we have had more enforcement actions involving financial statements than we have had in a long time, and we have a few others coming down the pike. But I think your point is well made. I'm a little frustrated in terms of what to recommend to my colleagues.

One procedure which might be responsive to your concern would be to institute a public information program about the types of accounting decisions that are made internally. Many of the matters that you see and have trouble with in filings we have already questioned; we have a memo in the file that indicates that we have had a conference with someone and they have explained to us why this method of accounting is an acceptable one.

This would be similar to our policy of making no-action letters public, a procedure we instituted about a year ago; it is probably desirable in the accounting area to make public the more significant types of accounting decisions that are made at the Commission, without necessarily disclosing the name of the issuer.

We might take that step, and I think it would be helpful in overcoming your concern.

DISCUSSION LEADER: From this discussion, it is apparent that some analysts feel the need for an improved surveillance mechanism. What remains unclear is exactly what should be surveyed, who should do it, and what standards should be applied. The small matter of who should pay the bill also remains unsolved. Certainly this is an area which the organizations represented here at Seaview should jointly explore and develop in the years to come.

Professionalism and Codification Of Ethical Codes

Ethics and professionalism are closely related. An ethical code has traditionally been one of the significant characteristics that define a profession. At the same time, professional standards of competence have served to encourage a high level of ethical behavior in dealing with those outside the profession who rely upon it.

In the area of corporate financial reporting, professionalism and ethical standards are concepts relevant both to preparers and users of financial information, although there are different dimensions to the tasks and responsibilities of each group. The definition of these dimensions and the establishment and enforcement of standards of professionalism are major problems which require attention and about which there are major disagreements.

There are some who regard the simple virtues of honesty and integrity as sufficient to insure both professionalism and ethical behavior. Accounting and financial reporting in general are pragmatic disciplines which have developed to a significant degree from the application of common sense to a variety of problems. The attempt to apply defined standards of competence and behavior is felt by this group to add little to the quality of the reporting environment.

There are others who feel that while honesty and integrity are necessary, they are not sufficient. In both reporting and interpreting results, many situations arise where these attributes do not point to one path or even one direction among viable alternatives. Such problems come up both in the process of reporting and in the many relationships that exist among those concerned with the area. This group feels that without more defined standards of ethical behavior and professional competence, honest and well-meaning persons will be left in uncertainty which may lead to contradictory behavior.

These issues underlie most of the discussion in regard to the codification of ethical and professional standards which follows. Among the problems considered are those of establishing and enforcing standards, and the relative lack of success of formal procedures for enforcement in those organizations with ethical codes now in existence—along with steps some have taken to improve this situation.

Discussion Leader: In reviewing the papers and critiques prepared by the four sponsoring organizations, one of the ideas which seemed to be frequently expressed was a need for professionalism both in corporate reporting and in the use of such reports. Perhaps we should start by asking what professionalism means in this context, and then consider how standards of professionalism should be set and enforced.

Public Relations Society Representative: The definition of professionalism must begin with the definition of a profession. In our field, we face this problem every day. We don't have an answer, but we do have some guidelines which are the usual, predictable things: a body of knowledge, a method by which that knowledge is passed on, a professional organization for assuring the professional growth of members, and a code of ethics with a means of enforcing that code.

But there is another element which I think is of interest. A profession is an activity which the average layman is not in a good position to evaluate. The average layman is not in a position to know whether the legal advice given by an attorney is good or bad, or whether the diagnosis by a physician or a surgeon is good or bad. I assume that this is true in your professions.

If that is the case, a professional must ultimately be judged by his peers. The profession, by definition, is that body which is best informed and which necessarily must take upon itself the obligation of policing. Whether we do it well or not is a good and legitimate subject for debate.

CPA: I think professionalism implies a set of standards but not necessarily formal written ones. Some of our standards are codified, but some are not. Nevertheless, a member of our profession has to adhere to the standards, just as a doctor or lawyer or teacher would.

CPA: I agree. I am sure that accountants do apply standards instinctively to the decisions they must make. These are really moral standards; although not reduced to writing, they are an important part of professionalism.

CPA: When we look at professionalism, aren't we really talking about what might be called philosophical problem-solving? This is an approach by which we define the best and the shortest solution to a problem. As professionals, we encourage the best solution but require compliance with the minimum.

Financial Executive: This discussion leads to the question of whether there are standards of professional conduct which could be used to discipline a member of a professional society even though they have not been codified.

Attorney: There is certainly a due-process question involved in disciplining somebody for violation of an uncodified ethical rule unless virtually everybody in the profession could be made to agree that an unwritten rule was violated, or unless the conduct was so bad that nobody could dispute the violation of ethical principles.

CPA: In our state society, we have a first rule of conduct which requires a member to deal fairly with the public, his clients, and his fellow practitioners. Of course, if we all knew exactly what that meant, we wouldn't have needed any more rules. It is a sort of golden rule for us, but it is one approach toward codification that relates to professionalism in its broad sense.

CPA: Even more related to professionalism is the statement in our proposed new code of ethics which states that "a member shall not undertake any engagement which he or his firm cannot reasonably expect to complete with professional competence." This reflects the professional's basic responsibility for not accepting a job which he cannot perform adequately. Since the public is not qualified to judge our competence in technical areas, they have a right to rely upon us to make that judgment. I understand that a similar provision gave the American Bar Association the most problems in passing its new code, and it may be that we will have trouble with this too.

ANALYST: It is very difficult to enforce a code of ethics and standards of professional conduct even when they are codified. An enforcement procedure requires elaborate machinery involving both an investigative and a judicial function. When there is no code, or when the code represents only vague statements subject to multiple interpretation, enforcement is almost impossible because of the legal aspects involved. Yet if a profession is to mean anything, it must have an enforceable system of ethics. Mere words mean nothing at all.

PUBLIC RELATIONS SOCIETY REPRESENTATIVE: In the Public Relations Society of America we have a very detailed code of ethics and standards, but all of our proceedings against members who are charged with violations of it must necessarily be kept secret until such time as some kind of disciplinary action can be taken. Much of the procedure is informal pressure—calling a member and saying, in effect, "Stop doing that; if you don't, you are going to be in trouble."

I think this is true in most professions. There is a great deal of informal pressure brought to bear by peers who force compliance with ethical and technical standards by the implied threat of bringing charges or halting referrals. Only when there is still a problem after these efforts should more formal and legalistic steps be invoked. These informal pressures do not show up in the statistics of enforcement cases, but they are a real factor nonetheless.

FINANCIAL EXECUTIVE: I think we can expect too much of both ethical codes and formal standards. In the final analysis, such codes and standards as accounting principles primarily keep an honest man honest. Devious persons can find a way around them. This isn't to say that they have no value, but only that our expectations shouldn't be too high.

FINANCIAL EXECUTIVE: I think that a discussion of this sort is not complete without bringing in the question of professionalism in financial journalism. There are well-known financial writers who have on numerous occasions criticized the reporting practices of companies in a fashion that is grossly unfair. They have selected cases of reporting which are in complete accord

with generally accepted accounting principles and have asserted that they give a misleading impression or that they did not go far enough in particular situations, leaving the general feeling that the reporting company was unethical. Shouldn't we have some standards and enforcement of professional responsibility in this area?

DISCUSSION LEADER: While there is no formal participant representing the press, we do have one member of the financial press covering the symposium who might like to respond.

REPORTER: While I could agree that from your standpoint such problems may exist, I should point out that reporters do not invent their stories. They either find material on their own or obtain the data from someone who feels that he knows something about the inside situation. In the financial reporting area, the latter is more often the case. A person with access to the inside story tells the reporter, who checks it out and writes it. I spend a lot of time checking out what people tell me; I don't believe it just because it is told to me.

DISCUSSION LEADER: One aspect of professionalism that we have not touched upon is the continuing demonstration of competence. Both accountants and analysts have professional credentials which require an initial demonstration of competence. After the credential is achieved, however, nothing is required to sustain it. Should something be necessary?

ANALYST: I think that there is an extension beyond the initial qualification for financial analysts. This is done through the enforcement of a code of ethics and standards of professional conduct.

As we all know, it's very nice to have a code. It's relatively easy to put together some fine-sounding words, but to enforce a code is extremely difficult. We have worked on this for several years to develop a machinery consisting of rather detailed procedures, including both investigation and a judicial function. If you are to have a meaningful professional designation, then the acid test of it is the continuous enforcement of that designation. We require every one of the 3,000 Certified Financial Analysts to respond to a detailed professional questionnaire which asks very specific questions as to whether or not his personal or professional conduct has ever been questioned.

While we are on the subject of ethical codes, I would like to ask the financial executives why they do not have a code or any articulated standards of performance? Wouldn't this be a good start, even though the enforcement mechanism might develop slowly?

FINANCIAL EXECUTIVE: If we are going to take that line, we must start first with a code of ethics for the chief executive officer. If we parcel out ethical codes so that the financial officer has a code, but the person to whom he reports does not, our efforts are a waste of time. You have to start at the top.

FINANCIAL EXECUTIVE: This is correct. The financial officer is not the one who is responsible for the report. Responsibility for ethical reporting behavior must start with the top man, whether the chairman of the board or the chief executive officer.

We as financial executives may have a code of ethics, but if our ethics do not agree with the chief executive, and he won't change, we either have to accept his or resign. That's our choice.

CPA: It strikes me that we need interlocking and supporting codes of ethics on the part of management, financial executives, financial analysts, and CPAs, which are designed to provide the kind of objective financial information that the user needs, as well as intelligent use of that information.

When we approach ethical codes in our individual, segmented fashion as we have in the past, problems have been created.

ANALYST: I don't believe that the absence of a code for chief executives is a worthy reason for financial executives not to develop a code of their own. I don't say a code works wonders, but I think it may offer support, and very important support, for the financial officer who on occasion gets in a situation where he must confront his chief executive. It can be of considerable help to have something to point to and say, "This is an accepted standard for people in my line of work."

ANALYST: An additional benefit in creating a code is that anybody who has some degree of good will in pursuing his own career objective derives a tremendous amount of benefit from going through the process of defining the valid criteria, in exchanging some of these definitions with other members of his own profession, and gradually, on an evolutionary basis, working toward some modestly higher standards of behavior.

FINANCIAL EXECUTIVE: We have been placing emphasis on a code of ethics for financial representatives, but perhaps what we really are talking about is a code of ethics in financial reporting to which the corporation or business enterprise could subscribe—a code that would be agreed to and signed by the corporation and its officers as a whole.

FINANCIAL EXECUTIVE: Everything is subject to change and improvement. As many of you probably know, the Financial Executives Institute is looking at the possibility of developing a code of ethics. It won't come tomorrow or even within six months, but it is being considered.

DISCUSSION LEADER: We seem to have put a number of good ideas on the table for consideration by the various groups in the months to come. Not only can we await a possible code of ethics from the Financial Executives Institute, but we can consider the possibility of interlocking codes and the development of new dimensions of reporting professionalism from the corporate community as a whole.

Conclusion and Thoughts About The Future

At the end of the symposium, participants were asked for their views on the success of the program and their suggestions for subsequent steps to be taken by the sponsoring organizations. The discussion which follows, together with the written comments of participants, serve as the charge to the Symposium Steering Committee by the group.

Discussion

DISCUSSION LEADER: Commissioner James Needham of the Securities and Exchange Commission has been a participant for the entire meeting and has indicated a desire to say a few words summarizing his reactions.

COMMISSIONER NEEDHAM: One of the clearest messages I have heard here has been an expression of the desire for change. This desire is pressing on us from all sides, and we may as well recognize it. We all have new roles to perform. The difficulty is going to be in establishing the respective roles to the various groups involved in reporting.

There must be a joining of interests in the public interest to strengthen the confidence of the investor in order to improve the capital markets of the United States. The more confidence we can build into our system, the greater benefits will inure to all of us.

The other side of the ethical question is that of legal responsibility; while we don't have time to consider that in depth today, I do want to tell you that the Commission is not just focusing on increasing the level of performance of the groups present here, but we are also studying what the implications are from the liability point of view. We have taken some preliminary steps to try to focus on the problem, to determine what kind of liability situations are arising over which we have some control, and what the long-term implications of strike suits are—suits against accountants and lawyers, suits against directors and officers. While law suits have a role, we are exploring the possibility that they have reached the point where they are really counterproductive. At this point, we haven't gone too far with the question, but it is being examined. We know, however, that we can't take

away from the people the rights to which they feel they are entitled, so it is important for you in the private sector to raise the standards of business conduct.

It may be that, after we have made this preliminary analysis, we will announce a public hearing on this in the not-too-distant future to give all of the interests in the country an opportunity to discuss this question of increased liability of people involved with publicly owned companies.

When I asked last night how long ago it was since the other symposium was held, I was told three years. I would suggest to you that it would not be appropriate for you to let so long a period of time elapse before you reconvene; there are many things to do, and the private sector is really more capable than the government in dealing with these kinds of problems.

I urge you to consider having this type of meeting on an annual basis, and I would hope that as a result of such a meeting some specific recommendations could be made to the SEC. In addition, I would hope to find a willingness on the part of the organizations that are present here to commit themselves to a higher level of conduct in the day-to-day course of business affairs, perhaps through an expansion of their rules of conduct or by other means.

I want to thank you very much for allowing us to come. We have a common interest here; it's been very informative and educational for us.

DISCUSSION LEADER: Are there other reactions to the symposium?

ANALYST: I have attended both symposia and found them most helpful. I think we ought to think about an annual meeting, since I believe fully in the exchange of ideas that took place here. On the other hand, we have not solved some of the problems which came along—particularly the problem of forecasting which seems to be steam rollering down on us. I believe we should attempt to formulate a collective idea on this subject, and soon.

ANALYST: I would like to see this program continue. I think it's very valuable, but I believe that particular problems should be focused on and an attempt made to find some answers.

FINANCIAL EXECUTIVE: I think the symposium should be continued. Perhaps, in retrospect, three years was too long to wait for the second. I think it has been confirmed for us that the pace and sweep of events is quite swift, and we must keep abreast of them.

I hope in the future that we can be more definitive in identifying and reaching a broad consensus on some principles, as opposed to dealing more with the philosophical aspects or expressing our concern about problems; we don't ever seem to reach the definitive stage.

Finally, it appears to me that we have an open gap in the composition of our participants, which would be filled by the attendance for half a day or a full day of a representative group of chief executive officers of various companies. While we can now go back and talk to our chief executive officer, something gets lost in translation because he hasn't heard it first-hand.

CPA: I think this has been a very useful symposium. The benefits from the interchange have been immense, and I would favor continuing it in some fashion; but I don't think it is reasonable to expect this sort of group to be a decision-making body. I don't think we are going to come up with conclusions. We haven't taken any votes, and my guess is that you couldn't get any majority in favor of anything, even though there has been, perhaps, a seeming consensus from time to time.

FINANCIAL EXECUTIVE: I subscribe completely to that, because this is not an organization designed to come to conclusions or specific decisions. Its purpose is an interchange of ideas that we can all carry back to our own associations.

DISCUSSION LEADER: Is there anything else that need be done in terms of an action program?

ANALYST: It occurs to me that there is some opportunity to institutionalize the Steering Committee, which has already been functioning for four years. With some expansion of that committee, it could be converted into something of a center for financial reporting; here would be the opportunity for a continuing dialogue, and perhaps even a deliberative assembly which would give the opportunity to develop position papers, to sponsor some joint research, and to talk to each other. This might serve as an organization within which communication and dialogue could be pursued.

CPA: I was going to make a very similar observation, though perhaps not with as formal an organization in mind. It is important that there be an "on-going" dialogue between these four groups, and maybe a few more, that continually clears the air on differences and what might be done about them, so that individual groups could act upon them.

DISCUSSION LEADER: Thank you for your thoughts and your participation in our discussions. I hope the seeds have been planted in these two days which will result in productive changes in the financial reporting environment in the months and years ahead.

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Symposium Papers and Critiques

The Role of Ethical Standards In Business

By Clarence C. Walton, *President, The Catholic University of America*

When men define ethics as a practical, "ought" science, they do so with an intuitive sense for accuracy. All ethical codes are built from a conceptual platform which sustains the premise that certain human activities ought or ought not to be done. The force of the injunction depends, of course, on a logic influenced by the individual involved, the nature of the act itself, and the circumstances surrounding the act. To use a simple illustration, one may observe how the American penal code distinguishes conceptually between two kinds of acts —those that are *malum in se* and those that are *malum prohibitum.* The former includes such things as assault, arson, rape, and murder because they are actions which no society can tolerate if it wishes to survive: *malum prohibitum* acts are those which may not be considered universally evil but which are disallowed by society and punished under the criminal justice system. In Japan, it is perfectly legitimate for businesses to discuss pricing policies whereas similar practices in this country are outlawed under the Sherman Anti-trust Act; gambling is disapproved in Utah and encouraged in Nevada; England permits the sale of certain drugs, such as marijuana, which are outlawed here.

The Human Element

Regarding the human agent, psychologists make much of individual differences and ethicians are also aware of these factors. Minors are treated differently from adults when crimes are committed; the mentally retarded are rarely held fully culpable by the courts; insiders are dealt with more harshly than outsiders in certain cases of fraud and deception; and in times past the buyer carried the major burden for his own faulty purchasing habits.

The varying nature of the action itself and of the person involved is related to motivations to make more uneven and tortuous the road of ethical inquiry. To mix metaphors, while every effort has been made to develop a logical tapestry, let it be noted only that there is awareness that unraveling occurs when one moves from generalization to specificity, from conceptualization to concretization, from principle to practice. There is the ever-present danger that ethical principles can degenerate into delectable ambiguities pre-

cisely at that point of decision-making when they are most needed.

In a real sense, however, it is the practitioner himself who must refine general rules of conduct to make them meaningful to his own profession; it is the practitioner, too, who is in the best position—and who has the primary responsibility—to develop codes which assure clients and competitors that the rules of the game are understood and honored. The philosopher can proffer a general design and building materials. The professional must erect a bridge which allows transit from theory to action.

Some Critical Questions

How the architectonic features which characterize ethics are developed becomes clear only by asking questions. These questions fall within general and specific categories—the second of which are generated by a certain intrigue with practical problems unique to American business. The interrogation can proceed along these four lines:

1. What is ethics? Or, more properly, what is ethical inquiry? What does it yield?
2. How are principles derived through ethical inquiry institutionalized within the large American society?
3. How are the societally approved norms influenced by business management and how is management, in turn, influenced by them?
4. What are the early warning signals which constitute the "DEW lines" for the future?

What Is Ethical Inquiry?

Because ethics deals with human behavior, it is too often assumed that ethics can provide prefabricated and automatic signals on the highway of life. Ethical guide posts tell where to go: warning signs tell when to slow; traffic lights tell when to stop. In practice, this complex industrialized society operates within a complex democratized society in ways which generate conflict situations for which traditional precepts seem remote and inadequate. But it is helpful to ask where and how ethical inquiry begins; what yield we can expect from it; what is its ultimate utility?

Ethical inquiry begins with relationships. These relationships are essentially two-fold: (1) man's relationship to the cosmos and (2) man's relationship to other men. Often built into the marrow of these relationships, however, are unstated assumptions which may be totally acceptable to some men and totally unpersuasive to others. Simple illustrations drive this crucial point home. The term *cosmos* generates discussion in terms of popular words

which seem to communicate but which fail to carry exact meaning. Think of the radically different meanings attached to the cosmos by Moses and by Monod. In the rich imagery of the Old Testament is the towering figure of Moses who says that the cosmos is something which has emerged from the hand of God. The story of man is the story of his creation by an Omnipotent Being who made a physical universe to serve as man's temporary abode. Behind all—and permeating all—is a Supreme Intelligence who has given the human habitat a symmetry of organization and a logic of construction that finds expression in a set of natural laws. All who have been profoundly influenced by the Judaic-Christian tradition are caught up with this vision of the cosmos. Man's nature forces him to seek contact with this transcendent being, and this contact may be experienced in various ways—externally through scripture, cult, oracle, or human intercession, and internally through prayer and other mystical devotions.[1]

Against the traditional religious views is an interpretation recently advanced by Jacques Monod, the brilliant French Nobel scientist, whose book, *Chance and Necessity,* commands growing interest in the Western world. Monod's postulate, in oversimplified terms, is this: the Cosmos, a product of chance forces, represents no great feat by an omnipotent intelligence but a great fluke. Through some inexplicable random assemblage of physical forces, human life and the cosmos itself evolved into their present states. Man is, therefore, no different from a baboon or from a fish except in terms of superior genetic endowments which are, in turn, the product of the random assemblage of physical forces. And the earth is not simply man's temporary home—his half-way house to heaven, as Moses averred—but the only home he will ever know.

Modern intellectual history is writ large in terms of a bias toward the scientific position. Under traditional religious views, men were presumed to sacrifice and to suffer on this earth in the sure knowledge that afterlife would bring rewards and evenhanded justice. The new rubric provides powerful incentives to believe that, if our cosmos is the product of chance forces alone, one should enjoy *this time* and *this earth* to the full. It can create a subtle kind of hedonism which scorns traditional sacrifice. In the face of so much obvious tragedy, it can also induce a fatalism bordering on nihilism.

If different assumptions about the cosmos lead to different conclusions regarding human goals, it is equally true that different assumptions regarding human nature will produce the same effect. Theological and philosophi-

[1] The way thoughtful men approach the study of the Transcendent is, in itself, a fascinating exercise of intellectual exploration. For example, Emile Durkheim concluded that all of man's gods are but man-created symbols of society itself. See the *Elementary Forms of the Religious Life,* Trans. Joseph W. Swain (London: G. Allen and Unwin, Ltd., 1950). If Durkheim approached the Transcendent through sociology, Rudolph Otto approached the Transcendent through philosophy arguing that the Divine can be known only by first analyzing human feelings. *The Idea of the Holy,* Trans. John W. Harvey (London: Oxford University Press, 1923).

cal reflections on the nature of the human being illustrate not only dichotomous views but significant practical lessons for social engineering, that is to say, the way men construct social organizations such as corporations, governments, labor unions, churches, and the like.

One viewpoint holds that human nature is essentially perverse, essentially greedy and lustful, essentially unreliable, and essentially irrational. On the other hand, we are told by some moralists and philosophers that human nature is essentially reasonable, essentially accomodating and responsible, essentially creative, and essentially good. In theology men like Augustine, Calvin, and Jansen took a dour view of human nature; and they were paralleled in philosophy by Machiavelli, Hobbes, and others. Against this essentially critical model of man is a theological position represented by Aquinas, Bellarmine, and a philosophical interpretation found in Rousseau, Condorcet, and Locke who believe human nature to be fundamentally good and noble.

Practical consequences flow from these assumptions. If the prevailing belief is in the pessimistic view of man, there are found political and business structures which repose power at the top and which build in tight controls over members of the enterprise. Max Weber reflects this trend when he developed a typology where all authority is focused on the top and trickles downward in a series of precise commands. Somewhat the same view permeates the thinking of Henry Taylor on industrial management and Alexander Hamilton in his political designs.

The more optimistic view results in a social structure that is broadly democratic, permissive, and open. In politics, Thomas Jefferson reflects this philosophy; in organizational theory, Chris Argyris, Mason Haire, and Douglas McGregor are expositors of this viewpoint. By way of incomplete summary, we can say that assumptions regarding the cosmos and man give a bias to our ethical perceptions. *One of the first problems of ethical inquiry, therefore, is to expose those assumptions.*

The Ethical "Yield"

The next and almost inexorable question is the one of "yield." Why should a statesman or a businessman or a spouse concern himself with ethical inquiry if there is no practical result? Are there some postulates which have value to all men? An affirmative response requires specification and this, in turn, is dealt with in terms of four items: *rationality, freedom, sanctions,* and *monitoring*. These form the ethical pillars of a just society.

There can be no ethical choice for animals or babies or idiots. This is an oblique way of saying that man is a creature who can think things out, who has the capacity to perceive and to pursue his own best interests, and who has, uniquely, the further capacity to reflect on what he has done in terms of its goodness or its badness. This elemental truism may seem little

more than a cliche; in fact, however, it is important because there can be no democracy, no free enterprise system, no network of interacting voluntary associations without the "rational man" premise.

Also, there can be no ethical choice without freedom. If a man lacks meaningful options, he is incapacitated in making an ethical choice. Freedom is painful because it means accountability. Despite all talk about "delegating authority," anyone in a leadership role knows how difficult it is in crisis to get people to accept authority which enlarges their freedoms. The higher one climbs on the political or business ladder the heavier is the burden. This explains why greater ethical demands are made upon leaders in our society than are made on the followers. Like Caesar's wife, the man "on top" must be above reproach.

The third thing which emerges from ethical inquiry is a realization that rational and free acts inevitably require rewards or punishments in the ethical effort. Built into the spirituality of the Judaic-Christian tradition is the concept of deferred benefits; built into the whole concept of capitalism is this same ideal. Through innate endowments or through social engineering, this sanction system must be seen as reasonable and attainable; otherwise the ethical code on which it relies collapses.

The final product of ethical inquiry is the realization that without a monitoring system ethical behavior by the many is jeopardized by irresponsible behavior by the few. In the ideal order, monitoring is self-imposed and operates through the individual conscience; when, however, human actions are intersocial and when such actions have long-term consequences for large numbers of third parties, then a monitoring system eventually comes into being. It has been a tendency in business to develop self-policing devices which express themselves usually in professional codes of ethics; when such codes fail, the external force of government may be employed.

Thus far a summation of the argument would tell us that the human agent is a reasonable fellow who has freedom to play the game and who believes, further, that the game is worth playing under the watchful eye of an impartial umpire. It tells us that whether one interprets human nature as glorious or subversive, creative or destructive, responsible or irresponsible, there must be an ultimate result. *What are these finalities? The answer, simply put, is a peaceful society based on justice.* Religious men are motivated to go beyond justice to practice a higher form of living by placing the good of the neighbor in parallel track with the self. This small group makes up our heroes and our saints.

The average man seems content to let the honor roll of heroes or saints remain small. For himself, he expects justice from others even as he practices justice toward others. No political order and no business system can long survive if based on any other concept.

Justice, of course, expresses itself in various ways. Within the economic order one perceives quickly two forms which might be described as *transactionalist* justice and *equity* justice, respectively. Transactionalist justice is

simply an arithmetic one-to-one exchange; it is a *quid pro quo* where one voluntarily surrenders something in order to acquire something else of greater subjective utility. Medieval philosophers spent a great deal of time on exchange justice and developed theories for a "living wage" and "fair prices" to further this goal. It was the genius of Adam Smith to devise a theoretical construct which made justice the *automatic result* of a free market system; men did not have to will to do the just thing because the market literally forced it. In our day of vast conglomerates and highly sophisticated expertise, the simple Smithian formula cannot be presumed to yield justice automatically.

A second form, called equity justice, is concerned with one's fair share of the gains by an enterprise. Again, in our kind of industrial order, the fulfillment of this ethical imperative is difficult; it is a rather amazing fact, nonetheless, that through personnel policies (including job descriptions and salary scales) we have approached equity justice with more wisdom than critics of the system care to admit.

Justice in America — Making Dreams Come True

How does a society make the ideal of justice into an existential reality? This chapter in human history is of perennial concern to moralists and historians. For purposes of economy one perforce cuts through an enormous range of complexities in American life to learn how justice was achieved. Our legal, political and economic traditions spell out a fascinating story. By focusing on these three interdependent and interrelated constructs, one can understand how Americans have taken big dreams to little lives.

Suppose we were asked to create a society which best could achieve justice. At a point in time our forebears wrestled with this very challenge. Their response was a series of social innovations that, in the aggregate, built an adversary system as the best method for assuring justice. Illustrations drive the point home quite effectively. In the legal realm, a cherished social creation is "due process," embodied in the Fifth and Fourteenth Amendments. With this technique was developed an elaborate adversary procedure where the accused is brought to trial, is given adequate defense, is allowed to challenge witnesses, is allowed to remain silent. A mantle of confidentiality covers relations between lawyer and client. Then the opponents engaged in one-to-one peaceful "combat" before a group of good and true men sitting as jurors. To ensure justice we insist on a simple rule: "The truth, the whole truth, and nothing but the truth." This suggests, incidentally, that in other kinds of human exchange, partial truth might be acceptable on an ethical basis. Underlying this legal jousting is a win-lose premise: a verdict is reached by the jurors; a sentence is passed. And that is it!

In the political realm our Founders also introduced the adversary concept on a one-to-one organizational confrontation. Perhaps the most elaborate

theoretical formulation is found in Madison's essay in *The Federalist* which brilliantly expounded the idea of group conflict. At a time when men worried whether large states would dominate small states, rich states dominate poor ones, populous areas control less populous ones, Madison cut through the size issue to assert that throughout American society there are group conflicts based on a variety of economic, religious, political, local issues. In a sense Madison anticipated Galbraith's Countervailing Theory as a mechanism which would work to the good of all. Madison then moved to politics.

The political system was built on a simple proposition of peaceful conflict resolution. The further assumption was that small groups would merge into large groups and then into ever larger groups which would eventually be incorporated into a political party. At one point in time (election day) Republicans and Democrats would enter into the arena, and through the adversary process one would emerge as the winner and the other as the loser.

In business we accepted as part of our secular scripture the notion of market competition. But Smith added an interesting variation on the old adversary theme. Instead of a simple win-lose proposition, both parties to the exchange system wind up winners. Because of specialization of labor and because of multiple units in the competitive field, each man's utility would be generally enhanced through the market mechanism. It was not simply happenstance that we talk of an exchange of "goods."

This conceptual framework Americans developed and, for a century, sought to elaborate with increasing refinement. Unhappily, the age of industrialization was precisely at the Rostovian take-off point when Charles Darwin published his famous *Origin of Species* (1859). In it he argued that ruthless competition and survival-of-the-fittest were laws of nature. Herbert Spencer was so entranced by these general ideas that he applied them to the social order. As a country—and above all others—America embraced wholeheartedly the concept of Social Darwinism. Business was part of life, and life represented the jungle ethics in the fight for survival. There were winners and there were losers; the struggle was intense and vicious.

The post-bellum society moved through an age of robber barons and muckrakers, tough-muscled and tight-lipped buccaneers who took the infant country into industrial manhood—at a price! In the interim, a compliant court rendered a series of decisions which apotheosized property rights, winked at ruthless competition, allowed labor to be treated exclusively as a factor in production, and kept government intervention to a minimum.

Men still preached the values of Jeffersonian agrarianism, small-town virtues–the essentially "good man" model. But the gap between reality and myth widened. There seemed to be a wholesale refusal to face facts and to recognize that personal competition had been superseded by organizational competition, that the win-lose concept had now been moved fully into the economic sphere, that those that failed to succeed were victims of a system and not victims of their own corrupt natures.

As freedoms were curtailed for many, as the monetary systems creaked

into inefficiencies, as business cycles became more severe, business was put on the firing line, and the great depression of 1929 marked the nadir of confidence in the American dream.

The Ethics of Business

It is now opportune to recall some general criteria that emerged from our ethical inquiry. Postulated was the notion of rationality, and the distinction was made between the infant and the adult. In a social sense, the American corporation was still an infant whose managers had no clear notion of how a corporation fitted within the larger goals of American society. The lack of relevant corporate data meant, further, that rationality was handicapped—if rationality is defined as an ability to perceive and pursue enlightened self-interest and to be aware of long-term consequences. Postulated, too, was a notion of freedom, but freedom of initiative was drying up at such a rate that Congress was driven to pass the Sherman Anti-trust law. The rewards system, premised on Darwinian concepts, made it only a matter of time until the working masses revolted against rules of the game that were slanted against them.

It was his powerful appeal to the working classes that helped Roosevelt to victory in 1932 and ushered in what was to be a radical transformation in the numerical strength of the two major political parties.

It may be unfair to say that a depression was required to bring reform. But the depression did induce serious and agonizing reappraisals of business ethics. Challenged was the dictum, given by R. E. Badger, author of a major book on investment analysis: "let the buyer beware."[2] In their landmark book, Berle and Means argued in 1932 that there was a desperate need for new ethical principles to govern disclosure policies;[3] working along parallel tracks were Graham and Dodd whose remedy for ethical deficiencies was advocacy of a more activist stockholder policy as a kind of countervailing force to the power of insiders.[4] When business moved slowly to clean its own house, the government moved promptly and the passage of the Securities Exchange Act of 1934 represented a new monitoring force of great power—and considerable uncertainty—in the business community.

It need only be remarked at this point that the old concept of simple adversary relationships was no longer regarded as the automatic safeguard for the promotion of justice. The evolutionary process had begun.

The most dramatic developments have occurred since the end of World War II. Approaching the problem of business ethics, men tended to divide

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[2] R. E. Badger, *Valuation of Industrial Securities* (New York: Prentice-Hall, 1925), p. 115.

[3] Berle and Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1932).

[4] Graham and Dodd, *Security Analysis* (New York: McGraw-Hill Book Co., 1934).

between those who advocated a *representationalist* ethic for business and those who advocated a *trusteeship* ethic for business. Under the former rubric, corporate managers were asked to behave like members of the British House of Commons who were elected for one purpose: to represent their constituency. The Member of Parliament was not expected to act out Edmund Burke's dream of the independent statesman leading his people; rather, he was to behave in the sense of a delivery man. What the voters wanted was what he expected to get.

In a similar vein it was argued that corporate managers were responsible to one client–the stockholder. It was a manager's obligation, therefore, to get what the stockholder wanted. And what he wanted was maximization of his investment. The ideas of the representationalist ethic are articulated today by scholars like Milton Friedman of Chicago and Henry Mannes of Rochester and by businessmen like Arnold Maremont and Nathan Cummings. The business of business is business: any attempt to accommodate to larger sets of claimants is foredoomed to failure.

Against this tradition is a new view which argues persuasively that a corporation holds a franchise from the entire American people. It follows, therefore, that the corporation must behave like a good citizen and discharge certain civic responsibilities. These obligations transcend the claims of a single constituency called stockholders and require something more than mere profit-maximizing. Men like Alfred Sloan of General Motors and David Rockefeller of Chase Manhattan, support this concept. The trusteeship model holds that in a complicated society like ours, management decisions affect not only stockholders and competitors, but the entire society. The claimants go well beyond one-to-one relationships embodied in a simple adversary model. The model recognizes that corporate decisions can shake the entire society.

If one were to venture a judgment on the relative strengths of the two positions, it seems that the trusteeship model is gaining ascendancy. Clearly, in the area of corporate financial reporting, the public auditor enjoys no role similar to the privileged position of lawyer to client. By the nature of things he is expected to take a broader view of societal needs. He must slap wrists when hands attached thereto are reaching for the wrong things. Wrong things could include, of course, conflict-of-interest situations, negligence, inadequate or dishonest disclosures, and even errors of judgment.

It seems, however, that a more difficult problem is arising. It is recognized, on one hand, that upon management falls the burden of success or failure for the corporate enterprise; presumably it is management's right, therefore, to determine what is economically relevant in disclosure. On the other hand, it is the public auditor who, increasingly, is held responsible for developing ground rules in preparing financial statements; and, such financial statements cannot escape concerns with economic relevance for the long pull. At this point, the professional will be driven to develop greater precision in defining the concept of "generally accepted accounting principles," of sharpening professional codes which will tell both management and the public

the accountant's range of responsibilities and limitations thereon. Judicial decisions increasingly demonstrate a single fact: whereas deliberate wrongdoing was prohibited and negligent wrongdoing often condoned, the area of responsibility has been extended to include negligence. The burden is less on the buyer and more on the vendor: the accountant who sells his services does so today under the watchful eyes of judges and legislators.

Ethical Behavior and the Future

There often occurs in human affairs an event which signals momentous changes. Such an event was the *Associated Gas and Electric* case of 1942 which distinguished between formal compliance with generally accepted accounting practices and the reality of service to truth. One can argue persuasively that this distinction was a warning the full import of which was not understood by the auditing community.

It is in this sense that one looks at the larger society to discern trends of importance to business. There has always been a "hostile elite" operating in the world so far as business is concerned. It has consisted, at various times, of the intellectual, the moralist, and the politician. Today a new dimension is added with the youth culture. If ever these hostile elites should coalesce, business would face powerful adversaries. At the moment, one can look only at the most numerous of these elites, the young, to ask what is the message in their so-called counter culture. The messages are numerous, crisp, jolting.

1. We are being told there is massive dissatisfaction with all major institutions of our society (church, state, corporation, family).
2. We are being told that adversary relationships are not the best way to achieve justice.
3. We are being told that competition has a limited utility and that what really counts is harmony and complementarity.
4. We are being told that in an affluent society there ought not be winners and losers; the new heresy affirms that everyone should be a winner. The implications of this for a competitive society and for the Protestant ethic are enormous.

Clearly, the judicial arm is getting ever longer and the judicial fingers ever more grasping. The court decisions would suggest strongly that in certain conflicts there is a measure of predictability for the outcome. Illustrations might include the following:

1. If there is a conflict of rights between the individual and the organization, the individual will receive preferential treatment.

2. If there is a question of judging decision-making on the basis of short- versus long-term consequences, the judgment will be concerned with the long-term result.

3. If there is a conflict between the innocent and the expert, between the ignorant and the informed, between the layman and the professional, the preference will be in favor of the innocent, the uninformed, the layman.

4. If there is a conflict between the weak and the strong, the bias is toward protecting the weak.

5. If there is a conflict between serving a narrow constituency and the larger society, the support will be for the greater number of claimants.

The accounting profession, in a very special way, deals with objective reporting of facts to serve justice. It deals with the material prosperity of the entire American people; it involves highly complex human and social relationships between client and professional.

If society is moving toward new directions, the professional must adjust. Such adjustments may be achieved by forces external to the profession or by men of vision within the accounting fraternity. If justice and prosperity are to be the fortunes of all Americans in these troubled days, then one hopes for the emergence of new Colonel Carters and George O. Mays who in the past sensed significant changes and responded creatively.

The Changing Ethical Environment in Financial Reporting

Ethical Standards in Financial Reporting: A Critical Review

By Douglas A. Hayes, *Professor of Finance, University of Michigan; member of the Professional Grievance Committee, The Institute of Chartered Financial Analysts*

If we accept the premise that extensive public holdings of corporate securities, including both bonds and stocks, roughly coincided with the transformation of this country from a largely agrarian economy to an industrial economy near the end of the nineteenth century, then the doctrine, which would be consequent to this event, that corporations have an obligation to provide reasonably accurate and extensive financial information to their outside investors is necessarily of fairly recent origin. As recently as 1925, for example, a leading book on investment principles was reluctantly obliged to offer the following statement:

> But for the securities of manufacturing and industrial companies generally, investment principles degenerate into a series of caveats, until it seems as if the only dictum of common application is the caution of caveat emptor, "let the buyer beware."
>
> It is no reflection on the class of securities called "industrial bonds" that they do not receive treatment in these pages. The inference is merely as implied above, that the conditions governing their issuance are not sufficiently uniform for safe generalization.[1]

The language clearly suggests that commitments to industrial securities at that time could be regarded as suitable only for "insiders" or perhaps as short-term speculative vehicles because of the inherent lack of relevant corporate data for an intelligent investment appraisal.

[1] Lawrence Chamberlin, *The Principles of Bond Investment* (New York: Henry Holt & Co., 1925), p. iv.

Corporate Reporting: The Early Phase

One of the first extensive books on valuation methodology also reluctantly concluded that the art of financial reporting was then in a primitive state. Badger, in his landmark book, *Valuation of Industrial Securities,* was one of the first to hold that expected long-term earning power capitalized at an appropriate rate should be the basic approach to the determination of the investment value of a common stock. But in discussing analytical techniques for determining earning power, it is almost ludicrous to note that Badger recommended the earnings be determined from a comparison of the change in equity between successive balance sheets rather than from direct use of income statements because the latter were likely to be arbitrary and often misleading.[2]

Perhaps because the "Corporate Establishment" invoked the respect, if not the awe, of all but the lunatic fringe of academic economists (such as Thorstein Veblen) during the New Era of the twenties, the literature on investment analysis of that time did not include a protest against the paucity of financial information and the lack of generally accepted standards for its preparation. With the onset of the Depression, however, the doctrine that economic progress would best be served by a laissez-faire policy toward corporate management quickly evaporated. The shocking revelations of price-rigging and manipulations in the securities markets, sometimes abetted by corporate insiders, indicated clearly that the public interest required sweeping reforms as to both market and corporate attitudes if the system was to survive. The almost religious faith that the American public had in laissez-faire was demolished, and a trend toward economic controls was set in motion that has continued to the present day.

In the context of these times, it is not surprising to find that the first edition of Graham and Dodd, *Security Analysis,* written in 1933-1934, severely criticized the prevailing policy of corporations to provide only a minimal amount of financial data in their annual reports. In fact, for the first time, leading members within the Wall Street community raised the ethical issue concerning corporate disclosure policies:

> Concealment of the sales total or the depreciation charge severely handicaps the analyst and the intelligent stockholder because it renders impossible any thoroughgoing study of the results. *Nor can it be denied that the restriction of this important information to a small group identified with the management may at times be of great benefit to them and a disadvantage to the general public.* The same is true of the failure to issue reports oftener than once a year. [Emphasis mine.][3]

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[2] R. E. Badger, *Valuation of Industrial Securities* (New York: Prentice-Hall, 1925), pp. 114-115.

[3] Graham and Dodd, *Security Analysis* (New York: McGraw-Hill Book Co., 1934), p. 44.

It is perhaps also significant that the authors did not recommend governmental intervention to remedy the situation as might be the case today. Instead an activist stockholder policy was recommended, and it is quite possible that one reason for the leading role occupied by Benjamin Graham in organizing the first Financial Analyst Society may be related to the following statement: "If the stockholders of companies pursuing such archaic policies of concealment would bring sufficiently vigorous pressure upon their managements, many changes for the better could speedily be brought about."[4]

Statutory Reforms: Objectives and Results

Whether the "stockholder pressure" strategy would have accomplished the desired results will never be known because shortly thereafter the Securities Exchange Act of 1934 became the law of the land. As we all know, Section 13 of that Act stipulated that all listed companies must file financial reports at such intervals and in such form as the SEC may require to provide "proper protection of investors and to insure fair dealing in the security."[5] The language of the statute clearly indicated that ethical considerations motivated Congress to seek a legal remedy for the intolerable state of corporate reporting; it was apparently concluded that ethical standards had to be imposed from the outside and enforced with legal sanctions because of the lack of an effective self-regulating mechanism to produce the desired result.

It seems fair to conclude that so far as the specific complaints voiced by Graham and Dodd were concerned, the statutory requirements as implemented by the SEC largely achieved the desired result. Their concern, as suggested by the quotation, was primarily with an inadequate quantity of financial data and not with the accounting concepts related to their preparation. Within a reasonable period of time, the development of Form 10K certainly seemed to provide the necessary corrective for listed companies. Moreover, most major unlisted companies tended to follow the general pattern imposed by 10K although they were not brought under the Act until 1964.

However, even after the legal disclosure requirements were implemented, there is some evidence that the annual reports of some major companies continued to provide only a minimal amount of financial information. For example, the R. J. Reynolds Tobacco Company did not publish an annual report until 1947 (for the year 1946) which included a standard form income statement, a management review of the previous year, and the outlook for the coming year. Up until that time the company had merely sent its shareholders once a year a two-page document entitled "Financial Statement" which set forth only a condensed income statement and balance sheet for the year

[4] *Ibid.*, p. 44.

[5] Securities Exchange Act of 1934, Section 13(a).

in question; in retrospect, it is shocking to recall the primitive status of financial reporting in a period as recent as the 1940s. In fact this particular company, which had long been listed on the Big Board, did not reveal its gross revenues in its income statement until 1937. Because this concession followed the 10K requirement by a year or so, it would seem a reasonable conjecture that statutory compulsion was the lever that reluctantly induced the change of policy.

Unfortunately, therefore, in reviewing the history of corporate reporting policies there would seem to be considerable justification for the position that adequate disclosure had to be forced on corporations through statutory sanctions. There is no substantive evidence that an enlightened attitude of management toward its responsibilities produces the wealth of information available in most annual reports today. While some may regard the analogy as unfair, the fact that many corporations had to be threatened with legal sanctions to take a more responsible position toward their shareholders may suggest that a voluntary restructuring of policies will not be adequate to meet the current emerging social responsibilities, such as the need for pollution control, and that statutory remedies are the only viable means of inducing satisfactory corporate performance in areas of crucial public interest.

Some analysts still argue that certain deficiencies exist with respect to the *amount* of disclosure offered by some corporations. For example, for the most part the integrated oil companies do not reveal estimated crude oil reserves and the changes therein produced by exploration activities during a given year. And there continues to be controversy concerning whether multiline corporations should report earnings as well as sales by major product groups. However, these alleged deficiencies in disclosure are of an entirely different dimension than those preceding SEC days. With respect to most of the additional disclosures presently advocated, corporations may have the legitimate defense that the data cannot be prepared with a reasonable degree of accuracy and may necessarily involve estimates subject to a wide margin of error. Estimates of proven oil reserves and of profit contributions by product lines (where arbitrary allocations of joint expenses might be required) would seem to be of this nature.

However, these measurement problems did not exist for such fundamental matters as total sales, sales by product lines, and major types of expenses that were previously withheld; the earlier defense was a vague allegation that disclosure of additional information would somehow result in a "competitive disadvantage" although just how and in what ways were never made clear. Therefore, the ethical overtones alluded to by Graham and Dodd in 1934 concerning the secrecy policies of those days cannot readily be transferred to a reluctance to supply data which cannot readily be quantified except on the basis of rather uncertain estimates.

Although ingenious financial and credit analysts will undoubtedly suggest analytical techniques that will require additional financial or operating data of some sort or other, the principle of diminishing returns may be appli-

cable to many proposed extensions of financial and economic information on both industries and companies. For example, the statistical supplements of some of the major oil and utility companies seem to provide more quantitative data than can readily be digested by even a professional analyst.

The Stewardship Theory: Development and Ethical Premises

There is considerable doubt whether the same sense of relative satisfaction can be applied to a second dimension of financial reporting that is equally crucial. Reference here is to the state of ethical behavior that has sometimes seemed to govern some managements in their decisions as to the basis for determining financial information. While the extent of disclosure is important, it would seem equally important that all disclosures be free from conflict of interest biases, be consistent, and be reasonably uniform in application. In short, reporting standards should so far as possible minimize interpretational problems in the financial and credit markets.

The issues here are subtle, complicated, and controversial with respect to both ethical considerations and accounting theory and its related principles. But in my opinion the issue that transcends all others is the emerging controversy concerning a basic premise of the corporate institution: the stewardship theory of management responsibility. This theory is based on the empirical evidence that in the large corporation there is a de facto separation of ownership on one hand and management control on the other. As a consequence, the doctrine has emerged that managements of publicly owned corporations should be considered fiduciary-professionals who necessarily must be given discretionary authority to manage corporate property for the benefit of outside shareholders to whom they render periodic reports.[6] By inference the doctrine almost seems to suggest that management should assume the role of a common law trustee and behave accordingly, although advocates of the theory have notably been silent on the question of whether the legal responsibilities incumbent on common law trustees should be applied to corporate management.

The theory is of relatively modern origin, and although perhaps not originating it, Berle and Means' *The Modern Corporation and Private Property,* published in 1932, gave the concept wide visibility in the academic and legal communities. In fact, this milestone work probably had considerable influence on subsequent legislation; the Securities Acts of 1933 and 1934 in-

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[6] Cf. J. C. Burton, ed., *Corporate Financial Reporting: Conflicts and Challenges* (New York: American Institute of Certified Public Accountants, 1969), pp. 5-6. The stewardship theory was used in these pages to argue that under it financial reporting becomes an important responsibility of management and, as a consequence, management also must have the ultimate authority to decide upon the accounting principles applicable to their situation. The assumption of no "conflicts of interest" would seem clear, though unstated, in this conclusion.

cluded remedies for many of their specific concerns, such as the lack of full disclosure on public offerings and the vulnerability of the public to insider trading abuses. Although it is phrased in terms of a recommendation for legal liability because their primary objective was a revision of legal standards to govern corporate behavior, the following extract from the original edition could easily be restated as a major element in an ethical code for disclosure under the stewardship theory:

> Granting the economic thesis that a share of stock is primarily a capitalized expectation, valued by an open market appraisal of the situation existing in the corporation and the industry, and granting further that it is reasonably foreseeable (as it certainly is) that appraisals will vary with the information given out, it is not difficult to suppose that the management of a corporation will be liable (a) for willful misstatement of fact designed to induce action on the part of anyone buying or selling in the market; (b) perhaps also on account of a negligent misstatement of fact not designed to induce action in the market but resulting in a material fluctuation; (c) possibly, for a failure to disclose a material fact leading to faulty appraisal.[7]

Despite their concern with legal remedies, Berle and Means did raise the specific issue of ethical standards under the stewardship theory and concluded that if disclosures are made with the intention of inducing market action, they should be interpreted as unethical because "it is not the business of the management to create market movements," unless it is to correct erroneous rumors that clearly appear to be affecting the price of the securities.[8] The need for ethical standards to supplement legal requirements resulted, in their opinion, from the inherent ambiguities concerning definitions, such as what is a "fact" and what is "material." As a consequence, it was their conclusion that the law could only intervene in obvious situations, and that legal remedies, therefore, could not correct the basic problems related to managerial responsibilities in this area.

Berle and Means, therefore, offered a persuasive case for establishing strict ethical codes to govern disclosure policies with the primary goal to be that of facilitating appraisals of credit quality and security values by outside lenders and investors. The reference to this work has been emphasized because a case can be made that it still offers the most penetrating and extensive analysis of the ethical issues related to corporate disclosures. However, their final conclusion that the failure of corporate managements to meet their responsibilities indicated the desirability of quasi socialization of corporate property was certainly too extreme since they largely ignored the basic eco-

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[7] Berle and Means, *The Modern Corporation and Private Property* (New York: Macmillan Co., 1932), pp. 321-22.

[8] *Ibid.*, pp. 320-21.

nomic question of what alternative system would maximize economic growth and welfare in the long run.

The Stewardship Theory: An Ethical Dilemma

Although for the great majority of corporations reporting standards have undoubtedly improved considerably from those practiced in 1932, recurrent revelations of alleged illegal or unethical disclosures can still be found in the financial press. It is apparent, therefore, that the problems in this area have not been entirely resolved. The proposition was advanced earlier in this paper that any reporting policies, or changes therein through time, that make a long-term appraisal of a company difficult (or erroneous) should bear the burden of proof to vindicate their ethical justification. Therefore, the possible motivations for less than optimal disclosure policies must be evaluated because a consideration of such motivations may go far toward establishing evidence as to whether such policies can be considered unethical. In this connection, a review of a number of instances of corporate reports that seem to have failed to meet the desired objective as set forth above included one or more of the following motivations:

1. The self-preservation motive which usually takes the form of manipulating the financial reports to cover up an inadequate earnings performance in order to avoid shareholder criticism possibly leading to a proxy fight.
2. The motive reflected in a desire to maintain continued access to bank and other loan markets. This may induce management to find means of improving their earnings and balance sheet figures through adoption of "favorable" accounting interpretations.
3. A desire to remove the vulnerability of the company to unfriendly takeover bids; this motive is usually implemented by attempting to improve the market price of the shares through adopting accounting principles which will increase per share earnings and their trend.
4. A political motive which usually takes the form of adopting accounting interpretations to reduce reported earnings; the objective has usually been to offset governmental criticism of product price increases.
5. The motivation to obtain or maintain a high multiple for a common stock in order to facilitate acquisitions through exchange of stock.
6. The motivation of management-shareholders to show earnings results that will facilitate disposal of all or part of their holdings at favorable prices.

There may be other motives which may induce management to depart from a strict adherence to the basic goals of financial reporting; however, this list should indicate that strong behavioral incentives may intrude from time to time to impede compliance with purely objective reporting standards. The

question remains, though, as to whether some or all of these motivational conditions are unethical based on the stewardship theory of managerial responsibility.

Some seem relatively easy to resolve. Certainly the slanting of financial reports to cover up a poor performance can only be regarded as unethical in the context of the stewardship theory. Therefore, any changes in accounting methods or interpretations during a period in which earnings reverses have taken place would be suspect if the changes had the effect of improving the results that otherwise would have been reported. Moreover, because it cannot be supposed that the large majority of the beneficiaries are expert financial analysts, disclosure of the changes in technical footnotes would not seem to be an acceptable defense against the presumption of unethical behavior. By these standards, decisions to reduce allocations to pension funds (U.S. Steel in 1958) or to change from a writeoff to a capitalization policy on research and development expenditures would be presumed unethical if they occurred during adverse years.

Motivations (2) through (4) above are more difficult to evaluate. On one hand, it can be argued that they represent ulterior motives which are incompatible with the fundamental goals of financial reporting, and as a result, if there is evidence to suggest any biases along these lines, criticism on ethical grounds is justified. On the other hand, the case can be made that these are defensive measures whose primary purpose is to protect the interests of the shareholders in a long-term sense. Bankers no doubt would deplore reporting practices designed to obtain more favorable credit terms than otherwise would be granted, but under the stewardship theory, the obligation to shareholders may be regarded as having first priority, particularly if management has only a nominal personal interest in the company. If, however, the obligation is to offer equitable and equal treatment to all classes of investors, then any reports which incorporated this motive would be open to ethical criticism.

But no existing class of investors can claim injury if the company attempts to ward off takeover bids which are viewed as undesirable from a long-term standpoint or if it moves to counter adverse political pressures on pricing policies. Therefore, if these motives can be identified as compatible with the long-term objective of all the parties of interest, the fact that the resultant reports may inhibit the valuation process may be considered as an unavoidable tradeoff which must be sacrificed.

Although the evidence is purely circumstantial, the several changes in depreciation policies instituted by Inland Steel over the past decade suggest the existence of both of these motives during these years. In 1962, it will be remembered, political criticism of the steel industry for increasing prices obtained considerable visibility. During that year Inland Steel increased its depreciation charges from $42.1 million in 1961 to $60.9 million in 1962 although gross plant assets increased only modestly; the maximum accelerated depreciation allowed for tax purposes was applied to the financial reports and, as a consequence, net income declined by the modest amount of $2.7

million from 1961. In other words, during a recovery year in corporate profits generally, Inland Steel managed to show a declining level of profitability coincidental with attempts to buttress a case for higher steel prices.

Then in 1968 several of the steel companies became prime targets for takeover bids, and of course Ling-Temco-Vought, Inc., conducted a successful bid for Jones & Laughlin at that time. In the annual report for 1968, it was announced that two accounting changes had been made to bring "accounting practices in line with those generally followed in financial reporting by major companies." Henceforth, the company would use the straight-line method for computing depreciation and the flow-through method would be applied to the investment credit. By these changes alone, earnings per share were increased by more than $1.20 per share in 1968, and not surprisingly the price of the shares became stronger in the market.

There would seem to be little doubt that these successive changes in policies with respect to a major category of operating expenses have made the appraisal of Inland Steel's shares more difficult; in fact, it would seem practically impossible to obtain any accurate insight into the real trend and fluctuation of earnings during these years. However, some might hold that because their purposes in instituting the policy changes were not inconsistent with long-term shareholder interests, they were not unethical. But the end results seem clearly at odds with the basic objectives of financial reporting under the stewardship theory.

Finally, a conscious structuring of reporting policies to obtain a high multiple for a stock, either to enable large inside shareholders to dispose of their holdings at favorable prices or to facilitate acquisitions, would seem open to serious criticism on ethical grounds. By definition, the objective is to mislead investors into an appraisal higher than otherwise would be justified. Although the first edition of *Security Analysis* in 1934 devoted considerable attention to the need for a critical analysis of reported earnings, and others have frequently repeated the caveat since, stock prices still seem highly sensitive to changes in the percentage growth of *reported* earnings per share. This observed fact, deplorable as it may be, has provided a definite temptation to unethical managements to make earnings "perform" accordingly.[9]

In my opinion, the trend distortions introduced by some applications of pooling of interests accounting on the part of a few conglomerates before remedial measures were taken by the SEC and the Accounting Principles Board represented classic examples of "performance" reporting. The allegations of the SEC with respect to data filed by Performance Systems, Inc. represent a fairly recent example of these motives. The allegations charge material over-

[9] The technical means used to achieve performance in earnings usually include revisions in accounting methods to accelerate revenue recognition (on leases, for example) and to defer expense recognition or some combination of both. Also large writeoffs in a single year may be used to relieve future income statements of normal expense charges. "Flexibility" in accounting principles makes these devices open to management.

statements of earnings in a registration statement covering both a debenture offering and insider shareholder sale of common stock. In short, the inference is clear that accounting policies used to determine earnings were influenced by the desire of insider management to unload shares at favorable prices. In this case, it is interesting to note that the disputed reports had been "certified by a prominent national accounting firm" and this fact represented the major reported defense against the allegations.[10]

The fundamental issue that emerges from the above discussion is whether the stewardship theory which makes management primarily responsible for the financial reports should not be discarded because of inherent and irreconcilable conflicts of interest. Although the formal position of the accounting profession still supports the theory, the dissents have grown more numerous and more visible in recent years. In this connection, the prestigious publication of Duke University's Law School, *Law and Contemporary Problems,* devoted an entire issue in 1965 to the subject of "Uniformity in Financial Accounting." To my knowledge, this publication still represents the most comprehensive collection of views on the legal, ethical, and institutional framework of financial reporting. In a number of these independently prepared essays, there is a pervasive theme that some type of sanction should be imposed to subordinate management's control over the financial reports rendered to outside investor interests. The following statement in support of this proposition, while it was not universally accepted, is illustrative of the views of several contributions:

> Management is primarily responsible for the choice among alternative accounting principles used in compiling annual reports. Yet accounting statements are essentially reports on managerial performance. Apart from the obvious conflict of interest in such a situation, there is little assurance that management, beset by a variety of pressures to mould accounting results purposively, uses the best measurement criteria in reaching its accounting policy decisions. . . . Freeing external accounting measurement from strong managerial influence may be an important first step in gaining acceptance for new accounting principles in which the inevitable compromise between objectivity and economic relevance is weighted more heavily toward the latter.[11]

Some might argue against imposing more rigorous constraints on management on the grounds that they would be incompatible with the tenets of a free enterprise economy. In their view, an excess of extraneous regulations already unduly inhibits the private sector to the detriment of economic effici-

[10] *The Wall Street Journal,* April 19, 1971, p. 6.

[11] Charles E. Johnson, "Management and Accounting Principles," *Law and Contemporary Problems* (Duke University School of Law, Autumn 1965), p. 705.

ency and growth. Therefore, further intrusions whether by legal means or otherwise should be strongly resisted at all costs.

However, a major, although usually implicit, assumption of free enterprise economics is that reasonably extensive and accurate information is available to the consumer and investor components of the private sector because only with such information will optimal decisions be reached both as to consumption and investment. Business firms can obtain external financing only if they can convince the financial markets that they offer an attractive risk-return matrix superior to available alternatives. If the information on which financial market decisions must be based is misleading or can only be compared to alternatives with extreme difficulty, then capital cannot be efficiently allocated at best and may be completely misallocated at worst. As the scope and complexity of economic activity have increased, the problems of efficiently allocating savings flows have consequently become more difficult. To have these difficulties compounded by a serious lack of agreement on appropriate reporting standards quite possibly would seem intolerable even to the most dedicated free enterprise economists. In fact, such economists might well advance the proposition that effective controls over reporting standards are greatly preferable to the possible alternative that might develop if the quality of information flows do not improve: direct controls over capital allocations.

The Ethical Interface: Financial Reporting And Investment Strategies

In the pre-SEC era, the preponderance of historical evidence suggests that the strategies which dominated stock market activities were short-term or at most intermediate-term in nature. Common stocks generally were either regarded as short-term trading vehicles (the casino strategy) or alternatively were to be traded according to the popular Dow theory or through some other means of forecasting the probable direction of the market in a cyclical sense. The implementation of these strategies required a minimum of corporate financial information because they were primarily based on technical market analysis supplemented by economic business cycle analysis.

It is quite possible that these strategies occupied a dominant position because the crude state of financial reporting made other strategies difficult to implement. This may have been particularly true in the 1925-1930 period because after Smith originated the theory of common stocks as long-term investments in 1924, Badger, Rose, Van Strum, and Irving Fisher, among others, refined and popularized it for a wide audience.

The trauma of the Great Depression merely led the adherents of the long-term strategy to modify the theory to include the caveats that satisfactory results would probably also depend on prudent selection techniques, wherein long-term values were estimated and compared to prevailing prices. The financial reporting revolution engendered by the legislation of the early thir-

ties made implementation of these caveats seem possible for the first time.

Although trading strategies never were completely discarded, the orientation definitely seemed to shift toward a long-term approach based on fundamental analysis. The scorn that John Maynard Keynes had shown for stock market investors in his famous *General Theory* gradually seemed to become undeserved. Keynes had compared the market to a game of musical chairs. Then followed the much quoted observation that most decisions were based not on an intelligent estimate of long-term economic expectations but upon what "average opinion expects average opinion to be," and he concluded that, based on the historical record, the stock market was a net detriment to economic stability and progress.[12] Although one cannot point to conclusive evidence that the casino strategies that Keynes had satirized so effectively occupied only a minor role in the markets of the forties and fifties, the fact that the turnover ratio remained well below that of the twenties suggests that a greater proportion of stocks were acquired for relatively permanent investment.

In the context of the revised approach to investment in common stocks, serious literature on investment analysis, including successive editions of Graham and Dodd (and three editions of my own book), stressed the need for a critical examination of reported earnings and for considerable skepticism toward "concepts" and short-term results unsupported by a seasoned earnings record tested by adversity.

If the trend in this direction had continued, the incidence of questionable reporting practices may well have declined. Managements might ultimately have become sensitive to the fact that their reports would be subject to careful scrutiny, and reports offering misleading or inadequate information might well have become counter-productive in terms of their effects on the related securities. In other words, there seemed to be developing a salutary interface between the slow trend toward improved professional standards in security analysis and improved reporting policies. The aspiration level in this connection probably reached a high point with the founding of the Certified Financial Analyst program in 1963, which had as its major objective the development of a professional status for financial analysts.

Unfortunately, however, the vogue for performance investment strategies which developed in the mid-sixties has had serious regressive effects on professional and ethical standards within the investment community and again there was an interface response from the corporate community. A new set of robber barons emerged in a portion of the mutual fund industry who used the new techniques of letter stock writeups, reappraisals upward of nonmarketable assets on the basis of contrived evidence, and concentrated activity in thinly traded "concept" stocks to generate self-propelled performance that in

[12] J. M. Keynes, *The General Theory of Employment, Interest, and Money* (New York: Harcourt, Brace and Co., 1936), pp. 156-59.

turn provided huge self-enrichment through incentive fees based on near-term upside performance with no penalties for subsequent declines. The Keynesian comparison of the market to a game of musical chairs proved to be more dismally accurate than amusing as rapid advances in some thinly traded stocks were followed by one collapse after another. Those that failed to gain a "chair" by an early exit suffered catastrophic consequences. A veil of secrecy has obscured the effects on the personal fortunes of the performance fund managers, but there is no reason to believe they have not retained their ill-gotten plunder.

As might be expected, the reporting policies of numerous "concept" companies aided and abetted performance strategies oriented to rapid trading on the basis of changes in quarterly reports turned out by these unseasoned "concept" companies. The temptations were great because if a company could catch the fancy of the performance funds for several months or so, large insider shareholders, including management with large stock options, could realize fantastic gains and become wealthy overnight. With this "pot of gold" awaiting them, apparently entirely within the law, it is not surprising that abstract ethical considerations were sometimes submerged by some managements in establishing criteria for financial reporting. Some might dismiss these comments as merely historical in nature while our concern should be with the future. But let us not delude ourselves. Greed will continue to be a strong behavioral motivation; and, if control over financial reporting policies remains with those who can use the policies for huge self-enrichment, then no amount of pious exhortation will eliminate unethical behavior.

Conclusion and Recommendations

The events of the late sixties have merely reinforced my conclusions concerning the desirable guidelines for imposing more effective controls over financial reporting that were set forth in 1965. In short, they seem more pertinent today than then and, therefore, are reproduced below. They were, in part, paraphrases of recommendations made by Dr. Herbert E. Miller,[13] then a professor of accounting and now a partner in Arthur Andersen.

1. Financial statements should reflect an objective and impartial report on management's performance.
2. The accounting profession has the obligation to correct any deficiencies in financial statements that impair an objective evaluation of managerial performances.
3. Disclosure of the use of unusual accounting principles or procedures in technical footnotes to the statements should not be re-

[13] See Miller, "Audited Statements–Are They Really Management's?" *The Journal of Accountancy,* (October 1964), p. 43.

garded as alleviating the responsibility of the public accountant for their use in statements which receive unqualified opinions.

4. The accounting profession should not tolerate or advocate an "either-or" position on alternative procedures because of some uncertainty concerning which alternative is best. It should make a single choice from among the alternatives, even though some practitioners might dissent from the choice, in the interests of improved consistency and comparability.
5. Management's freedom of action in choosing alternative accounting procedures that have a material effect on the reported results should be strictly limited, if not eliminated, as there is a natural inclination for management to select the alternative that will make its position appear most favorable.
6. The outside auditor and *not* management should be in full control of the "ground rules" for the preparation of financial statements. Improved consistency and comparability cannot be achieved under the basic presumption that financial statements are primarily the responsibility of management, subject merely to modifying constraints of law and accepted principles in certain respects, but with alternatives open for choice in many areas.

It would be sanguine to expect that the above guidelines will receive general implementation within the foreseeable future. Nevertheless, they do provide a clear and unequivocal framework for the development of more useful accounting data. Therefore, financial analysts would be well advised to support vigorously the above recommendations. The result may be at least evolutionary improvements in accounting standards to provide more reliable, consistent, and comparable financial statements.[14]

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[14] Douglas A. Hayes, "Accounting Principles and Investment Analysis," *Law and Contemporary Problems* (Duke University School of Law, Autumn 1965), p. 771.

The Accountant's Changing Legal Environment

By A. A. Sommer, Jr., Esq., *Partner, Calfee, Halter, Calfee, Griswold & Sommer*

> *The eternal struggle in the law between constancy and change is largely a struggle between history and reason, between past reason and future needs.* JUSTICE FELIX FRANKFURTER

The barrage of litigation which commenced in the sixties and has carried over into the present decade has jolted the accounting profession harshly. Like the victims of an earthquake or the fist of Joe Frazier, many wander dazedly asking what happened: where did the force come from; why wasn't it foreseen; how could it have been avoided; was it deserved; is the future to be simply more of the same; or is there a means of avoiding a repetition of the shocks of the last decade? In response to this disquiet and these questions, many proposals have been put forth: amend Section 11 of the Securities Act of 1933 to limit the perils to accountants posed by that statute; accelerate the move toward uniformity of accounting principles to reduce the dangers flowing from alternative treatments; double the amount of liability insurance (rapidly increasing premiums notwithstanding); legislate further to codify the common law; and deaden the puzzling, imprecise, and unpredictable impact of Rule 10b-5 under the Securities Exchange Act of 1934. Some look askance at the cries of the wounded and say, in effect, that they brought it upon themselves by inadequate standards, failure to recognize professional responsibilities, refusals to recognize portents, and deafness to the warnings of their leaders.

Truth has many faces and speaks with many voices—and in most of the foregoing there is a grain of truth. The purpose of this paper is to identify those grains with the hope that with understanding may come an ameliorating wisdom, a comforting balm, a less discouraged vision of the future. However, it may be that for some time to come the profession will have

to be content with Charlie Brown's avowedly new philosophy, "I only dread one day at a time."

Among the cases which have jolted the accounting profession, two stand out. The first, *Escott* v. *BarChris Construction Corp.,* 283 F. Supp. 643 (1968), unfolded judicially for the first time the implications of the liability provisions of the Securities Act of 1933, with resulting liability for one of the "Big Eight," accompanied by strong judicial language suggesting that the work of the auditors was less than professionally done. The effect of this decision on the profession was, however, mild indeed compared with that consequent on the jury verdict, affirmed on appeal, finding two partners and an associate of another national firm guilty of criminal conduct in certifying the financial statements of Continental Vending Machine Corp., (*U.S.* v. *Simon,* 425 F 2d 796 (1969)). Accompanying these judicial catastrophes has been the increasing tendency on the part of the Securities and Exchange Commission to fault financial disclosures and, increasingly, to include the auditors among those attacked, as witness the Utilities Leasing Corporation complaint. In addition, there appear to have been other disquieting developments within the domain of common law and that "jolly green giant" threatening to engulf all—Rule 10b-5. Enough indeed to intimidate and to cause questions concerning the financial survival of the profession. Where did it begin, where will it end?

The General Trend of Law

Of overriding significance in the development of accountants' liability is a broad legal trend. Prior to fairly recent times, courts had elaborated a body of restrictive rules concerning liability for torts or civil wrongs. Essentially they were intolerant of the deliberate wrongdoer, but when confronted with the negligent wrongdoer they were inclined to articulate substantial limitations on the reach of liability. For instance, until the fifties it was basic law that only someone in *privity* with a manufacturer, that is, someone who purchased directly from him, could bring an action for injuries arising from a "breach of warranty," that is, a claim that the manufacturer had expressly or impliedly warranted concerning his product. Thus, for instance, the purchaser of an automobile could sue his dealer for breach of warranty but not the manufacturer since he had privity of contract only with the dealer. Similarly, the manufacturer's liability under negligence law was limited to "cases where the . . . manufacturer knew of the defect unless the chattel [was] one dangerous to life, in which latter case the . . . manufacturer [was] under a duty to use ordinary care to warn prospective users of the chattel of the danger." In most states charitable institutions, including hospitals, were not liable for negligence in their activities.

The law has swung significantly in the last two decades. Now the purchaser of an automobile generally has no difficulty in pursuing an action for

injuries against the manufacturer if the automobile was defective and caused the damage. No longer does the law throw up a shield in front of the hospital and bar the victim of a nurse's negligence. On a hundred fronts the courts have opened their doors to the consumer who has cause to complain of the vendor, purveyor, or manufacturer of products and services. Impatient with the speed of the courts, the legislatures have hastened this process with a vast outpouring of consumer-oriented legislation designed to assist the consumer in asserting and realizing upon claims against manufacturers and suppliers.

The social roots of this trend are simple. First, the courts are shifting the burden of care onto the one who can do something to prevent a loss to the consumer. In this highly mechanized society, it is impossible to control completely the multitude of occasions when negligence may intervene, for instance, in the manufacture of an automobile; but the courts conclude—and certainly not without reason—that the manufacturer of the car can conceivably prevent negligence in the manufacturing process while the user has no opportunity to forestall it at all. Second, the courts increasingly "socialize" the risks and harms that are an inevitable concomitant of living in a civilized and industrialized society. The manufacturer can theoretically spread the cost of his mistakes over a larger totality—all the buyers of his products—by raising his prices to cover the liability exposure or by purchasing insurance and working that cost into his pricing structure. The victim of the manufacturer's negligence, on the other hand, has no means of spreading his loss, but must instead bear the brunt of it alone, with only the limited and often expensive opportunity to insure against some of the risks.

This concern with protecting the "consumer" is seen clearly in the securities field. What are the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as other federal securities enactments, but consumer legislation—legislation intended to shift the burdens and the detriments of an inferior product from the buyer to the seller? Forty years before cereal manufacturers were compelled to explain to the customer that the "large economy size" really cost more per ounce than the small "expensive" size, the seller of securities was required to furnish an abundance of information concerning his product.

In 1937, the significance of this trend for accountants was spoken of by Professor T. H. Sanders:

> For issuers and accountants to deny any responsibility to the considerable army of investors who act not directly on their own knowledge and judgment but on the judgments of intermediaries in whom they have placed confidence seems out of step with the general trend of the law, which is disposed to hold a producer responsible to his ultimate consumer through all the increasing complexities of distribution.[1]

[1] Sanders, T. H., "Accounting Aspects of the Securities Act," *Law and Contemporary Problems* (Duke University School of Law, April 1937), p. 216.

The accountant renders a service, purveys a product—his opinion of the financial statements of his client. When the issue is who shall bear the risk that there is error in certified financial statements, the courts are more prone than they were to place it on the one who has the means to, and the one who can, "socialize" it in fees or insurance premiums. Thus the accountant is the victim of the reorientation of courts as they swing to stronger protection of the *users* of goods and services.

To some extent this new approach of the courts is the result of the elimination of the *mythos* of our society that revered the businessmen, the entrepreneurs, the commanders of great wealth—an attitude that began to perish in the sordid disclosures following 1929. It is probably also a reflection of the conviction that businesses no longer need the protections once afforded by the courts and are able to fend for themselves.

The Maturing of the Accounting Profession

The inclination of courts to deal somewhat more sternly with accountants is also a reflection of the fact that the accounting profession has matured with the result that more is expected of it, and it is presumably able to reach higher levels of responsibility—financial, legal, and ethical. Not without significance, the first volume of the authoritative history of the profession by John L. Carey, *The Rise of the Accounting Profession,* is subtitled "From Technician to Professional." Saul Levy in his landmark work, *Accountants' Legal Responsibility*, published by the American Institute of Certified Public Accountants in 1954, called the accounting profession "a relatively new profession" and stated that "civil liability is a normal aspect of professional status and . . . being subject to it is an inevitable attribute of the development of the profession."

The maturity reached by the profession is not confined to an intellectual or social maturity; it also connotes financial maturity. At a time when the firms which certify the financial statements of the bulk of large publicly held companies are world-wide organizations with hundreds of offices and partners, thousands of professional and nonprofessional employees, and with revenues into the hundreds of millions, it is not surprising that courts are less inclined to treat the financial dangers of enhanced liability with the same concern they did in earlier days. One writer has pointedly remarked that "in the light of the economic maturity of the independent accounting profession, further dependence on judicial tenderness seems ill-founded."

With maturity has also come the capacity for penetrating criticism within the profession, a criticism which has undoubtedly served the purposes of those pursuing claims against members of the profession. Be that as it may, such criticism is a necessary part of the development of the profession. Similarly, with maturity has come a deeper and more extensive effort to develop profes-

sional standards for the profession. And again, as these have been articulated, they have been turned against the profession. Carey has stated:

> Thus, as the legal liabilities of professional accountants in the United States have seemed to be extended by court decisions and legislation, the [American] Institute [of Certified Public Accountants] has become increasingly aware that pronouncements and rules which encourage higher standards of performance might be used against its members unfairly in the courts.[2]

This progressively sterner articulation of standards is evidence of a confidence born of maturity and undaunted by the concerns expressed by Mr. Carey. (Some question may be raised as to the extent to which these pronouncements or rules have been used "unfairly" against members of the profession: Were they used unfairly in the *BarChris* case discussed below?)

Definition of the Role of the Auditor

The role of the auditor has increasingly been the subject of introspective analysis by the profession itself and critical comment by those outside. As this role has been more sharply etched, significant consequences emerged.

Where once the connotation of "public" accountant meant one who held himself out as available to any member of the public, now it connotes a responsibility to the public. One writer has said pointedly:

> . . . Some thirty years later, after *Ultramares,* the auditor is not a member of a new profession. He is a sophisticated member of society. Society has placed a sophisticated role at his disposal and society is now requiring sophisticated responses from him . . . the auditor has tried to impress upon society over the last 30 years the need for audited financial statements. He has been fairly successful in that attempt. . . . What society was doing at that time [enactment of the Securities Act of 1933] was making auditors the watchdogs of the financial community. . . . It is no wonder that now, some 30 years later, society is demanding from the accounting profession that they do precisely what they said they would do.[3]

Long before the Securities Act of 1933, though, this role of auditors had been recognized. Carey states:

> In the mid-nineteenth century English law created the independent auditor as a protection to stockholders against the incompetence

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[2] Carey, John L., *The Rise of the Accounting Profession,* Vol. 1 (New York: American Institute of Certified Public Accountants, 1969), pp. 248-9.

[3] Joseph J. Marcheso, "Mid-Program Recapitulation and Review" in *Accountants' Liability,* ed. J. McCord (New York: Practising Law Institute, 1969), p. 135.

> or malfeasance of the managements to whom the investors had entrusted their money. With the acceptance of responsibility to investors as well as to the employer, the accountant-auditor assumed the mantle of professionalism. He became a "public accountant," accepting a responsibility to the public as well as to the client who paid his fee.[4]

An executive director of the Institute has put the same proposition succinctly: "The certified public accountant owes a moral responsibility and under the Securities Act this is made a legal and financial responsibility, to be as mindful of the interests of the stranger who may rely on his opinion as of the interests of the client who pays his fee."[5]

This statement contains the seeds of a thought-provoking notion. In a sense, the history of legal advances has been the translation of ethical considerations into legal duties. No one doubted the ethical responsibility of the auto manufacturer to turn out a carefully made product; the law now translates that into a legal duty. The moral dictum expressed by the securities exchanges and the National Association of Securities Dealers, Inc., to the effect that their members shall conduct their businesses in accordance with "just and equitable principles of trade" has increasingly taken on legal content as it has been used to impose severe disciplinary penalties upon those who transgress this essentially ethical precept, and has increasingly become a source of pecuniary civil liability.

But has the profession fully accepted and recognized the role which society has given them—and which in some measure they have sought and have been compensated for assuming? Another commentator (a federal prosecutor) stated the thought tartly: "How can we explain the tremendous increase in recent litigation against accountants? I think the answer lies in the fact that members of the accounting profession itself have not recognized in recent years just who and what they are. In my opinion, his [the accountant's] legal problems stem, in part, from the fact that he has not fully understood the role he is playing in society. . . ."[6]

In the complicated maze of corporate finance, the auditor became the surest friend of the investor; and inevitably, given the trends of the law and the accountant's own proclamation of his professionalism, the courts demanded proportionate performance.

Inevitably, if a professional group fails to sufficiently articulate its identity, its duties, the identity of those to whom it owes a duty, and the manner in which the duty is to be acquitted, and if society assigns it a role which, despite its professional standards, it does not fulfill adequately, the courts, vested by society with the responsibility to define and enforce duties, will

[4] Carey, *The Rise of the Accounting Profession,* Vol. 1, p. 5.
[5] *Ibid.,* p. 148.
[6] *Ibid.,* p. 135.

undertake to do it. And that in some measure has been the fate of the accounting profession.

The Ascendancy of Disclosure

The insistence upon disclosure—full, complete, accurate, *informative*—since 1933 has been a coursing stream. Hard on the heels of the Securities Act of 1933 came the Securities Exchange Act of 1934 which supplemented the disclosures at the time of securities distributions with a system of continuous disclosure for listed securities, with the auditor called upon under both statutes to render his service to insure the integrity of the investment process.

The previous pressures for disclosure were augmented substantially by a brief, broad, and, at the time, seemingly innocuous rule promulgated in 1942 by the Securities and Exchange Commission which was intended to do nothing more than apprehend a greedy corporate officer who was committing fraud in the purchase of securities at a time when the statutory scheme somewhat shortsightedly imagined that frauds only existed in the context of sales. The rule became much more and became, once plaintiffs' counsel and the courts discovered its potential, the enforcer of officer and director integrity and a powerful goad to corporations to make accurate and reliable disclosures. Quickly many of the barriers which previously provided comfort to auditors—such as *privity*, the requirement that the defendant have been a seller to or buyer from the plaintiff—fell under the imaginative expansion of Rule 10b-5. Out of this came dramatic reinforcement of the transcending theme of disclosure, echoed often to the exclusion of its limitations. The Exchanges published guidelines for disclosure. The Commission importuned the business community to make a practice of prompt and complete disclosure. Analysts' and institutional investors' demands for more reliable information grew.

It was inevitable that accountants, who figured so prominently in the birth of the new world of full disclosure under federal parentage, should be burdened with new responsibilities. Through Colonel Arthur H. Carter, senior partner of Haskins & Sells, the profession had, after all, fought vigorously to establish its foothold in the new arena by opposing strongly, when the 1933 Act was under consideration, the notion that federal employees should assume auditing responsibilities and by asserting the competence and responsibility of private practitioners.

Disclosure, of course, is nothing more than communication. It has been said—too many times to dwell upon—that accountants must be constantly concerned with communication and with the arts of communicating, for otherwise there is no reason for their being. There is the constantly trying problem of seeking to translate the dynamics of economic events into the rigid symbolism of accounting, and as the dynamism of those events increases, the job of forecasting becomes more difficult.

These problems of communication have given rise to the now commonplace notion that the accountant communicates to different people who have need for different kinds of information and different modes of presentation, and who are capable of responding with varying sensitivity to varying degrees of complexity. While it has been suggested that the complexity of events sought to be translated by the accountant has increased to the point where one should not expect the average uninformed layman to understand financial statements, there is no assurance that the courts are yet ready to accept this judgment.

The case that perhaps more than any other has convinced the accounting profession that indeed the legal atmosphere has changed to their detriment is the celebrated case of *U.S.* v. *Simon,* in which a jury verdict of guilty rendered against two partners and an associate of a national accounting firm was affirmed by the Second Circuit Court of Appeals.

The defendants were indicted for violating the federal Mail Fraud Statute and the Securities Exchange Act of 1934 because they had allegedly willfully and intentionally certified a financial statement which was false in material respects (interestingly, the firm withdrew its opinion within a week after the statement was issued). The allegations all focused on footnote two to the consolidated financial statements of Continental Vending Machine Corporation and its subsidiaries. This note said:

> . . . The amount receivable from Valley Commercial Corp. (an affiliated company of which Mr. Harold Roth is an officer, director and stockholder) bears interest at 12% a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of February 15, 1963, the amount of such equity at current market quotations exceeded the net amount receivable.

The government alleged that this note was deficient in several respects, including its failure to disclose that a substantial portion of the collateral for the receivable consisted of securities of Continental; its representation that the Valley receivable and the Valley payable could be netted (the payable to Valley had been negotiated prior to the time of the statement), and in failing to disclose a post fiscal year-end increase in the amount of the Valley receivable. The charge with respect to netting was admitted, but the defendants contended this was not material and that the error was not intentional.

Besides contesting, of course, the question of knowledge and intent, the defendants sought to barricade themselves behind "generally accepted accounting principles," which had always been considered central to the integrity of financial statements. They based their defense largely upon testimony of eight witnesses, all acknowledged experts, who testified with varying degrees of certainty that the note was prepared in accordance with generally accepted accounting principles. Against these, the only contrary witnesses

were a staff accountant of the Commission and the esteemed Chief Accountant of the Commission.

The defendants were tried twice. The first trial resulted in a hung jury, the second in a conviction. In instructing the jury in the second case, the judge said:

> A firm of public accountants . . . engaged to perform an independent audit, represents that it will perform the audit in accordance with generally accepted auditing standards and accounting principles and that it will render an opinion, based on its audit, as to whether the financial statement of the company fairly presents its financial position and the results of its operations.
>
> Proof that a defendant, in conducting the 1962 audit, departed from such auditing standards, or participated in the preparation or approval of a financial statement that did not fairly present Continental's financial position, results of its 1962 operations in accordance with generally accepted auditing standards and accounting principles, is evidence, not necessarily conclusive, that the defendant did not act honestly and in good faith, and that statements contrary to such standards and principles may have been materially false or misleading. On the other hand, proof that the defendant did act in accordance with such generally accepted auditing standards and accounting principles is evidence which may be very persuasive *but not necessarily conclusive* that he acted in good faith, and that the facts as certified were not materially false or misleading. . . .
>
> *So the auditor's responsibility in accordance with his engagement is, first, to render an opinion that must satisfy the auditor that the statement fairly presents the results of the operations about the financial position of the client;* and, second, to be satisfied that the statement contains no misstatements of fact, or, at least, no misstatement of facts known to the auditor.
>
> *The critical test, therefore, is whether the financial statement here, as a whole, fairly presented the financial condition of Continental as of September 30, 1962, and whether it accurately reported the operations for fiscal 1962.* [Emphasis supplied.]

While the Court acknowledged the persuasiveness of adherence to generally accepted accounting principles, nonetheless the Court unequivocally rejected the notion that such adherence would be a complete defense. Rather both the trial court and the appellate court established the primacy of "fair presentation" of the financial position of Continental.

In commenting on this case, the author of the brief *amicus curiae* on behalf of the American Institute of Certified Public Accountants has said in explaining the Institute's submission of that brief that, "it was this seeming invitation to apply a lay standard rather than to look at the balance sheet as an accountant does—and as the defendants by their opinion on Continental had represented that they had—that prompted the Institute's concern."

He then construed the opinion of the Court of Appeals as "substantially narrow[ing] the possibility which the trial court had left open, of a jury's being allowed to take a purely layman's view and to disregard the standards of the profession in a future case."

In my estimation, thus narrowing the opinion of the Court of Appeals is a dangerous course—one that misconstrues the atmosphere in which the case was decided, an atmosphere in which the consumer is king, an atmosphere in which it has been spelled out that smoking may cause cancer, that the unit cost of cereal is so much, that Profile Bread won't recreate one's physique without the discomforts of dieting.

Accounting is communication. The accountant is a sophisticated, albeit specialized, communicator who must wield the symbols in which he expresses himself in a meaningful manner, so that others may understand that meaning and form accurate conceptions of what he said. Does he speak only to other accountants? Does he speak only to the upper reaches of financial sophistication? In 1947 the SEC surely did not think so:

> It is not enough to say that here perhaps much . . . of the factual background was given in footnote data. . . . *Even if [all significant data] had been given there is an additional obligation to present the material in a way in which it will be useful to the informed but less sophisticated readers.* (Emphasis supplied.)

And in at least one case a federal district court flatly rejected this notion:

> *The purpose of the financial statements is to inform the man on the street; and the underlying policy of the Securities and Exchange Acts and of Rule 10b-5 is to assure that he can have truthful information in buying securities,* regardless of the intended victim of the fraud. Moreover, the defendants have set themselves up to be independent certified public auditors. As such, they have assumed a peculiar relation with the investing public. As accountants, the defendant clearly cannot be immunized from suit. [Emphasis supplied.]

Is the thought that generally accepted accounting principles are subordinate to fair presentation or that generally accepted accounting principles have value only to the extent that they assist in fair presentation so novel a notion?

Hardly. In 1942, after discussing at tremendous length a multitude of technical accounting matters involved in determining whether to suspend or withdraw the registration of the common stock of Associated Gas and Electric Company under the Securities Exchange Act of 1934, the SEC said:

> We think, however, that too much attention to the question whether the financial statements formally complied with principles, practice and conventions accepted at the time should not be permitted to blind us to the basic question whether the financial statements per-

formed the function of enlightenment, which is their only reason for existence. Each of the accountants' certificates in question contained the opinion that, subject to various qualifications therein, the financial statements fairly presented the financial condition of the registrant, in accordance with generally accepted accounting principles. If that basic representation was not accurate as to the financial statements as a whole, no weight of precedent or practice with respect to the minutiae of the statements could justify the accountants' certificates. . . . For the average investor [read *layman?*] the financial statements of this system contain not a hint of the rot hidden beneath the surface of this holding company system.

We believe that, in addition to the question whether the individual items of financial statements are stated in accordance with accounting principles, practices and conventions, there must be considered the further question whether, on an overall basis, the statements are informative.[7]

With the increased emphasis on disclosure and the development of remedies for failures of disclosure, inevitably accountants, whose very profession is "presentation" or disclosure, are caught up in the trend.

How Radical a Change in the Atmosphere?

There is more than a trace of reason to suggest that in many respects there has been some exaggeration of the extent to which the accounting profession's posture vis-à-vis the law has changed sharply in the 40 years since *Ultramares.* Rather, in many respects the changes have been *evolutionary,* not *revolutionary.*

When three of the most significant developments are examined, there is reason to think that the departures are less dramatic than they might appear and that, in some respects, what has happened is simply the making explicit of forces that have long been latent and intimated.

The case of *Ultramares Corp.* v. *Touche,* 255 N.Y. 170, 174 N.E. 441 (1931) had been, until midway through the sixties, the definitive description of the extent of an auditor's liability to persons other than the one who retained him. For the accounting profession this was considered something of a safe harbor, though, interestingly, at the time the decision was rendered it was regarded with hostility and dismay by the profession.

In this case the New York Court of Appeals, speaking through the eloquent Justice Benjamin N. Cardozo, later to gain additional renown as a Jus-

[7] "In the Matter of Associated Gas and Electric Company, 1942," *Securities and Exchange Commission Decisions and Reports,* Vol. 11 (Washington, D.C.: U. S. Government Printing Office, 1945), pp. 1058-9.

tice of the United States Supreme Court, analyzed with characteristic skill and expressed with typically rich words, the standard which should determine the liability an auditor has to a third party who relies upon the audited statement to his detriment. Justice Cardozo was awed by the consequence of succumbing to the urgings of the plaintiff who sought to have the court adopt a rule that an auditor was liable for simple negligence to anyone who relied upon his work product:

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class.

To avoid this consequence, Justice Cardozo engaged in a careful examination of existing New York precedent and concluded that liability for negligence in making an audit extended only to the party with whom the contract was made and only to those for whom it was explicitly prepared—that is, cases where the delivery of the financial statements to a specified person was the "end and aim" of the contractual relationship between client and auditor. While recognizing that the ancient doctrine of privity had been pretty well diminished in importance, nonetheless he salvaged a substantial portion in this context. The opinion recognized that if there was fraud or a degree of negligence that really constituted recklessness or gross misconduct, then the result would be different.

The holding, that there could be liability to *anyone* other than the client for negligence, sobered the profession. However, they lived with it and eventually regarded it as a friendly barrier to further liability, until the sixties when new assaults were made on it.

The first significant questioning of its rationale was uttered in the dissenting opinion of Lord Justice Denning in a British case, *Candler* v. *Crane, Christmas* & *Co.* , High Court of Justice, King's Bench Division 2 K.B. 164 (1951). Lord Denning was deeply troubled that though the majority found the auditor guilty of being "extremely careless in the preparation of the accounts," nonetheless the court determined there was no liability since the auditor owed no duty of care to one whom the accountant knew would be shown the financial statements. Lord Denning said:

> [To] whom do these professional people owe a duty? They [accountants] owe the duty, of course, to their employer or client; and also I think to any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them. . . . *In my opinion accountants owe a duty of care not only to their own clients, but also to all those whom they know will rely on their accounts in the transactions for which these accounts are prepared.* [Emphasis supplied.]

Lord Denning's dissent became law in England in *Hedley, Byrne & Co., Ltd.* v. *Heller & Partners, Ltd.,* (1964) A.C. 465 (House of Lords, 1963).

The first dent on the *Ultramares* doctrine in the United States appears to be *Rusch Factors, Inc.* v. *Levin,* 284 F. Supp. 85 (1968). The court here confronted anew the possible economic consequences to the profession, which had so alarmed Justice Cardozo, of a rule broader than *Ultramares*:

> The wisdom of the decision in Ultramares has been doubted . . . and this Court shares the doubt. Why should an innocent reliant party be forced to carry the weighty burden of an accountant's professional misconduct? Isn't the risk of loss more easily distributed and spread by imposing it on the accounting profession, which can pass the cost of insuring against the risk onto its customers, who can in turn pass the cost onto the entire consuming public?

The Court then added this pregnant thought: "Finally, wouldn't a rule of foreseeability elevate the cautionary techniques of the accounting profession?"

The Court concluded after this renewed weighing of social consequences that an accountant should be liable in negligence "for careless financial misrepresentations relied upon by actually foreseen and limited classes of persons." (It should be noted that the onslaught has not been a rout; recent Florida cases have followed *Ultramares.*)

The *Proposed Restatement of Torts,* which is considered a summary of the thrust of American common law, limits the liability of a professional who fails to exercise due care to:

> Loss suffered (a) by the person or one of the persons for whose benefits and guidance he intends to supply the information, or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction which he intends the information to influence, or knows that the recipient so intends, or in a substantially similar transaction.

It further states that "the liability of one who is under a public duty to give the information extends to loss suffered by any of the class of persons for whose benefit the duty is created, in any of the transactions in which it is intended to protect them."

This brings us to the question: How radical has the change been since *Ultramares*? There the Court established, in effect, that the only one who could recover for negligence was the client or the one for whom the statements were prepared—those whose use of them was "the end and the aim." Is there such a radical extension when account is taken of the trends in securities laws since 1931?

Increasingly, audited financial statements have been oriented toward public investors in securities in addition to their use for longer-standing and more conventional purposes—securing credit, inducing small groups of new

investors, reassuring suppliers, and the like. This trend was accentuated in 1932 when the New York Stock Exchange adopted the rule that all listed companies had to furnish to their shareholders certified financial statements. A further strengthening of the trend was in 1933 when Congress, confronted with the alternatives of having financial statements authenticated by federal auditors, or having them certified by private professionals, opted for the latter and required as a part of a registration statement under that act that certain financial statements be certified by an "independent public or certified accountant." The 1934 Act reinforced the exchange requirements by requiring the filing of certified financial statements with the Commission.

Through this process it became apparent that the financial statements of companies which sought to secure capital from the public and those which had their securities listed on the exchanges had to avail themselves of the professional competence of the accounting profession, and just as obviously, that this was intended to give to the public additional protection it would not have if they were not so certified. Thus, in a very specific sense, it may be said that the public investors were the ones whom the accountants could reasonably forsee would rely upon them (the test in the *Rusch Factors* case) or those for whose benefit and guidance he intended to supply the information (the proposed Restatement test). In fact it truly becomes the "aim and end" of the relationship between the auditor and his client that statements be available to the investing public.

It is evident that as a consequence of the increased reliance of industry upon publicly raised equity capital, and in many instances, debt capital, and the increased effort to assure to those investors fairness and full disclosure, the burden upon the auditors has grown heavier. Indeed, one writer has said,

> The factors which may affect accountants' liabilities and to which they call attention have developed in the market place. The significant dissatisfaction is not that of the law professor, but is expressed on the part of the users of financial statements. Judges, sooner or later, would have taken note of the conditions in the marketplace which impel matters toward a broadening of liability.[8]

A second case which aroused concern was *Escott* v. *BarChris Construction Corp.*, 283 F. Supp. 643 (1968). In this case, a national firm of auditors was held liable for negligence in preparing certified financial statements and in its "S-1 review" in connection with a registration statement under the Securities Act of 1933. There may be legitimate concern about the factual conclusions of the trial judge and about the manner of his application of the relevant law to those facts, but surely his conception of the Securities Act of 1933 as it applied to auditors was beyond reproach.

[8] Edwin J. Bradley, "The Public Auditor," in *Accountants' Liability*, p. 42.

The decision was alarming, not because it established new law, but simply because, for the first time in the 35 years since the enactment of the 1933 Act, its implications for auditors were exposed clearly: auditors may be liable for faulty financial statements to anyone who buys a registered security if they fail to establish their due care, regardless of any notion of privity. As far as "foreseeability" is concerned and as far as "end and aim" are concerned, the 1933 Act carefully avoids those considerations by requiring a consent from an accountant before his opinion may be incorporated in a registration statement. Thus, in effect, he acknowledges that the public's reliance on his certificate is foreseeable and that the "end and aim" of his certificate is the transaction in the marketplace.

The law was not in the case; the case was in the statute. All the raw nerves exposed by the *BarChris* opinion were foreseen by that genius of the accounting profession, George O. May:

> I cannot believe that a law is just or can long be maintained in effect which deliberately contemplates the possibility that a purchaser may recover from a person from whom he has not bought, in respect of a statement which at the time of his purchase he had not read, contained in a document which he did not then know to exist, a sum which is not measured by injury resulting from falsity in such statement.[9]

Few today would question the justice of the 1933 Act; few would question its efficacy in raising the standards of disclosure; and there is probably no court today in the country which would strike it down. It has stood for almost four decades and promises to be preserved in substance in the codification project headed by Professor Louis Loss.

Statutory enactments, of course, have significance in the development of law beyond the areas governed by them. They are expressions of public policy, and often their thrust carries through into matters outside the technical scope of the statute. Justice Holmes once stated:

> [It] seems to me that courts in dealing with statutes have been too slow to recognize that statutes even when in terms covering only particular cases may imply a policy different from that of the common law, and therefore may exclude a reference to the common law for the purpose of limiting their scope.

And James M. Landis stated succinctly that "much of what is ordinarily regarded as 'common' law finds its source in legislative enactment."[10]

Thus, the decisions of the courts in the sixties concerning matters out-

[9] Carey, *The Rise of the Accounting Profession,* Vol. 1, p. 192.

[10] J. M. Landis, "Statutes and the Sources of Law," in *Harvard Legal Essays,* ed. Roscoe Pound (Cambridge: Harvard University Press, 1934), p. 214.

side the reach of the 1933 Act have undoubtedly felt the influence of the determinations made in drafting the 1933 Act—the abrogation of privity, the imposition of liability without a foreseeability more certain than presence of the financial statements in a registration statement, and no necessity of *scienter*. These concepts have clearly been absorbed through an osmotic process into the common law without perhaps the judges, who are the means through which these influences are manifested, realizing the extent to which the statutory determinations have influenced their judgments.

Perhaps a more accurate analysis would be that the same growth of values, the same shift in emphasis, which gives rise to statutory innovation eventually manifests itself in judicial innovation. Thus the common law and judicial developments were anticipated in statutory development.

The foregoing would indicate that the change in atmosphere has not been a radical or abrupt development; rather, it has the earmarks of a stage in a development with roots in basic conceptions of the accountant's role which began to be elaborated in England in the middle of the last century, found confirmation in statutory developments in this country during the 1930s, and gained explicit judicial recognition in the 1960s.

But in one particular there has been a significant change. Despite statements long ago about the accountant's role as a protector of the investor, the accountant's opinion was in years past almost universally directed to a small group or to one party, such as a creditor, a bank, a supplier, or a potential investor. In more recent times the "consumer" of its product has become masses of people, the investors in publicly distributed, held, and traded securities. The Securities Act of 1933 specifically recognized this thrust as did the New York Stock Exchange in its requirement of audited statements from listed companies. This somewhat abrupt change of emphasis is amply seen in the litigation pattern. Until fairly recently the landmark accounting cases almost invariably involved creditors, suppliers, banks, and others susceptible of being identified by precise and small numbers. Now those who rely on the financial statements may be numbered in the hundreds of thousands and even the millions. The result is that all of the landmark cases of the sixties and seventies involved statements prepared and published by publicly held companies, statements reasonably intended and expected to be relied upon in investment decisions. In this significant respect, there has indeed been a sobering change of accountants' exposure to liability.

And of course this shift has meant far greater monetary exposure. The liability of an auditor whose statements are used by a corporation in securing credit or satisfying a supplier of its solvency is usually significantly less than the potential liability when masses of shareholders rely on those statements in committing funds in connection with a distribution of securities or trading in the market.

More than anything, this expansion of dollar exposure has been alarming, and no amount of analysis concluding that recent developments are merely gentle extensions of basic principles will quiet that alarm. It may well be

that the sharply enhanced danger of unbearable losses to firms in the profession with accompanying personal exposure on the part of partners will result in a reversion to the concerns expressed by Justice Cardozo in the *Ultramares* case.

In the midst of deploring the consequences of the litigation storm which has hit the accounting profession, it is well to step back a moment and ponder whether these adversities have been entirely without redeeming social benefit. It is very doubtful if that can be said. As a consequence of *Fischer* v. *Kletz,* 266 F. Supp. 180 (1967) the AICPA developed Statement on Auditing Procedure No. 41 which provided the additional safeguard to the investor that the error or deceit discovered after completion of an audit would not be concealed by the silence of the auditor. It is reported that, as a consequence of the *Simon* decision, the auditing firm involved there has instituted a procedure whereby a partner not involved in the audit, as one of the final steps before release of the opinion, steps back and considers the financials as a whole in terms of their understandability for *laymen.* Unquestionably the S-1 review procedures of the profession as a whole were sharpened up as a consequence of the criticisms of the court in the *BarChris* case. This and other litigation has undoubtedly stimulated even greater endeavors to eliminate opportunities for misleading financials marching under the protection of generally accepted accounting principles.

It is clear that in very large measure the courts have shaped the responsibilities of the auditors and provided them with benchmarks against which to measure their conduct because the auditors were slow in doing so themselves in response to such "surging" forces in society as a greater demand for disclosure, a greater involvement of the public in the securities markets, more insistence upon disclosure reasonably understandable in the marketplace, and more demanding definition of the role of the auditor in this society.

The Emergence of Rule 10b-5

The most recent storm on the accountants' horizon, and the most recent impetus to disclosure, has been Rule 10b-5, adopted by the Commission under Section 10 of the 1934 Act. This Rule had innocuous origins. It was designed to close the hiatus in the scheme of federal securities regulation by affording the Commission a tool by which to frustrate fraud in the purchase of securities as well as in the sale of them. Largely because of the ingenuity of private counsel and the responsiveness of the courts to the plight of those defrauded in securities transactions, Rule 10b-5 was transformed into a potent tool for seeking private redress. As a consequence the implications of Rule 10b-5 have unfolded at a frightening pace, and its reach has extended to a bewildering array of transactions and relationships.

The raw rule is relatively simple: it simply declares as unlawful certain

fraud-like and deceitful conduct and material misrepresentations and omissions, when they occur "in connection with the purchase or sale of any security."

The history of the judicial development of the Rule's implications has largely been the story of the erection of barriers to undue extension of the Rule followed by a dismantling of the barriers. The courts have assiduously sought to relate common-law concepts to the Rule and interpret it in their light: privity, *scienter,* negligence, reliance, causation. Some of these, particularly privity and *scienter* in the narrow common-law sense of "guilty knowledge" or intent, have been discarded: the defendant need not have been in a transaction with the plaintiff, and it has become established that simple negligence may give rise to an action, though questions remain concerning the appropriate remedy when negligence is coupled with an absence of privity.

Obviously the involvement of financial statements in the purchase and sale of securities gave rise inevitably to the inclusion of accountants among defendants in Rule 10b-5 actions. The first case was an easy one: *H. L. Green Co.* v. *Childree,* 185 F. Supp. 95 (1960), in which the auditor was charged with fraudulently preparing financial statements in connection with a fraudulent conspiracy.

Subsequent cases posed more difficult problems. In *Fischer* v. *Kletz,* 266 F. Supp. 180 (1967), the Federal District Court in New York was confronted with charges that an auditor discovered during special work subsequent to the rendition and publication of his opinion concerning the client's financial statements that the statements were false. He thereafter took no action to disclose this discovery to anyone. The Court determined both on the basis of common-law principles and Rule 10b-5 that a claim was stated, rejecting the notion that accountants were immune from attack under Rule 10b-5 because of the absence of privity or because they did not gain from the alleged misconduct, thus establishing a new requirement of disclosure which was codified in Statement on Auditing Procedure No. 41.

In another case, decided in Chicago, *Drake* v. *Thor Power Tool Co.,* 282 F. Supp. 94 (1967), a national firm was sued because of alleged negligent preparation of financial statements. Again the Court determined that a claim was stated. If the *Drake* case is confirmed in subsequent litigation as the appropriate law, then the struggle over the extension of common law discussed above may be moot, for Rule 10b-5, interpreted to create liability to public investors for negligently prepared financial statements, given the advantages of litigation in the federal courts, will provide all the relief previously sought in state and federal courts under state common law—and more.

Unquestionably the development of Rule 10b-5 has given rise to a considerably greater volume of litigation involving transactions in securities. As the number of cases has mounted, and the courts have eased the restrictions which previously frustrated plaintiffs in such litigation, inevitably the example set has given rise to greater temptation for investors and others to litigate

when they believe they have been the victims of fraud or misleading representations, including financial representations.

With the increased stress upon the responsibility of investing fiduciaries, a new group of plaintiffs has been added to the list—institutional investors and institutions themselves. In several instances, mutual funds, banks, and trust companies have been among the plaintiffs who have initiated litigation under Rule 10b-5, alleging misconduct on the part of auditors as well as others. Recently the New York Stock Exchange brought an action against a national firm alleging improprieties in the audited statements of a member firm resulting in outlays from the Exchange Trust Fund. Thus, in many instances, unlikely plaintiffs are impelled to bring actions to protect themselves vis-à-vis their beneficial owners, thus swelling further the volume of litigation and with it the concern of auditors.

Conclusion

Despite the apparent broadening of common-law liability of accountants to include the consequences to relying third parties of auditors' negligence, and despite the vast expansion of applications of Rule 10b-5, still there has not apparently been any final judgment for damages entered against auditors based upon simple negligence in favor of investors relying upon the statements. So far most of the disquieting decisions have been on motions by which defendants have sought to persuade courts to dismiss the actions because they failed to state a claim under the law, leaving the proof of negligence for later. This should not obscure the fact that in instances involving alleged negligence, such as the *Drake* case discussed above, substantial settlements have been reached (in one case reportedly $4,950,000 was paid by the auditors or their insurers).

Does this absence of final verdicts mean the concerns of the auditors are groundless? It should not. If courts continue in directions that portend liability to relying third parties—public investors who act in response to the certified financial statements in annual reports, filings with the Commission and other audited statements—then, unquestionably, the time will come when such verdicts will begin to appear. Out of the welter of litigation now pending, it is optimistic to expect that there will be no such consequences.

If these consequences do emerge, the courts or legislative bodies at some point will have to confront the root question: is this extension of liability likely to cripple a needed profession incapable, given human frailties, of ever effectively regulating its conduct sufficiently to avoid all such liabilities? In considering this question, it is obvious that heed will have to be paid to the fact that the accounting profession, while dominated increasingly by the national firms, nonetheless is not like the automobile manufacturing business—immensely endowed with resources and consisting of only four domestic units.

The accounting profession consists, in addition to the national firms, of innumerable small firms and practitioners. These might very quickly be excluded from the market if the dangers of liability reach too far.

Perhaps the ultimate salvation of the profession lies in the words of one of the masters of the art of accountancy, Arthur Andersen, who said in 1935:

> Fundamentally the financial statements are a vehicle for conveying information. If they are truly informative and if they are predicated upon a reasonable examination in accordance with duty and custom, the question of statutory liability will automatically be answered. When confronted with the necessity for a decision on a difficult question of policy with respect to financial statements the accountant should search his conscience rather than the statutes.[11]

[11] *The First Fifty Years 1913-1963* (Chicago: Arthur Andersen & Co., 1963), p. 110.

Enforcement of Ethical Standards in Corporate Financial Reporting

By Donald A. Scott, Esq., *Partner, Morgan, Lewis & Bockius*

We live in a litigious society. Accountants, financial executives, and brokerage firms are rapidly learning this fact, if they had not already been aware of it. The expansion of the bases for legal liability under Rule 10b-5 and the refinement of the class action for enforcing this liability has resulted in a flood of suits exposing the preparers and auditors and certain users of financial statements to massive claims for damages.

For that reason one might immediately think of court litigation as the principal means of enforcement of ethical standards in corporate financial reporting. Litigation, however, is only the last step in enforcement and by far the least satisfactory. It is costly and time-consuming. The delays due to discovery procedures and court congestion are interminable, with the result that memories blur and hindsight distorts the reasonableness of judgments made at a much earlier time. The decision-maker—whether judge or jury—is likely to be unsophisticated in financial matters, making the outcome a purely hit-or-miss proposition.

Using the benefit of hindsight, it did not have to turn out this way. The accounting profession was given a long breathing space by Judge Cardozo's *Ultramares* decision in 1931 when he limited the scope of an accountant's liability for negligence to those persons having a direct contractual relation with him. What would have happened if the profession had taken this decision as an opportunity to move firmly and effectively to enforce ethical standards? Would the present interpretations of Rule 10b-5 have taken place?

The basic thrust of this paper is that there are many means short of litigation for enforcement of ethical standards which have not been

adequately utilized. The multimillion-dollar stockholder suit is apparently here to stay but more effective use of nonlegal enforcement may well serve to lessen the impact of these suits.

The topic of enforcement of ethical standards in corporate financial reporting divides itself readily into two sections: (1) the fair presentation of financial information and (2) the fair use (or nonuse) of financial information. The financial executive participates in both areas, but the accountant participates primarily in the first, and the financial analyst and credit analyst primarily in the second. Within each of these categories, the paper first will discuss whether existing methods of enforcement are adequate and second, will suggest various possibilities for improving enforcement. The survey of existing methods is designed to give a background for discussion purposes and not to be definitive. Statements concerning present practices are based in a number of cases on informal discussions with various persons.

The Fair Presentation of Financial Information: Are Existing Methods Adequate?

Effective enforcement of ethical standards has three basic requirements: First, there must be an adequate definition of the ethical standards; second, there must be adequate surveillance—a means of detecting violations of the standards; third, there must be an adequate means of preventing violations, either through correction prior to public issue or through punishment in order to deter future violations.

It is assumed for the purpose of this paper that ethical standards can be adequately defined and that they fit generally under the broad standard that persons participating in the preparation or audit of financial statements have a duty to the public to see that those statements fairly present financial information concerning the particular enterprise.

THE FINANCIAL EXECUTIVE. The financial executive is the starting point in the presentation process. He is generally the most familiar with the financial facts of the enterprise and makes the initial selection of the accounting principles to be applied.

The pressures on the financial executive to produce a favorable financial picture are great. While he may rise above the effect which favorable results will have on his bonus, profit-sharing plan participation, and stock option, it takes considerable courage to refuse the wishes of his superiors when his job is at stake. The easy way out is to leave the ethical determination to the company's outside auditors.

Officers have fiduciary obligation to the stockholders. Is it a violation of this fiduciary duty to reject an "acceptable" accounting alternative with a resulting decrease in earnings per share and the market value of the stockholders' interest? The SEC has recently stated in the Douglas Aircraft-Merrill

Lynch proceedings that "the obligations of a fiduciary do not include performing an illegal act."[1] Are there instances where an accounting treatment may not be illegal but still be unethical? This distinction is really academic in the light of the *Continental Vending* case, *U.S.* v. *Simon,* 425 F2d 796 (1969) since the trial judge's instructions to the jury made fair presentation the critical test.

At the present time the Financial Executives Institute has no formal code of ethics. The *Simon* case, while directly applicable only to accountants, may do much to improve adherence to ethical standards by financial executives. It may also reduce the pressures from top management when the possibility of their liability is explained. However, the *Simon* case contains only the broad standard of fair presentation. It may be that a code of ethics could be more specific, thereby providing some form of guidance to the executive.

THE BOARD OF DIRECTORS. The board of directors, charged by state corporate law with the management of the business and affairs of the corporation, is the first step in the surveillance process. This surveillance is extremely uneven since it occurs on an individual company basis. Some boards may consist entirely of company executives who are subject to the same pressures as the financial executive. Other boards may have outside directors who have little understanding of financial reporting. Even board members who are experienced in this field may not have sufficient time available to explore fully the company statements.

Some corporations have an audit committee consisting of outside board members to meet with the financial executive and with the accountants to review the statements. The effectiveness of this committee again depends on the ability and availability of members to review financial reports.

The state corporate laws have actually tended to discourage this type of surveillance by providing that a director shall not be liable (at least for unlawful distributions) if he relied "in good faith" on financial statements certified by an officer of the corporation or by a certified public accountant. If a director inquires behind the statements, he may become privy to facts which cast doubt on their validity, thereby removing the defense of reliance.

Section 11 of the Securities Act of 1933 carries forward this policy to some degree in its distinction between the so-called "expertised" portions of the registration statement and the balance. A director may defend against a suit for misleading statements in the audited financials by showing that "he had no reasonable ground to believe" the statements were untrue; whereas a defense for the balance of the registration statement requires showing that "he had reasonable ground to believe" the statements were true. The key difference between this Act and the state statutes is the requirement of "reasonable

[1] "In the Matter of Investors Management Co., Inc.," SEC Release Nos. 34-9267 and IA 289, CCH Fed. Sec. L. Rep. ¶ 78,163 (July 29, 1971).

investigation" by the director. Does "good faith" reliance require a reasonable investigation?

The board of directors is an inadequate means of enforcement. An outside director is unlikely to have the comprehensive knowledge of a company's affairs which would permit consistent enforcement of ethical standards. Because of the unevenness in surveillance, the company with a conscientious and knowledgeable board may well be penalized in the marketplace. The pressure, therefore, is to produce the lowest common denominator of ethical standards even though responsible boards may resist this pressure.

THE INDEPENDENT PUBLIC ACCOUNTANT. The independent public accountant has been given the role, by statute and administrative regulation, of watchdog over financial reporting. Some state laws require certified annual reports to shareholders. The Securities Act of 1933 requires certified financial statements in a registration statement. SEC rules under the Securities Exchange Act of 1934 require certified statements in Forms 10 and 10-K, in certain types of proxy statements, and in annual reports. Stock exchange rules similarly require certified statements for listed companies.

The accountant is interposed between the preparers of the financial statement and the public. He is therefore in a position to correct violations of ethical standards before they occur publicly, at least in audited statements. If the client refuses to make the correction, the accountant may qualify his opinion or refuse to give an opinion. A qualification discloses to the public why the accountant believes there may not be a fair presentation; a "no opinion" may trigger action by the SEC or a stock exchange.

In order to ensure that the accountant is objective and not subject to the pressures mentioned previously, he is required to be independent by SEC rule and by the Code of Professional Ethics. On paper, the program looks good. Why hasn't it worked?

1. Ethical standards of financial reporting have not been adequately defined; consequently, the administration of existing standards varies between accounting firms, giving an ostensible benefit to the company which has a "sympathetic" firm.

2. The accountant is still subject to pressures from the client since the client selects him and pays him. A qualified or "no opinion" can be avoided by changing to another accounting firm, although the SEC has moved in this area to a small degree by requiring that the change of accountants and the reasons therefor be publicly disclosed.

The present *annual* auditing process also leaves gaps since management customarily reports to the public on a quarterly basis. Misstatements of quarterly earnings may appear by mistake as well as design; however, in view of the expanding scope of liability, accountants are reluctant to review unaudited interim reports except when required for prospectuses and proxy state-

ments. Unethical managements have three quarters to report results without "the watchdog." This makes downward adjustments for the year more difficult and sometimes rather dramatic for the stockholders. Annual attempts can be made to beautify year-end balance sheets. Surprise audits are required in other fields, such as for stock exchange member firms, a requirement which might alleviate this problem.

THE ACCOUNTING PROFESSION: WATCHING THE WATCHDOG. AICPA Code of Professional Ethics begins as follows:

> The reliance of the public and the business community on sound financial reporting and advice on business affairs imposes on the accounting profession an obligation to maintain high standards of technical competence, morality and integrity. To this end, a member or associate of the American Institute of Certified Public Accountants shall at all times maintain independence of thought and action, hold the affairs of his clients in strict confidence, strive continuously to improve his professional skills, observe generally accepted auditing standards, promote sound and informative financial reporting, uphold the dignity and honor of the accounting profession and maintain high standards of personal conduct.

The enumeration of rules of ethical conduct does not define further "sound and informative financial reporting." Rule 1.02 proscribes "an act discreditable to the profession" which includes, under Rule 2.02, a failure to disclose a known material fact, a failure to report any material misstatement, and a failure to direct attention to any material departure from generally accepted accounting principles. These nebulous statements hardly provide a sound basis for enforcement of ethical standards. Content is added by the definition of generally accepted accounting principles by the Accounting Principles Board, but the efforts to define these principles have been slow and hotly contested.

Surveillance is also inadequate. The ethics committees of the state societies and the AICPA generally react only to complaints which usually represent the most egregious violations. There is no systematic review of reports nor any program for publicizing deficient practices.

As discussed at the last symposium, some state societies have established practice review committees to comment upon financial reports submitted to them. This type of surveillance is again on an "impact" basis. Furthermore, an adverse conclusion by the committee is not even transmitted to the person submitting the report, let alone enforced by publicity or otherwise.

One of the principal impediments to effective enforcement—and this is true of lawyers, too—is the reluctance to admit publicly that members of the profession do not always adhere to high ethical standards. This impediment becomes even greater when there is such a division within the accounting

profession over the definition of certain accounting principles. For example, is the approval of an accounting treatment contrary to APB Opinions Nos. 16 and 17 *unethical* when the Opinions were adopted by a bare two-thirds vote of the Board over strong dissents by respected members of the profession?

Eight "expert independent accountants, an impressive array of leaders of the profession," testified in the *Simon* case that the questioned accounting treatment was in accordance with generally accepted accounting principles. Consequently, the court was presented with a direct confrontation between "fair presentation" and generally accepted accounting principles. It has been suggested that this confrontation need not have taken place if the eight witnesses had not felt compelled to rally behind other members of the profession.

THE PUBLIC. To what extent do the users of financial information assist in the enforcement process?

Financial analysts and credit analysts exercise a high degree of surveillance and are well qualified to detect violations. They may submit questionable statements to the practice review committees mentioned above. Their reports may point out departures from fair presentation and attempt to reconstruct the published figures on a fairer basis. However, these reports generally receive limited distribution so that the deterrent effect is minimal.

The financial press also exercises a limited amount of surveillance. Professor Briloff's articles in *Barron's* on "dirty" poolings and purchases, for example, brought public attention to the treatment of business combinations. While the public exposure of the columnist is much greater than that of the financial analyst, the expertise of the columnist in making the accounting judgments varies greatly.

Stockholders may watch the accounting practices of the companies in which they invest. Except for the professional stockholder, they are not likely to complain if management presents the most favorable picture. Accordingly, it is unlikely that a proxy contest to remove management would be started over unethical accounting practices, at least until the bubble bursts, at which time litigation is much more probable.

The role of the public in the enforcement process is therefore limited. Publicity is the principal means of enforcement; so long as the marketplace uncritically accepts published earnings-per-share figures as the main performance indicator, adverse publicity on accounting practices of a particular company will have little deterrent effect.

THE UNDERWRITER AND HIS COUNSEL. In the limited area of public offerings of securities, the underwriter and his counsel may play an important part in enforcing fair presentation. The underwriter's desire to see fair presentation comes principally from Section 11 of the 1933 Act which makes the underwriter, as well as the issuer and its directors, liable for misleading statements unless he can show with respect to the audited financials that, after

reasonable investigation, he had no reason to believe the financials were false. For unaudited financials, he must prove that he had reason to believe the statements were true.

The underwriter ordinarily has available within his firm personnel who can analyze the financials, request additional information as necessary, and cross-examine the financial executives and accountants. In offerings where litigation is likely, such as a contested stock tender offer, the underwriter may employ another accounting firm to review the company statements and practices. The requirement of a "comfort letter" causes the company auditors to reaffirm their prior reports and review the accounting practices used for unaudited figures.

If the underwriter disagrees with the company, it can refuse to handle the underwriting, after which it may be difficult to find a responsible new underwriter. The threat of Section 11 liability is a strong factor in the underwriter's review of the financials. On the other hand, the underwriter has a direct financial interest in the success of the offering and any revisions which reduce earnings per share might well endanger public acceptance of the offering.

THE STOCK EXCHANGES. The stock exchanges, of which the New York Stock Exchange is here used as an example, have two areas of concern: first, the financial condition of companies listed on the particular exchange and second, the financial condition of member firms.

Section 12 of the 1934 Act provides for the registration of securities on a stock exchange through the filing of a registration statement with the SEC and a listing application with the stock exchange. As part of the listing application, the company must enter into a listing agreement with the exchange which sets forth certain requirements such as the mailing of certified annual reports to stockholders and the publication of interim unaudited earnings statements. Copies of these reports, together with copies of quarterly and annual reports filed with the SEC, are filed with the stock exchange. The original listing application requires certified financials, and subsequent listing applications for shares issued in acquisitions require financial statements of the acquired company.

Each listed company is assigned a listing representative who oversees approximately 100 companies. It is his responsibility to be familiar with the operations of the listed company and its securities through review of the listing applications and annual and other reports as well as direct communication with company officials and counsel. This procedure is particularly valuable in the area of fair use of information, as will be discussed later. In the fair presentation area, the listing representative could bring matters of questionable accounting practice to the attention of the Board of Governors of the Stock Exchange. In practice, however, he tends to rely upon the certificate of the company's independent public accountants and to raise only formal matters in comments on the financial portions of the listing application.

The enforcement tool for the Exchange is delisting, which is provided for in Section 12(d) of the 1934 Act. While delisting normally occurs when a company fails to meet the numerical criteria for market value of publicly held shares or earnings history, the exchange can also delist a company if it fails to file the prescribed financial statements or if it fails "to observe good accounting practices in reporting of earnings and financial position."

The New York Stock Exchange has acted on an overall basis to enforce APB Opinion No. 16 by requiring listing applications for shares to be issued in a pooling of interests to be accompanied by an opinion of the company's auditors setting forth the compliance of the transaction with specified criteria.

The stock exchanges are given authority by the Securities Exchange Act of 1934 to regulate the financial requirements and reporting of member firms. Surprise audits are required, and the accountants make a detailed report to the exchange on the results of the audit. In this area, however, the exchange is principally interested in the financial stability and practices of the member firm and not in a fair presentation of the results of operations. Prior to 1970, member firms had no public stockholders, and reports to customers generally contained only balance sheet information.

THE SECURITIES AND EXCHANGE COMMISSION. During the legislative consideration of the Securities Act of 1933 it was proposed that the auditing function for registration statements be performed by government personnel, such as bank examiners. This proposal was rejected in favor of audits by independent certified public accountants. The SEC (originally FTC) was, however, given power over all other aspects of accounting.

The SEC has authority in all three areas of enforcement: establishment of standards, surveillance, and correction and punishment of violations. In establishing accounting principles, however, the Commission has tended to work through the AICPA, commenting and prodding from time to time to achieve certain results. This has led to the charge that the procedure whereby the APB Opinions are put into effect by the SEC violates the provisions of the Administrative Procedure Act for comments, administrative decision, and judicial review. In any case, it is clear that the SEC has not fully used the authority given to it by statute for the establishment of accounting principles.

The SEC is in an extremely well-placed position to exercise surveillance over financial reporting in view of the large amount of financial information which is required to be filed with it under the 1933 and 1934 Acts and the SEC rules. Any company issuing securities which are not exempt from registration under the 1933 Act must file a registration statement containing specified financial information. Companies subject to the 1934 Act must file certified annual reports on Form 10-K and unaudited quarterly financial information on the new Form 10-Q which replaced the Form 9-K required for semiannual financial information. Merger proxy statements require financial statements, and proxy statements for annual meetings must be accompanied

by annual reports which must be sent to, although not "filed with," the Commission.[2]

In the past, SEC surveillance has primarily been devoted to review of the financial information contained in registration statements and merger proxy statements. The Wheat Report recommended that more emphasis be placed on the current reports filed with the Commission. This recommendation has resulted in the adoption of Form 10-Q for quarterly information and a program for current review of the 10-K's and 10-Q's which are filed. The extent to which this program can be accomplished remains to be seen. The budgetary problems of the SEC are severe and, even with an increased budget, implementation depends upon the ability of the Commission to hire a competent staff to make the review.

The Commission also receives complaints from the public which are investigated, but complaints of unethical financial reporting do not receive high priority until the public has been injured.

Enforcement takes a variety of forms. It starts with the review of a registration statement and the resulting letter of comment. The policy of the 1933 Act is basically one of disclosure; that is, as long as the terrible news is fully disclosed, a registration statement may be allowed to become effective. However, the Commission went beyond this policy in Accounting Series Release No. 4 (1938) by stating that financial statements prepared in accordance with accounting principles for which there is no substantial authoritative support "will be presumed to be misleading" despite disclosures in footnotes or the accountant's certificate.

The "letter of comment" approach has a number of drawbacks. In the first place, different branches in the Commission's Division of Corporation Finance may take different positions on matters of accounting policy. Second, the establishment of many policies is not publicly announced and often can be determined only by a close examination of SEC filings. For example, the SEC position on the accounting treatment of unrealized appreciation of marketable securities in the income statement for broker-dealers was deduced by the more knowledgeable observers from a comparison of the initial registration statement of Donaldson, Lufkin & Jenrette, Inc. with the subsequent amendments.

Similarly, the Commission's approach to the treatment of compensating balances in stating the effective interest rate for borrowings was heralded by footnotes in a few prospectuses. It was then learned by a telephone call that all branches would require recognition of compensating balances. Nevertheless, this policy has never been publicly announced.

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[2] The foregoing requirements relate to corporations in general. Special types of corporations, such as investment companies, broker-dealers, and public utility holding companies have other filing requirements with the SEC. Banks must file with federal and/or state banking authorities; carriers with the ICC; insurance companies with state insurance commissioners, etc.

The power of the Commission in enforcing its letter of comment is great, for issuers and underwriters normally feel themselves under heavy time pressures and do not want to delay the offering in order to do battle. The specter of a stop order proceeding is untenable in most situations since, even though it could ultimately be successfully defended, the very institution of the proceeding would kill the proposed offering. The result is that concessions are made in the prospectus which would not ordinarily be made in more tranquil times. The program for reviewing 10-Ks and 10-Qs and commenting upon those filings could change this aspect since the issuer and its accountants will be able to discuss the comments with the staff in a less charged atmosphere.

The federal securities laws provide a number of weapons for SEC enforcement. The Commission can issue interpretive releases on accounting practice, which it has done relatively infrequently. It can issue a stop order suspending the effectiveness of a registration statement. It can suspend trading in outstanding securities. It can conduct private and public investigations into possible violations of the laws and take administrative action against persons subject to its jurisdiction, such as broker-dealers and investment advisers. It can recommend to the Department of Justice that grand jury proceedings be commenced with a view to criminal indictments. It can institute civil proceedings to enjoin persons from further violations of the securities laws and, as held in *SEC* v. *Texas Gulf Sulphur Co.,* 446 F2d 1301 (1971), for damages to the corporation and its shareholders.

In the accounting area, one of the principal means of enforcement is Rule 2(e) of the SEC Rules of Practice which provides for the suspension of the right to practice before the Commission if it finds, *inter alia,* that a person has engaged in unethical or improper professional conduct or has willfully violated the federal securities laws. This rule has recently been broadened to permit the Commission to temporarily suspend without a hearing any person permanently enjoined from violating the federal securities laws or found by a court to have violated or aided and abetted a violation of those laws.

There may also be peripheral effects from an SEC injunction proceeding. For example, Section 9 of the Investment Company Act makes a person who has been enjoined from violating the securities laws ineligible to serve as a director of an investment company unless the SEC otherwise orders. Even the commencement of an investigation may have side effects since it appears to be staff policy to hold up processing of registration statements of the company under investigation until the investigation proceedings have been completed.

The Commission, therefore, has a large arsenal of weapons. Assuming that informal enforcement can be made more uniform and less undisclosed, the principal problem is a budgetary one. Review of 10-Qs and 10-Ks alone requires a large staff; administrative proceedings are time-consuming, and court proceedings require a tremendous number of additional man-hours.

THE COURTS. The Courts are the final step in the enforcement process. They are the cornerstone of the Anglo-Saxon system of jurisprudence which goes back to the Magna Carta.

> The framers [of the Magna Carta] had grasped the great truths that jurisprudence is a science; that the law must be administered by men learned in that science and bound to obey its rules; that uniformity, certainty and impartiality are essential to the administration of justice, and that the highest political liberty is the right to justice according to law and not according to the will of the judge or the judge's master or according to the judge's individual discretion, or his notions of right and wrong. They had also arrived at the conclusion that every Englishman was entitled as of absolute right to a day in a court that would hear before it condemned, that would proceed upon notice and inquiry and that would render judgment after a fair trial and then only according to law.[3]

The courts do not act on their own motion; consequently, they are not a part of the surveillance process. In addition, they enforce legal standards, not ethical standards (if there is in fact any distinction between the two).

Access to the courts for correcting or punishing unfair presentation of financial information comes from several directions. State and federal statutes provide criminal penalties for making fraudulent statements, and fraud also provides a common-law ground for civil recovery. Negligence may also give rise to a civil cause of action.

The main avenue at the present time is the federal securities laws. The statutory scheme, as *stated* in the 1933 and 1934 Acts, looked to the SEC as the principal enforcer through administrative proceedings and suits for injunctions and criminal penalties. Private remedies were provided in Sections 11 and 12 of the 1933 Act and Sections 9 and 18 of the 1934 Act, but these sections have relatively short statutes of limitations and, in the case of Sections 11 and 12(2), a specific provision on the standard of care required.

The courts' expanding interpretation of the private right of action under Section 10(b) of the 1934 Act and Rule 10b-5, which is traced so well in Mr. Sommer's paper, has shattered the statutory scheme. Since there is no specific statute of limitations in the Act, the courts have borrowed the various state limitation periods. This lack of uniformity is compounded by the differing standards of proof required by the various federal courts. Some circuits require the plaintiff to be a purchaser or seller of securities, others do not. Some circuits require proof that the defendant knew of the misleading statement; others require only gross negligence; some require only negligence. Some require reliance on the statement, others do not. The United States

[3] "Magna Carta," *The Lawyer's Treasury*, ed. Eugene Gerhart, *American Bar Association Journal* (Bobbs: 1956), pp. 82-83.

Supreme Court, which resolves conflicts among the circuit courts, has taken relatively few 10b-5 cases so that the uncertainty and unevenness of application continues.

Suits under 10b-5 almost always take the form of a class action—a suit by a stockholder on behalf of himself and all others similarly situated. The courts have approved this type of action on the ground that the individual stockholder has so little at stake he would not be economically able to bring the action only on his own behalf. Rules have been established for defining a class, but application of the rules to each case has produced a variety of results.

The class action has been further fostered by the rule that successful plaintiff's counsel may recover his fees from the judgment awarded. In many cases the size of the class is so large that even the recovery of $1,000,000 will mean less than $1 to the average member of the class. Thus, the real party in interest becomes plaintiff's counsel.

It used to be that counsel could only recover his fees if a fund was produced; but the Supreme Court, in *Mills* v. *Electric Auto-Lite Co.,* 396 US 375 (1970), concluded on the basis of the policy expressed in the securities laws that fees could be awarded without a fund if a violation of law had been established. Again, this encourages suit even though recovery may be small. In recent years, the practice has become common for attorneys, to be plaintiffs as well as counsel. One Penn Central case was brought by an attorney who owned one share of stock.

Prior to the time 10b-5 became fashionable, a rash of stockholder derivative suits influenced a number of state legislatures to pass "security for costs" statutes which usually required a stockholder owning less than 5% of the company to post a bond for costs which might be assessed against him if the suit were unsuccessful. The cost of the bond in many cases effectively discouraged groundless suits. Section 18 of the 1934 Act contains a provision for security for costs, which may be why that Section is infrequently invoked. However, under another section of the Act which does not have such a provision, the Supreme Court held, in *J. I. Case Co.* v. *Borak,* 377 US 426 (1964), that security for costs could not be required because it would inhibit enforcement of the Act.

From the defendant's standpoint, litigation is a costly process. The discovery procedures provided in the Federal Rules of Civil Procedure are extremely time-consuming. Plaintiff's counsel customarily serves 20 to 30 pages of interrogatories which must be answered, followed by a motion to produce stacks of documents, followed by notices of depositions which may take many weeks in far-off places. Counsel fees mount up as this procedure continues.

The defendant therefore looks for a means of having the case rapidly dismissed, but the law is not helpful in this regard. The federal rules require only "notice" pleading so that a plaintiff need not be particularly specific in his allegations. Furthermore, the decisions say that, in view of the policy

found in the federal securities laws, a court should be reluctant to dismiss a case until the plaintiff has had a full opportunity to conduct discovery. The courts are also liberal in allowing discovery so that attempts to narrow the scope of interrogatories or motions to produce are generally resolved in favor of the plaintiff.

The extreme to which this type of litigation has gone is illustrated by a recent suit brought by an attorney who had purchased stock and sold it a month later for a $400 loss. The suit was brought on behalf of all persons who had purchased stock during a 13-month period. The basis of liability specifically alleged was that the assets were overstated, the liabilities understated, and expenditures were capitalized which should have been expensed. Accompanying the complaint were 21 pages of interrogatories containing such questions as "List all assets of the company as of——————"; "List all liabilities of the company as of the same date"; "List all expenses of the company during the year ended on that date," etc.

If a quick dismissal cannot be achieved, then the defendant might look for a way to have a speedy trial. The federal courts are moving to reduce the time within which a case can be reached for trial. However, discovery procedures must still be completed, and the present state of court congestion militates against a rapid trial.

Finally, the trial itself presents problems in any case involving questions of accounting principles. Juries are generally composed of people who are not sophisticated in financial matters and who are likely to have preconceptions of the role of an accountant which vary materially from the AICPA pronouncements. Judges are drawn in many cases from government service or from personal injury litigation practice, and it is unusual to find a judge with a background in financial reporting.

Furthermore, suits for unfair presentation of financial information in almost all cases take place after the fact. Resolution of the suit does not occur until many years after the publication of the statements under attack. A judgment on what was or was not material looks very different with the benefit of hindsight when a company has become bankrupt. Similarly, a decision to capitalize research and development costs changes color when subsequent events show that the product could never be marketed.

It is no wonder, then, that most stockholder suits are settled. The defendants can add up the counsel fees which they would incur in a successful defense and see that settlement would be preferable despite the distaste of, in effect, paying the plaintiff's counsel fees. The one benefit of a class action to the defendants is that a settlement prevents further suits by members of the class unless they have affirmatively elected not to be included in the class.

The stockholder class suit has been attacked as being a haven for "strike suit" lawyers. Proponents of this type of action say that they provide a valuable protection for the public and supplement the enforcement efforts of the SEC. It is clear that the threat of a stockholder suit is one of the most effec-

tive deterrents against departure from ethical standards. It is also clear that the stockholder suit as presently constituted does not produce the "uniformity, certainty and impartiality" which in the quotation at the beginning of this section was found to be "essential to the administration of justice."

How Can Existing Methods of Enforcement be Improved?

The foregoing catalogue of existing methods of enforcement may not be definitive, but it does show that there are many points in the enforcement process at which available tools are not being effectively utilized. The purpose of this section is to suggest some ways in which enforcement can be made more effective. The suggestions herein are for discussion purposes and may or may not represent the views of the author.

It might be helpful first to look at the possible reasons for departures from ethical standards in order to determine the most effective ways to prevent them.

1. Executives and accountants are not fully informed on the ethical standards to be followed in financial reporting.
2. Ethical standards are inadequately defined, making adherence difficult.
3. Ethical standards are defined in a way which executives or accountants believe does not lead to fair presentation. An analogy would be a 25 mile per hour speed limit on a dry, uncrowded superhighway.
4. Another person supposedly subject to the same ethical standards has "gotten away with it."
5. Ethical standards are outweighed by a desire to show a favorable picture for personal economic reasons (increase in value of stock holdings or option or in incentive compensation, fear of stockholder complaints or suits), corporate economic reasons (sale of additional stock, acquisitions, stockholder relations), or simply personal justification.
6. Ethical standards of the accountant are outweighed by the desire to retain the client and/or the personal relationship with the client.
7. Nobody will discover the departure from ethical standards.

With these thoughts in mind, the principal categories discussed in the first section of this paper can be reviewed. Once again it is assumed that ethical standards can be defined and in such a way that they do not result in the 25 m.p.h. superhighway analogy mentioned above. It is by no means certain that this assumption is correct, but without it enforcement can only be effective in cases of clear fraud.

THE FINANCIAL EXECUTIVE. It is surprising to find that the Financial Executives Institute does not have a formal code of ethics at the present time. Accountants and lawyers, of course, have a certification process which makes

discipline for violation of the code effective. Nevertheless, the Financial Analysts Federation and Robert Morris Associates have codes of ethics.

Would it be possible for the FEI to establish a means of certification which would provide status and perhaps economic benefit to the certified financial executive?

Education regarding ethical standards is important for both executives and accountants. Is the FEI doing an adequate job in this area?

There are various ways in which the personal economic pressures on the financial executive could be reduced. For example, he could be prohibited from having stock options or receiving additional compensation based on financial results; or, he could be hired, and his salary fixed, by the board of directors or by a committee of outside directors.

The first suggestion is not really fair to the financial executive unless his salary is adjusted accordingly. The second suggestion is inconsistent with the concept of a chief executive officer having direct responsibility for the operations of the company and concomitantly the right to select the persons under his command.

THE BOARD OF DIRECTORS. The board of directors' role in enforcement is a limited one. It can deal only with the individual company, resulting in a lack of uniformity in enforcement and, perhaps, short-run benefits to the company with an inactive board.

Requirements that every board have a certain number of outside directors or have a financial analyst as a member would obviously be ineffective since enforcement would still depend upon the ability and availability of the directors.

Should the state corporate laws and Section 11 of the 1933 Act be changed to require the directors to look more deeply into the financial statements? This change might well accelerate the present movement toward departure from the board of nonmanagement directors. Already the threat of stockholder litigation has begun to outweigh the status and fees of being a director. Premiums on director and officer liability insurance have skyrocketed, and the efficacy of coverage is in doubt. Suggestions have been made that outside directors be held to a lesser standard of care than management directors. It is apparent that the imposition of further responsibility for financial reporting is not practical at the present time.

The use of an audit committee of outside directors should, however, be encouraged. This committee should meet with the financial executive and with the outside accountants and review the accounting alternatives selected. In fact, following the Atlantic Acceptance disaster in Canada, the Ontario Business Corporations Act has been amended to require an audit committee for companies offering securities to the public. The committee's duty is to review the financials before they are submitted to the board of directors and the auditor is given access to the committee. A majority of the audit committee must be directors who are not officers or employees of the company.

THE INDEPENDENT PUBLIC ACCOUNTANT. The accountant is not really independent so long as he is selected and paid by the client. Various alternatives suggest themselves:

- Require rotation of accountants every certain number of years.
- Have accountants selected by a committee of outside directors or a stockholder committee.
- Have accountants designated by the AICPA or the SEC.
- Have the SEC take over the auditing function as suggested in the early 1930s.
- Have accountants paid from some form of industry or public fund.

The first suggestion would appear to have substantial merit depending upon the time period selected. On the other hand, this requirement would penalize highly ethical managements who believe that the accounting firm selected by them is the most effective in auditing and requiring adherence to high standards.

How can the accountant's role be made more effective? Should an audit or review of the Form 10-Q be required? Should a surprise audit be required in place of or in addition to the annual audit? Should the common practice of submitting a post-audit memorandum on internal controls and accounting procedures be made a requirement? Whom should it be submitted to–management, the board of directors, the AICPA, the stock exchange, the SEC? Should other detailed reports to the SEC be required–publicly filed or as supplemental information?

THE ACCOUNTING PROFESSION. Short of the SEC, the accounting profession has the most room for improvement. It should begin with the education of the members of the profession in ethical standards of financial reporting. This could be done by increased use of interpretive releases.

The profession is also in the best position to exercise surveillance since its members are the most knowledgeable in the field, and supervision over all reporting companies can be obtained. Filings could be required from member firms or coordinated with the SEC. The principal problems are budget and manpower. There is also the question whether AICPA surveillance is necessary when the SEC has embarked on a program along the same lines. The answer may depend on whether the SEC can carry out its program within its budget and staff. Is there room for cooperation between the AICPA and the SEC in this program? Should representatives of other organizations interested in financial reporting be made a part of a surveillance task force?

Once violations of ethical standards are found, correction or punishment is required. It has been pointed out previously that a profession is reluctant to criticize publicly some of its members since this may tend to besmirch the entire profession in the public's eyes. On the other hand, it would seem that effective discipline should enhance the profession's standing.

The Philadelphia Bar Association has recently been under fire for al-

leged failure to take disciplinary action. One of the recommendations made was that the public should be represented on the disciplinary committee since it is directly affected. The same point has merit for disciplinary action by the accounting profession.

Serious consideration should be given to suggestions which have been made for the establishment of an accounting "court." This court could be composed of, for example, one accountant, one financial analyst, and one member of the public designated by the SEC. It would not establish accounting principles (which is a legislative determination) but would discipline violations and could also resolve current questions of interpretation presented by members. While a decision of the court would not necessarily be conclusive in a subsequent stockholder suit, it would obviously be persuasive and would have been made by persons knowledgeable in accounting.

The court might duplicate some of the present SEC work, but, if it is effective, one can surmise that the SEC would be happy to have the court take over enforcement in this field.

THE SEC. The Wheat Report produced a beneficial change in direction of the surveillance efforts of the SEC from registration statements to annual and quarterly reports. Under the new policy, the effect of SEC review should be felt evenly throughout the financial community and not just in those companies having public offerings. The principal question now is whether the SEC can adequately review and comment within a reasonable time after filing. While the SEC is a revenue producing agency, its budget is woefully inadequate for the tasks given to it by statute. It is in the interest of the financial community to see that this budget is increased so that the Commission can act fully and fairly in the area of fair presentation.

The letter of comment approach, while effective, is not the best means of enforcement. Accounting policies developed by the staff should be publicized promptly. Interpretive releases should also be used more frequently to call public attention to bad accounting practices. The SEC has been given a mission by the 1933 Act which should be carried out.

THE COURTS. The uncertainty and diversity among the various federal courts in the 10b-5 area needs to be eliminated either by Supreme Court decisions or by Congress. The latter would be preferable since it could be accomplished more promptly on a broad basis rather than case by case, and the entire philosophy of the federal securities laws could be reviewed including the respective roles of the SEC and private litigants, the basis of liability, and the time within which suit must be brought.

The class action needs to be refined to prevent abuses. One approach would be to fix a jurisdictional amount as is the case in other federal suits, so that the plaintiff(s) must show that the amount in controversy arising out of his or their stock exceeds, for example, $10,000. The provisions of Section 18 of the 1934 Act that permit the court to assess defendants' counsel fees

against an unsuccessful plaintiff and to require security at the commencement of the case for such an assessment could be extended to all stockholder suits.

Another approach would be to provide for a preliminary hearing prior to commencement of discovery in order to eliminate the obviously groundless suit. The hearing could be held before the court, a master appointed by the court, a panel of experts, or even the SEC.

The actual trial might also be assigned to a master or arbitration panel with appropriate review by the court. This is presently provided in most state statutes for dissenting shareholder appraisal suits which require an understanding of financial statements and securities valuation. The result would be to speed up the trial and provide a trier of fact with expertise in accounting matters.

These are merely a few suggestions. If remedial steps are not taken, it well may be that the "Securities Act of 1983" will provide for audits by SEC personnel not because of any change in policy but because there will be no public accounting firms left.

The Fair Use (or Nonuse) of Financial Information: Are Existing Methods of Enforcement Adequate?

Ethical standards in the use of financial information take their content directly from the federal securities laws. The Supreme Court has said: "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry." (*SEC.* v. *Capital Gains Research Bureau,* 375 US 180, 186 (1963).)

The standard stated in *Texas Gulf Sulphur,* 401 F2d 833 (1968), and recently reiterated by the SEC in the Investors Management Co., Inc., opinion[4] relating to the Douglas Aircraft-Merrill Lynch matter is that a person who has material nonpublic information concerning a company which comes from inside sources should not effect transactions in the company's securities nor transmit the information to others who may effect such transactions.

The difficulty in following this standard lies in determining what is "material" and "nonpublic." The financial executive is almost always the possessor of some inside information which the public does not know. The materiality of this information may appear entirely different in hindsight than it does at the time of purchase or sale of stock.

The financial analyst's stock in trade is collecting all relevant information concerning a company and advising on the basis of that information. While the financial executive may refrain from purchasing or selling in

[4] SEC Release Nos. 34-9267 and IA 289, CCH Fed. Sec. L. Rep. ¶ 78,163 (July 29, 1971).

doubtful situations, it is much more difficult for the financial analyst to refrain from making recommendations. He also has an additional problem in determining whether the information has come from an inside source.

In recognition of the importance to the securities industry and the investing public of more adequate guidelines, the SEC in the Investors Management case decided on its own motion to review the decision of the hearing examiner censuring various broker-dealers and investment advisers. The Commission found that the following elements should be present for the imposition of responsibility: "that the information in question be material and nonpublic; that the tippee, whether he receives the information directly or indirectly, know or have reason to know that it was nonpublic and had been obtained improperly by selective revelation or otherwise, and that the information be a factor in his decision to effect the transaction." The footnote to this statement is instructive:

> Our formulation would clearly attach responsibility in a situation where the recipient knew or had reason to know the information was obtained by industrial espionage, commercial bribery or the like. We also consider that there would be potential responsibility, depending on an evaluation of the specific facts and circumstances, where persons innocently come into possession of and then use information which they have reason to know is intended to be confidential. Our test would not attach responsibility with respect to information which is obtained by general observation or analysis.

The Commission then goes on to discuss each one of the elements as related to the disclosure by Merrill Lynch of the reduction in earnings of Douglas Aircraft.

This opinion is a valuable step in the enforcement process for it serves to educate the users of financial information on the standards to be followed. The definitional gap is narrowed but, unfortunately, the problem of what is "material nonpublic information" still remains for each individual case.

SECTION 16 OF THE 1934 ACT. The blunderbuss which Congress fashioned to deal with insider trading is Section 16 of the Securities Exchange Act of 1934. It applies to the securities of a company registered under the 1934 Act held by its directors, officers, and ten per cent stockholders. Each person covered must report to the SEC on a monthly basis if any change in his beneficial ownership occurs. Any profit made within a six-month period on a purchase and sale or sale and purchase belongs to the company; if the company does not bring suit to recover it, a stockholder may.

Surveillance is excellent by reason of the required reports. While the SEC does not review the reports on a systematic basis, it publishes summaries of the information on a periodical basis, and any stockholder can have access to the reports. *The Wall Street Journal* and other newspapers also publish

selected portions of the summaries from time to time. The information provided by the reports may be useful for other than Section 16 purposes since it covers all changes, whether or not within a six-month period. Further surveillance is conducted by certain professional stockholders who review the SEC summaries and then initiate the enforcement process by requesting the management of the company to take action on any violations. In the event management fails to bring suit within sixty days after request, the stockholder may bring suit and is entitled to receive his counsel fees out of the recovery. Section 16 provides that suit must be brought within two years after the profit is realized. If no report is filed, the courts have held that suit may be instituted within two years after discovery of the facts.

The scope of Section 16 is limited. It applies only to directors, officers, and ten per cent stockholders of the registrant, not to directors and officers of any subsidiaries of the registrant nor to other persons who may be privy to inside information, although the SEC has defined *officers* to include persons without title who perform functions corresponding to those performed by a president, vice-president, treasurer, secretary, or comptroller. Section 16 applies only to purchases and sales within a six-month period. Transactions within a six and one-half month period, for example, are not covered, and yet this is much more likely in view of the long-term capital gain provisions of the Internal Revenue Code.

The conclusive presumption of the statute that any purchase and sale within a six-month period was made on inside information produces harsh results. It has become a trap for the unwary, but no problem for the person knowingly trading on inside information.

The principal difficulty has arisen from court interpretation of *purchase* and *sale* and the date on which the transaction occurs. The receipt of an employee stock option is a purchase unless certain procedural steps specified in an SEC rule are followed. The conversion of debentures or preferred stock may or may not be a sale of that security and a purchase of the underlying security, depending upon which district court hears the case. In two recent cases it has been held that a merger is a sale of the old security and a purchase of the new one.

In one case it was even argued that a gift of appreciated securities to charity was a sale because the donor received the same economic benefits he would have received if he had sold the securities and donated the proceeds. Fortunately the argument was rejected, but there can be no assurance that it will not be adopted by another court since the modern trend in decisions under this section is to adopt the theory that best effectuates the purposes of the Act, i.e., the theory that finds the defendant liable.

It is difficult to tell how much therapeutic effect Section 16 has had. It does not prevent an executive from purchasing with inside information and selling out later at a profit so long as the two transactions are more than six months apart. It does, however, give publicity to purchases and sales by corporate executives and may thereby deter an executive from effecting a trans-

action which could at a later date be tied to a public announcement of important information.

RULE 10b-5. Because of the limited scope of Section 16, the principal means of enforcement of ethical standards in the fair use of financial information has been through Rule 10b-5 adopted under Section 10(b) of the 1934 Act and, to a lesser degree, Section 17(a) of the 1933 Act which is similar in language to Section 10(b) but applies only to sales of securities. As discussed in the first section of this paper, it was originally thought that these Sections of the two Acts did not provide a private right of action, and it was not until the late 1940s that the floodgates were initially opened.

The stock exchanges monitor by computer the price and volume movements of listed securities in order to maintain an orderly market. The SEC also monitors trading so that any unusual activity comes to its attention and is followed up by investigation and perhaps direct inquiry of the company involved. This type of surveillance catches a large amount of trading on inside information but it does not necessarily detect less substantial transactions. The SEC also receives a large number of complaints from the public which are followed up by the staff and may reveal violations of Rule 10b-5.

Administrative proceedings by the SEC play a more important role in the fair use of financial information because violations often involve broker-dealers and, to a lesser extent, investment advisers, both of which must be registered with the SEC in order to stay in business. Section 15 of the 1934 Act gives the SEC authority to censure a broker-dealer or to suspend or revoke its registration upon a finding that the broker-dealer has willfully violated, or aided or abetted a violation of, the federal securities laws; the Investment Advisers Act of 1940 contains similar provisions. The administrative proceedings can be accomplished more rapidly than court proceedings, but the legal expense and the executive time consumed are still great. Furthermore, the hearing examiner, being an employee of the SEC, is likely to take a strict view of the requirements of the Act. For that reason, persons named in administrative proceedings will normally prefer to attempt to settle the proceeding by agreeing to censure or some form of suspension rather than fight the case through the Commission and ultimately the courts.

The SEC may also move in the federal courts for an injunction against any future violations of Rule 10b-5. Even though the violation has already occurred, the cases hold that an injunction should be granted unless it is absolutely clear that there is no likelihood of further violations. The significance of the entry of an injunction is that violations by the defendant place it in contempt of court thus providing a more rapid means of enforcement and probably heavy penalties. The injunction also has the peripheral effects discussed in the first section of this paper.

The SEC has plowed new ground in the *Texas Gulf Sulphur* litigation with the court's holding that the SEC may recover damages from the defendants. The court held the defendants liable not only for the profits they real-

ized on their purchases but also for the profits realized by their tippees. This extension of the scope of liability will certainly serve as an additional deterrent against the transmission of inside information to others. Private class actions may also be brought on behalf of persons who sold (or purchased) as a result of the failure of the defendants to release the true facts. The previous discussion concerning stockholder suits is also relevant here. Particularly pertinent is the fact that the materiality of the information will undoubtedly look entirely different four or five years after the fact than it did at the time the transaction occurred.

The SEC proceedings have an educational effect. They also spawn private suits, sometimes within 24 hours after announcement of SEC action. The Texas Gulf Sulphur Company has been subjected to a large number of suits by persons who sold stock between the time the court found the news should have been released and the time that it was actually disseminated to the public. Suits have likewise been brought against Douglas Aircraft Company (now merged into McDonnell-Douglas Corporation) and Merrill Lynch as a result of the publicity given to the SEC proceedings. Thus, the SEC proceedings have an additional effect on enforcement by providing publicity and a factual basis for subsequent stockholder suits.

SELF-REGULATION. It is customary in many companies for management to request counsel to prepare a memorandum for directors and officers setting forth the liabilities which arise from trading on inside information. Securities firms likewise generally have a compliance program for employees. The code of ethics of The Institute of Chartered Financial Analysts does not expressly deal with the fair use of financial information but does provide that the financial analyst shall comply strictly with all laws, governmental rules and regulations of the stock exchanges, and the National Association of Securities Dealers. The Robert Morris Associates' Code of Ethics for the Exchange of Credit Information begins: "The first and cardinal principle in credit investigation is to respect the confidential nature of the information received." In this regard, it would appear that the credit officer may transmit inside information to another credit officer, but the inquirer must maintain the confidentiality.

As discussed above, the stock exchanges have a dual role under the 1934 Act to supervise (1) member firms and (2) listed companies. Section 6 provides for registration of the exchange with the SEC and makes it a prerequisite that the rules of the exchange shall contain disciplinary provisions for conduct by a member inconsistent with "just and equitable principles of trade," which shall include violations of the Act and the SEC rules. Section 12(d) states that a security may be delisted in accordance with the rules of the exchange.

These statutory provisions are expanded in the rules and policies of the exchanges. The New York Stock Exchange listing agreement, for example, is designed to achieve timely disclosure of information that "may affect secu-

rities values or influence investment decisions." The Exchange policy pronouncements also discuss in an informative manner such matters as internal handling of confidential corporate matters, corporate compliance programs, relationships with security analysts, relationships between company officials and representatives of member firms, public release policy, and stock transactions by directors and officers. Company officials are encouraged to discuss important matters preliminarily with their listing representative. The educational process is therefore a good one. The policies of the Exchange also provide that a factor in determining whether to delist a company is the failure "to make timely, adequate, and accurate disclosures of information to its shareholders and the investing public."

Through the computer surveillance mentioned above, unusual market activity can be ascertained promptly. If necessary, trading can be suspended until company officials are contacted and news is released to the public. In this way the Exchange can maintain public confidence in the fairness of market trading. The informality of this system enables it to react quickly. If the Exchange should cease being the principal market place for listed stocks, it is important that a similar means of surveillance and enforcement be developed in the new market.

The Exchange supervises its member firms and in turn requires them to supervise their employees. Personnel of member firms are permitted to act as directors of listed companies although the Exchange policy is expressed as follows:

> Every director has a fiduciary obligation not to reveal any privileged information to anyone not authorized to receive it. Not until there is full public disclosure of such data, particularly when the information might have a bearing on the market price of securities, is a director released from the necessity of keeping information of this character to himself. Any director of a corporation who is a partner, officer, or employee of a member organization should recognize that his first responsibility in this area is to the corporation on whose board he serves. Thus, a member firm director must meticulously avoid any disclosure of inside information to his partners, employees of the firm, his customers or his research or trading departments.[5]

A confrontation between this statement and the duty of a broker to its customer was presented in the 1968 case of *Black* v. *Shearson, Hamill & Co.*, 72 Calif. Rptr. 157 (1968). Mr. Black claimed that he had purchased stock of a company through the brokerage firm at a time when one of the firm's partners, as a director of the company, knew of adverse financial information. The defendant cited the foregoing statement as a defense. The court held both the brokerage firm and the partner liable to Mr. Black, saying:

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[5] New York Stock Exchange Company Manual, p. A-21, (7/18/68).

> We have been given no sufficient reason for permitting a person to avoid one fiduciary obligation by accepting another which conflicts with it. . . . The officer-director's conflict in duties is the classic problem encountered by one who serves two masters. It should not be resolved by weighing the conflicting duties; it should be avoided in advance . . . or terminated when it appears.

Violations of Rule 10b-5 may result in discipline by a stock exchange as well as by the SEC. The National Association of Securities Dealers, which is given statutory recognition by Section 15A of the 1934 Act, is also required to have rules which are designed to prevent fraudulent acts and to promote just and equitable principles of trade with appropriate disciplinary provisions.

How Can Existing Methods of Enforcement Be Improved?

It appears that ethical standards in the fair use of financial information have been more effectively publicized by the professional organizations, the stock exchanges, and the SEC than those for fair presentation. The definition of *material* and *nonpublic* still remains fuzzy in the individual case, but pronouncements such as the SEC Investors Management opinion and the New York Stock Exchange policies have helped to establish guidelines for the user. It may, of course, be that ethical standards are more easily defined in this area.

The principal reason for departure from ethical standards in the use of financial information, aside from the fact that some people can never keep a secret, is personal economic gain for the recipient of the information or his client.

This motive could be removed for the financial executive by prohibiting his ownership of securities in his employer. Such a prohibition would, however, run contrary to the commonly held idea that directors and officers should have a meaningful investment in their company and would also deprive the executive of whatever tax benefits are left in the qualified stock option. A periodic investment program, as suggested by the New York Stock Exchange, would solve the purchase end of the problem, but it would seem inequitable to prohibit sales in view of the likely personal needs of the executive.

Section 16 reports are not seen by most stockholders. More effective publicity could be given to transactions by directors and officers by amending the proxy rules to require the proxy statement for the annual meeting to list all transactions by directors and officers during the year instead of just the directors' current holdings as now required.

The broker-director continues to be a prevalent condition despite the *Black* case discussed above and the much publicized resignations of the partners of Butcher & Sherrerd in 1968 from their directorships. It may be that

the courts will extend Section 16 liability to the brokerage firms, following the theory of deputization established in *Feder* v. *Martin Marietta Corp.*, 406 F2d 260 (1969), which will bring an abrupt halt to this practice. Even if this does not occur, the practice should be ended.

Another source of conflict is the investment by bank trust departments in companies which have borrowed money from the bank. If a bank credit officer receives unfavorable information about a company whose stock the bank holds as trustee, is he not in the same position as the partner in the brokerage firm in the *Black* case?

A means of restricting the use of inside information would be to insulate the insiders to the maximum extent possible from the public. This occurs during merger negotiations, for example. Such an arrangement would obviously not be satisfactory to financial analysts or other members of the investing public. It runs counter to the expressed purpose of the federal securities laws to foster the disclosure of information.

Is it possible to restructure Section 16 of the 1934 Act in order to make it more effective and yet less of a trap for the innocent? The extension of the reporting requirement to other employees would flood the SEC, but could not the company be made the collecting agent for the information with a composite monthly filing? While many companies have compliance programs, should not all companies be required to supervise employees in the same manner as stock exchange member firms and other broker-dealers? Would a change in the six-month time period improve enforcement?

One of the most ridiculous effects of the present state of the law is the trap in which several unsuccessful tender offerors have been caught. Their purchases put them over ten per cent which made them subject to Section 16 even though they had no access to inside information. Management then merged with another company within the six-month period, which is treated as a sale, thereby triggering liability. Should not the Act permit a ten per cent holder to prove he is not an insider? In fact, should not the Act permit an officer or director by some strict standard of proof such as "clear and convincing" to show he had no inside information?

In concept, Section 16 provided absolute liability within relatively certain bounds. In practice, through court interpretation, these bounds have become uncertain. Either the boundaries should be redefined or the absolute liability lifted.

Conclusion

Enforcement of ethical standards is important first in deterring future violations and second in stiffening the moral backbone of the well-meaning by showing that "crime does not pay." In the last analysis, however, the maintenance of ethical standards must come from the individual: "For from

the inside, from a man's heart, come the evil ideas which lead him to do immoral things."

The comparison of enforcement of ethics in fair presentation and in fair use leads to the conclusion that the standards have been better defined, better disseminated, and better enforced in the fair use sector. It can be said that standards are easier to establish there. It is submitted, however, that the real reason for the difference is that the fair use standards have been drawn from the statute by the SEC and vigorously enforced. The establishment of fair presentation standards has been left by the SEC to the private sector, and it has failed. Effective enforcement of ethical standards of fair presentation will come only when the SEC, through proper administrative procedures, establishes accounting principles.

In summary, the following recommendations are made for improving enforcement of ethical standards of fair presentation:

1. Ethical standards should be established by the SEC in cooperation with the accounting profession and with the participation of other interested organizations. This could be accomplished within the present statutory framework by the SEC proposing rules based upon APB Opinions.
2. There should be a systematic means for reviewing financial statements to detect unethical practices.
3. The budget of the SEC should be increased so that it can adequately carry out these two recommendations. If the budget and staff of the SEC are not equal to the task of surveillance, the AICPA, FEI, FAF, and Robert Morris Associates should combine their funds and personnel in establishing a review body.
4. Unethical practices should be publicly disclosed by the reviewing body.
5. An accounting court should be established to take disciplinary action and to interpret ethical standards on a current basis. In the absence of such a court, disciplinary action should be taken promptly by the SEC.
6. The foregoing steps will reduce the need for the "prophylactic" action of the stockholder class suit. It should be properly confined by requiring a jurisdictional amount, fixing a reasonable statute of limitations, providing a means for an early hearing on the merits of the suit, and permitting the assessment of defendants' counsel fees and expenses against the plaintiff in circumstances where the suit was not brought in good faith.

It is submitted that this was the statutory scheme of the 1933 and 1934 Acts and that the present distortions are due in large part to the failure of the SEC to carry out the rulemaking and enforcement procedures for fair presentation contemplated by the Acts.

The Public Image Problem

By Robert O. Carlson, *President, Public Relations Society of America*

There is no need to labor the moral and pragmatic importance of finding better ways for corporations to report on their financial operations. The papers presented three years ago at this symposium were characterized by candor and sincerity, and I am persuaded that much careful thought is being given to trying to establish norms by which the financial performance (both past and present) of corporations can be measured with greater precision.

Time and again in the discussions of three years ago, the term "comparability" was mentioned and, repeatedly, participants noted that even within industries in the same field, "comparability" in financial reporting is often difficult to achieve, becoming almost a nightmare when one seeks to establish it as a norm for measuring financial performance between industries as different, for example, as the extractive industries, the data processing and information retrieval industries, industries operating in the transportation sector of our economy, or the more conventional manufacturing firms producing established lines of consumer products.

I am intrigued as a social scientist, a public relations practitioner, and a small investor with the problems facing the corporate executive who tries to report on the present health of his corporation and its future prospects. In a world characterized by chaotic change, what guidelines are available by which any management can truly describe the potential for its new products and the possibilities for success of strategies which seek to insure its growth?

Developments of the past three years—consumerism, concern over air and water pollution, and an increasing clamor that management take into account the social implications of its investment decisions—all suggest that noneconomic forces will increasingly impinge on the economic performance of companies and, in turn, on their efforts at better economic forecasting. If these and comparable noneconomic factors continue to muddy the waters of corporate financial reporting, they must necessarily have profound implications for any discussion of the ethical aspects of corporate financial reporting. As the business community continues to seek better tools for measuring financial performance by corporations, I suggest that it must also assume a

far more aggressive and realistic role in alerting its publics to the sizeable amount of ambiguity and uncertainty which is a necessary concomitant of any financial report or forecast. And that, in summary, is how I visualize the ethical problem facing those in the business community concerned about improving the quality of corporate financial reporting. This paper is an effort to document that thesis.

Attitudinal Problems as a Focus of Business

Americans have traditionally been nurtured in an intellectual climate which held that economic and social success were hallmarks of the Almighty's approval—the so-called "Protestant ethic." Several world wars and several massive economic depressions have badly battered that concept, but some of its rhetoric still lives on and influences the way tough-minded businessmen try to describe the state of health of the corporations which they manage.

They are reluctant oftentimes to admit that they do not possess reliable yardsticks by which to measure the success or failure of their past performances and predictions. In their eagerness to reduce complex problems to dollars and cents, they have allowed themselves to be cast into roles as experts in forecasting on topics about which they should not be expected to have precise knowledge. Since the last meeting of this symposium, we have seen how difficult it is to assign dollars and cents values to a whole range of intangible attitudinal problems which have surfaced largely within the past three years—concern over the quality of our environment, the "right" of the consumer to have a voice in determining the quality of the goods he purchases, and the "obligation" which the corporation has to be concerned over the social implications of its investment policies. These invisible attitude changes have carried a high price tag for American companies in recent years. I am not suggesting that three years ago, or even today, there were or are any precise tools available for assessing the potential cost of such shifting areas of public concern which, in turn, influence the way industry manufactures and prices its goods. For example, how seriously should today's management take the current agitation on some campuses and in some intellectual circles for zero population growth and zero consumption growth; I don't know, and I suspect few of our leaders in the business world do either. Even the more traditional areas where businessmen have tried to predict the future—new product development and acceptance in the marketplace or the early identification of management potential among younger executives—are fraught with sizeable uncertainties and a spotty history of failures mixed with some success. Projections of future financial performance by business firms must be made with a full realization that the business community has only a limited influence on the political, economic, and social environment in which it will find itself operating in the years ahead.

Importance of Communication Processes In Financial Reporting

In the papers presented at the 1968 symposium, I noted an underlying assumption which, while highly laudable, deserves a certain amount of scrutiny and hard questioning. Many of the papers presented at that meeting were based on the assumption that, given enough time and hard work, the means will be found for establishing criteria which will indicate when companies are being candid and realistic in reporting on their financial operations and when they are not.

The logical extension of that assumption, of course, is that once the means of establishing a common language and a set of yardsticks have been agreed upon, it will be possible to provide more accurate data to the investing public, the financial press, and the general public.

The Public Relations Society of America has a special committee on financial liaison which is working with the business community and the Securities and Exchange Commission in pursuit of these same objectives. It has already made important contributions to informing members of our Society and the corporations and clients which they serve regarding the legal obligations which govern their corporate financial reporting. Nothing in the remarks which follow is intended in any way to downgrade the very important work which PRSA's Committee on Financial Liaison or the National Investor Relations Institute are doing in the field of improving the quality of financial reporting by business.

Rather, in these observations I shall be wearing my hat as a student of the communication processes. I would like to explore some of the sociological, psychological, and organizational considerations which may get in the way of realizing total success in producing truly accurate financial reports.

In our highly fragmented world, it is far from simple to gain a consensus as to what is true and correct even in seemingly simple situations which develop on the job or in our own families. People evaluate the same phenomenon in quite different terms. Currently, the media of communications in this country (particularly television and the press) are experiencing a form of the consumerism problem themselves inasmuch as segments of the public and the government are questioning the degree to which the media are responsible and accurate in reporting and editorializing on controversial international and domestic news events. We know from a great number of sociological studies that the process of communications begins long before the communicator speaks, writes, or acts. This is so because the image of the communicator plays an important, but as yet little investigated, role in determining which publics will listen to him, what they are likely to remember, and whether or not they will be moved to act as the communicator wishes.

We in the public relations profession make a fetish of this fact, and per-

haps we have done ourselves a disservice in letting this complex process be oversimplified by the catch phrase "image." Yet the fundamental truth remains that the manner in which an organization is perceived–its public relations–has an overriding role in whether, and in what manner, its words will be heard and believed.

Typically, financial communicators deal with two kinds of audiences: peers, as represented by the several professional groups at this symposium, and "the rest of the world"—the underinformed and somewhat apathetic public. Each of these audiences has characteristics which make the job of reaching them easy in some respects and difficult in others.

Problem Identification Within Corporations

To the outside world the four professional societies sponsoring this symposium may seem like one homogeneous professional group, with some areas of specialized interest, of course, but with basically the same perception of problems and priorities as they relate to improving corporate financial reporting. Outsiders cannot fully appreciate the extent to which there are honest differences of opinion among those participating in this discussion—either as to the precise nature of the problem involved in improving corporate financial reporting or the remedies which are available. This phenomenon is not unusual.

Honest differences of opinion as to problem identification are also found among staff specialists working for large business corporations. To the outside world a business corporation may look like a monolithic structure. The outsider may assume that there is general agreement in the ranks of management as to long range corporate objectives and the most profitable means of achieving them. In point of fact, however, any one of us who has worked for a large business firm knows how revealing it is to call a meeting of the heads of various staffs and operating departments and ask each department head to list the five most serious problems facing his company at the present time and five possible solutions to these problems. It is rare indeed to find any general agreement on the problems themselves or the priorities which management should assign to them. If each department head is asked to predict which major problems will materialize in the next five years, the areas of disagreement are likely to be even greater.

It is fairly predictable that some department heads will stress people problems—the nature of the changing labor market, probable new wage and fringe benefit demands by unions, or the need for more flexible criteria for executive development. Others on the management team will talk about production problems–the cost and availability of raw materials, the likely impact of competition from existing or from new companies, and possible changes in the market itself which might increase or decrease demand for a

product. Still other top management people may very well stress money matters—they would be preoccupied with the cost of money and its availability today as compared with two or three years from now, the impact of changing tax laws, the pros and cons of one or another method of depreciating property, and even the nature of the international monetary market and its implications on the value of the corporate dollar five years from today.

If this picture is fairly typical of a large corporation (and I am persuaded that it is), then even within the ranks of top management of a single company in a single industry, one finds deep and significant differences of opinion with respect to the state of health of the corporation at any given time and its prospects for growth. Presumably, our private business corporations operate in the belief that top management has the ability to listen to the frequently conflicting inputs of data from its staff specialists, and by some elusive and still mysterious process, sort out and evaluate what is sound and what is extraneous and make correct decisions for the future.

Reporting Financial Performance: Censorship

Given the difficulties which management in a single firm has in securing a sound reading on the state of its corporate financial health, how can the financial analysts and the outside experts in financial affairs be expected to make a realistic diagnosis of a company's financial well-being? Not having access to the mass of staff data and studies which go into recent investment decisions, they must necessarily study past performance records and extrapolate from them some guess as to the soundness of the latest numbers which purport to reflect present financial performance. The certified public accountant is in a slightly different position. He may be privy to the inner counsels of a company and in time he may come to know something about the idiosyncrasies which characterize the managers making investment decisions. But even the CPA must basically rely on standard accounting procedures to evaluate the numbers which are presented to him by management in reporting on its stewardship. I suggest that the successful CPAs have learned over the years to add an educated correction factor based on their familiarity with the top management of a particular company reporting on its financial status.

If these assumptions on my part are in some measure correct, then I believe that our discussion of the problems in ethical financial reporting goes beyond whether accounting procedure X or Y is a better tool for evaluating corporate financial health. I think we are really talking about the need for the business and financial communities to be more forthright in acknowledging the limitations built into the financial data which they report to their publics.

Note has already been made of the honest, but often contradictory, opinions to be found in any business corporation as to how it can best direct its

financial resources and energies. Not only do experts within a single company differ as to "the facts" with respect to corporate financial planning, but another very human phenomenon enters the picture to still further muddy the decision-making picture. Subordinates have an annoying habit of withholding or delaying bad news which they fear might reflect discredit on their job performance. Lower echelon managers want to look good, and given the option, they may prefer to accentuate the positive rather than the negative in the reports they send to top management.

There is a word to describe this very human and understandable trait: it is called censorship. I do not recall that it was ever mentioned in all of the discussion which this group had three years ago on improving corporate financial reporting. As far as I know, there is no systematic method by which top management can ever know how much bad news is being kept from it by affiliated companies operating in other geographic areas or even by departments domiciled within headquarters itself.

Bad news, whether it be financial, political, or marketing, is unpleasant, especially when it translates itself into lower profits and higher costs. It would be intriguing, indeed, to know when the automotive, petroleum, chemical, paper, and soap and detergent industries' top management first heard the "bad news" about a rising tide of public concern over the quality of our air and water. How well was this reported to them; to what extent did they correctly foresee the eventual costs to them of this nationwide movement? We shall probably never know the answers to such questions, but this very lack of data makes one uneasy that other equally significant clouds on the social horizon are not now being called to their attention before they become the occasion of a major dollars-and-cents cost.

The word censorship is so fraught with ominous connotations that it is understandable it is normally avoided in any discussion of improving corporate financial reporting. But is this a realistic view? I think not.

On the national and international level, governments find they must impose certain limits on the kind of information they give out. From time to time they may come under criticism for being too rigid in assigning high security classifications to information that does not deserve it; witness the recent confrontation between *The New York Times, The Washington Post,* and the United States Government.

Obviously all institutions in our society have a right and obligation to preserve their existence and ability to grow—whether they be business corporations, churches, political parties, or universities. No reasonable person would argue that these groups have to reveal all the "bad news" which they are privy to and which might affect their ability to survive. By the same token, most of us would recognize that in the name of preserving institutional integrity, there are great opportunities in the corporate world to cover up blunders in judgment, bad management of capital, and wasteful uses of plant facilities and human resources.

A central ethical problem which faces us in our discussion today focuses

on this issue. What are the criteria which an honest, intelligent, and generally competent management can employ in knowing when, or whether, to tell the financial community and the public at large about adverse developments which probably will affect its earnings and competitive position?

Increasing Creditability of Management

There is, of course, the other side of this coin—when and in what detail does management have an obligation to reveal good news which it sees developing and which will influence the selling price of its stock? Court battles have been waged on this tricky subject. In some measure, each piece of corporate "good news" is probably unique enough that management can truly wonder whether previous SEC and court guidelines offer any meaningful guidance.

With the benign benefit of hindsight, we can wonder today whether management of some of our largest firms gave the investing public sufficient early warning when they saw signs of certain investments going sour during the 1950s. Manufacturers of color television sets appear to have been overly optimistic in their projections of public demand for their product. So too were many petroleum companies in the sixties who decided to move into the petrochemical field, especially into the manufacture of fertilizers. And it took a long time for the automotive industry to accept the fact that buying patterns were changing among American consumers and that a market was emerging for the smaller cars being produced in Europe and Japan. On the other hand, during the past two years of economic recession, many companies in the steel, airlines, petroleum, and automotive industries—to cite only a few examples—have made candid and straight-forward announcements about the problems facing them in trying to improve their profit picture.

The dilemma of when and how to announce good or bad news has some interesting parallels in the field of social psychology where studies have been carried out as to the impact on people's attitudes by presenting only one side of an issue or telling both sides. While not trying to summarize the somewhat mixed findings from these experiments, they do seem to suggest it would be useful to determine whether the financial community and the public at large react negatively or positively to being given bad news in advance of the time when either the law or circumstances require that it be revealed. Are there possibly rewards in terms of increased creditability to be earned by the business firm which gives out bad news as well as good about itself, in advance of requirements of its charter or SEC regulations? Perhaps my point can best be summarized by suggesting that the objective of good financial reporting ought to be to minimize the surprise factor—whether happy or sad—in the data which are presented to the public.

To summarize, then, I suggest that censorship of relevant financial and related data takes place within the ranks of lower management before these

data are ever forwarded to top management and that, in turn, top management must make some very difficult decisions about when or whether to release data which might reflect well or adversely on its operations. I am not for a moment suggesting that these actions are malevolent or consciously deceitful, but rather that they are the logical outgrowth of an ethos which places great store on success and personal achievement.

Evaluation of Intangible Data

Earlier in this paper I referred to the apparent failure of the early-warning network in certain industries in spotting the movements associated with consumerism, concern over the environment, and the growth interest in the social implications of corporate investments. It is equally important to underscore a related topic. There is a crying need for management to devise better methods for evaluating the intangible data which it receives from its public relations, government relations, and consumer affairs departments—just to cite three examples—and thereby to ascertain the degree to which these departments and their outside consultants are providing the kind of pertinent data which will allow management to spot problems on the horizon and to defuse them before they are translated into dollars-and-cents costs to the corporation. These periodic audits of the reporting of such staff departments are every bit as necessary as audits of balance sheets and annual reports by an outside certified public accounting firm.

One cannot leave a discussion of the general problems of providing better financial reporting by all business corporations without recognizing that there is a special kind of headache in trying to evaluate the financial reports of our very large corporations. Large companies are characterized by a continual movement of personnel into and out of the top ranks of management. The world outside of these large corporations probably assumes that new members of the management team are indoctrinated in some formal or informal manner as to the ground rules by which the company makes disclosures regarding its financial health. There are reasons to question whether such a passing along of a corporate philosophy does in fact take place. If it does not, then the possibility exists that subtle changes in evaluating criteria of financial performance can creep into a company as new managers modify and change the ground rules under which their predecessors operated.

In addition, in any discussion of how corporate financial reporting may be improved, it is essential to recognize that corporate reporting is not limited to the annual reports, quarterly earnings statements, and briefings held for security analysts. A corporation, like an individual, reveals itself in many ways and in a variety of contexts which have nothing to do with the formal financial statements it issues. A facet of corporate financial reporting which deserves greater attention (because it usually goes unrecognized) is the usefulness of a formal content analysis of what the corporation is saying about

itself in publications put out for its employees and shareholders, the content of its marketing advertisements, and the speeches by its executives before non-financial audiences. Such a study may sometimes produce a picture considerably at variance with the company's rather rigid and stuffy financial statements.

What does all this add up to—this puzzling business of trying to communicate more accurate corporate financial information in a world where, ironically enough, the communications processes which we rely upon are full of paradoxes? For example, we have hardware today which permits us to send messages faster and to store more information than we ever dreamed possible a few years ago. Logically, one might expect these machines would insure that management have a clearer current picture of its financial health and thus be in a better position to report on it. But there is little evidence to support such an assumption. Data piled on top of still more data do not necessarily insure better financial reporting.

I do not suggest that corporations should ever stop trying to produce better balance sheets, better measures of discounted cash flow, and the host of other technical matters which provide some measure of management's performance. I am suggesting, however, that there is much to be said for publicly acknowledging the limitation which the business community faces in trying to portray its present and future corporate financial health. Those who have a primary concern with finding better ways of improving the quality of financial reporting might be pleasantly surprised to discover that their professional colleagues and the investing public at large would be disarmed by an admission of these limitations. These publics might be quite prepared to accept such an admission as a sign of professional maturity. In our own lives, each of us learns to live with a decent amount of uncertainty and ambiguity. In fact, psychologists speak about the ability to tolerate ambiguity as one of the hallmarks of the mature man. In the very commendable efforts by this symposium to develop criteria for better financial reporting, I suggest that we all accept the human and bureaucratic limits which will probably always frustrate our efforts to make perfect our financial reporting.

Conclusion

Business corporations are more than a summation of the numbers on the bottom line of a financial report. The average management knows this, and for that reason, seeks to project itself to various audiences as an enlightened employer, a producer of high quality products, and a concerned citizen of the communities where it operates. The financial reports which primarily concern this symposium are but one part of the mosaic by which a corporation is judged by its publics. They are an important part of that picture, and I applaud efforts toward improving them. But, at the same time, I am mindful that shareholders, customers, dealers, and the general public will pass final

judgment on the corporation in terms of a complex mix of impressions, of which financial reports will be but one part. If this sounds like a call for corporations to give more time and attention to their public relations—of which financial reporting is a vital element—that is exactly what is intended.

Ethical Problems From the Viewpoints of the Auditor, Analyst, Financial Executive, And Banker

Ethical Problems Of the Auditor in Financial Reporting

By Wallace E. Olson, *Executive Partner, Alexander Grant & Company; Chairman of the Executive Committee of the Professional Ethics Division of the American Institute of Certified Public Accountants, representing the American Institute of Certified Public Accountants*

Since the subject of ethics deals essentially with human relationships in society, it should not be surprising that it involves some rather complex concepts and considerations. The ethical problems of the auditor in financial reporting are no less complex simply because they involve only one small area of human endeavor. To the contrary, because of the auditor's unique role as an attestor, a review of the ethical conduct required of him demands an examination of a great number of areas of potential conflict. Each of these areas is a major subject which would warrant individual papers to cover them in depth. However, for the sake of brevity, this paper will be restricted in scope to presenting merely a broad overview of the ethical problems encountered by auditors in carrying out their responsibilities in expressing their professional opinions on financial reports.

The Role of the Auditor

Fundamental to an understanding of the ethical responsibilities of the independent auditor is an awareness of the evolution of his position and role in society. The auditor's initial function had its origin in times when business entities were relatively small, and the owners and management were one and the same small group of persons. An auditor was sent by the owners to check on the managers of branches at remote locations. The auditor was an employee, functioning as an internal auditor, responsible solely to the owners.

As business entities grew in size and public ownership involving large

numbers of shareholders evolved, the present role of the independent auditor became a necessity. Management was no longer a small group of owners but had become an almost self-perpetuating group responsible to a large number of remote shareholders whose ability to look after their collective interests had been greatly diminished by the diffusion of ownership. To provide a measure of protection to the shareholders, it became imperative to employ auditors as independent contractors to provide assurance that management's financial reporting was fair and reliable.

With the advent of governmental regulatory agencies and the growth in the financial stake of credit grantors in huge impersonal business entities, the need for independent auditors became even more pronounced. The birth of the Securities and Exchange Commission was an especially important event in this evolutionary process.

Today, the wide recognition that the public accounting profession is vital to the trust and confidence on which the free enterprise system is based has thrust the auditor into the harsh glare of the spotlight. Even though in theory he is hired by the shareholders, in practicality he is hired by management which pays him a fee for his services. He is no longer an employee, but functions as an independent contractor serving many clients. He is expected to act as a quasi public servant to provide assurance to all those who may rely on management's financial reports that the facts have been fairly reflected and that such reports may be relied upon. His responsibilities extend to an audience with which he has little, if any, contact except through a written opinion consisting of two or three short paragraphs. In this type of environment the potential for conflicts of interest and the demands for high ethical behavior are enormous. It is also understandable that this position of high public trust has generated a mounting volume of publicity and public concern about whether the profession is satisfactorily meeting its responsibilities.

Ethical Responsibilities

Broadly stated, the independent auditor today is expected to meet the following ethical responsibilities:

1. He must be independent of his client (including both hired management and shareholders) and be objective and honest.
2. He has an obligation to perform audits with competence and due care and to insist on the application of those accounting and reporting treatments which will best achieve the goal of fair reporting.
3. He has a responsibility to be fair with his client but must recognize that where there is a conflict his obligations to the public are overriding.
4. He has a general responsibility to help his profession meet the needs of the public in the best possible manner.

While these ethical requirements may not appear too formidable when stated in such broad terms, they involve a whole host of difficult issues and problems in their application to everyday practice. The nature and scope of these considerations are discussed in the succeeding paragraphs.

Independence, Integrity, and Objectivity

Because the concept of independence is basic to the role of the auditor, it is the subject of a great deal of comment and controversy in the literature both within and without the profession. Not all of this literature is entirely clear about what is meant by the word *independence* in the context of the auditor's function.

Independence is intended to mean an absence of relationships with a client which, if they existed, would, in the eyes of a reasonable man having knowledge of the facts, be likely to impair the auditor's ability to attest to the client's financial statements with integrity and objectivity. When viewed in this manner, it becomes clear that independence is not an all-or-nothing matter, as is often asserted either directly or by implication, but is a matter of degree of involvement with a client. It is obviously impossible to serve any client in the capacity of an independent auditor without at least coming in contact with the client's management and employees and, in many cases, some of its shareholders.

Within this context it seems obvious that any relationship poses a potential impairment of integrity and objectivity. However, there are many countervailing pressures which, under normal circumstances, can be relied upon with a high degree of confidence to insure that an auditor will retain his integrity and objectivity. Examples of these strong pressures are the possible loss of reputation, the threat of censure or suspension by a regulatory body, the loss of license to practice, and not by any means least, the threat of litigation. In addition, most professional persons have, ingrained as part of their training and experience, an inherent honesty.

In weighing whether the pressures of too close association and identification with a client have tipped the scales too far, a reasonable man must evaluate the degree of the threats to integrity and objectivity in relation to the countervailing pressures. This is obviously a difficult task, and where the public interest is at stake any extensive doubts must necessarily be resolved against the presumption of adequate independence.

Possible Impairments of Independence

What are some of the relationships which might raise significant doubts in the mind of a reasonable man? Perhaps the most obvious is that of having a financial interest in a client's business or being otherwise involved in a joint

closely held business venture with a client. This type of involvement has been regarded for many years by the profession's code of ethics as being improper when expressing an opinion on the client's financial statements, and there is every indication that there is almost universal compliance with the rule.

A second type of conflict stems from a relationship which is equivalent to that of being an officer, director, or employee of a client or similar types of involvement, such as acting as a promoter or trustee. These have also been regarded for many years as being fatal to the auditor's independence, and it is a well-settled issue. However, there continue to be questions raised about the propriety of an auditor preparing financial records for a client on whose financial statements he also expresses an opinion. While this practice can be logically defended if kept within certain restraints, the entire matter is not of sufficient importance to cover in detail for purposes of this symposium.

A third type of conflict would exist if the auditor had a fee arrangement which was contingent upon the results attained. This also has been prohibited for many years in relation to the attest function as well as other types of services except those involving tax matters. Although members of the profession may differ in their views regarding contingent fees in connection with other services, there seems to be no question that such fee arrangements should be prohibited in connection with the expression of opinions on financial statements.

Another frequently expressed concern is whether the auditor can be independent of the management which engages his services. For this reason great care is taken to have the shareholders elect the auditors; special audit committees composed of outside members of the board of directors are being increasingly appointed to maintain separate liaison with the auditors. Even with these precautions, however, management usually has, in practice, a substantial influence on the selection of auditors. The only apparent alternative to the present methods of appointing auditors would be some form of governmental intervention. Many knowledgeable persons both within and without the profession are strongly opposed to this alternative on the grounds that it would lead to a complete takeover of the auditing function by government. It is asserted that bureaucratic inefficiency would be the inevitable result and that the public interest would ultimately be less well served than under the present system. If there are indeed no practicable alternatives, comfort may still be drawn from the fact that the countervailing pressures previously cited play an important role in maintaining the independence of auditors.

Closely related to the problem of engagement of auditors by management is the fact that auditors are paid for their services by the same entity which they are engaged to audit. It is often asserted that this arrangement poses a serious conflict with the reliability of auditors. However, a fee is a normal form of reimbursement of any independent contractor, and any conflict is greatly reduced by the fact that the auditor serves and is paid by many clients. There is a substantial safeguard in the fact that the auditor is

an outsider and is not a salaried employee. Nevertheless, it would seem likely that the threat to an auditor's integrity or objectivity increases with the size of a fee from a single client. This is particularly true where a fee becomes a relatively large proportion of an auditor's total practice. Even so, the auditor continues to feel the strong weight of offsetting pressures; there is little evidence that the present fee arrangement does, in fact, cause him to subordinate his judgment to that of the client.

Various reimbursement alternatives have been occasionally suggested. Some advocate employment of auditors by the government with some form of assessment system. A few have posed the possibility of payment of fees out of a trust fund supported by assessments of entities being audited. All of such alternatives have serious disadvantages, and on a comparative basis the present private competitive system would appear to offer a greater potential for achieving the best audits at the least cost.

The most recent and frequently raised question about an auditor's independence pertains to the effect on his integrity and objectivity of performing management consulting services for his audit clients or acting as an advocate in areas such as taxation. This question is usually directed primarily at those situations where the type of service is not directly related to the client's accounting system. Examples of the many types of services which seem to cause greatest concern are executive recruiting activities and assistance to clients in searches for business acquisitions.

Those who feel that such services impair an auditor's independence assert that it leads to an involvement in the client's affairs to such an extent that the auditor has a vested interest in defending the client's business decision. If business decisions based upon his advice proved to be disadvantageous, it is feared that the auditor would be likely to cover up the poor results in his report on the client's financial statements, thus losing his integrity and objectivity.

Despite the existence of this danger there is little evidence that in practice it prevails over the offsetting pressures previously cited. Perhaps this results from the fact that in the last analysis the client rarely, if ever, allows others to make his decisions for him. Also the auditor's opinions on financial statements do not relate to the quality of management but rather to the fairness of presentation of financial position and operating results. It is difficult to demonstrate how the auditor can cover up bad business decisions simply through application of accounting or reporting techniques. To achieve this by altering the underlying transactions and accounting records would require outright fraud as well as collusion by the client. The penalties for fraud are so extreme as to render any such action highly unlikely.

The auditor renders advice and has an influence on his client's decisions in all areas of service including auditing and taxation. Accordingly, the danger that he will gloss over the results of poor advice also stems from his influence on financial reporting and tax matters, as well as from consulting on management problems. It is difficult to distinguish between these various

types of services as to which constitutes a greater or intolerable threat to independence. To say that any or all of them impair an auditor's independence is to deprive the public of the availability of valuable and expert services. If the auditor is truly acting in the capacity of an outside contractor, the potential conflict of interest which flows from providing advice on accounting, tax, or other business matters does not seem sufficient to warrant confining him solely to the expression of opinions on financial statements.

To summarize, auditors cannot, in their daily activities, avoid the normal relationships with clients or the pressures which arise from such relationships. These would exist even if the auditors were governmental employees rather than private practitioners. Countervailing pressures are of such strength that in most cases they provide ample guarantee that auditors will remain objective and resist any temptation to act dishonestly. Auditors must, however, avoid undue identification with management or involvement in their client's affairs to an extent that would impair the credibility of their independence in the minds of reasonable men.

Competence and Technical Standards

In addition to being independent, honest, and objective, an auditor has an equally important responsibility to be competent, to exercise due care in his work, and to adhere to those technical standards which will result in financial statements that are not misleading. The reliance of users of financial statements on the auditor's work places a heavy burden on him to do everything that a reasonable man would do to assure himself that financial statements are reliable. Even though this does not mean that the auditor must be infallible, it is nevertheless a very difficult order to fill within the context of today's complex business transactions.

Gaining and maintaining competence involves continuing study, research, and consultation with others throughout the auditor's professional career. Not only must he be knowledgeable about all of the auditing procedures and techniques which may be applied, but he must also be familiar with the accounting and reporting standards which are appropriate. He must have an understanding of the peculiarities of the client's business and form judgments as to what a user of financial statements needs to know. It is of utmost importance that the auditor maintain a questioning, "show me" attitude, and that he base his opinion on the exercise of common sense rather than solely on the application of mechanical procedures.

Perhaps the greatest danger, that auditors will fail to exercise competence and due care, arises from the natural inclination to regard continuing study as unnecessary and the temptation to cut corners because of the fee resistance of clients. Also involved are the problems of recruiting, training, and retaining an adequate professional staff. Although all of these are continuing problems for the auditing profession, they have not resulted in any

serious public concern about the profession's competence.

The focal point of most public dissatisfaction with the performance of auditors centers on two main areas. The first of these is the failure of generally accepted auditing procedures to uncover major deficiencies in the client's accounting. A considerable number of liability suits are based on the assertion that the auditor should have discovered a material overstatement of earnings. This raises a whole series of questions which are not easily answered:

1. Did the auditor fail to exercise due care?
2. Are generally accepted auditing procedures adequate?
3. Is the public demanding a higher degree of assurance than it is economically feasible to provide?
4. Did the auditor simply rely too heavily on mechanical tests and fail to apply common sense?
5. Are the liability suits more a result of avaricious plaintiffs than of public dissatisfaction with auditors?

It may be that all of these elements are involved in the suits. In any event it is apparent that the auditing profession needs to give far more attention to the problem of how to achieve more effective audits within the economic limitations with which it is faced. A thoughtful review of the effectiveness of present auditing procedures is imperative if audits are to continue to be regarded as a satisfactory means of gaining assurance about the reliability of financial statements.

Accounting and Reporting Principles

The second area of public criticism of the profession relates to the deficiencies in accounting and reporting principles. The existence of alternative principles and their abuse by both management and auditors has given rise to a flood of critical articles and speeches pointing out that widely varying results are obtained depending upon which principle is applied. The demand for the elimination of alternatives and the establishment of principles in problem areas not yet covered by pronouncements has reached such a crescendo that the profession has appointed two study groups to determine what might be done to meet these demands.

The first of these study groups has been charged with the responsibility of determining the objectives of financial statements. While it is obvious that the broad objective of financial statements is to communicate financial and operating data which will meet the needs of the user and will not be misleading, it is not a simple task to determine how this can be best achieved.

At the present time the same form of financial statements is used for

communicating with all segments of the public. Report letters, footnotes, supplemental schedules and captions, and details on the face of the financial statements are all employed to achieve fair and adequate disclosure. However, the degree of sophistication and the needs of users vary so widely that it seems inevitable that multiple types of financial statements must be designed to meet the specific needs of each user group.

In approaching this problem consideration will have to be given to the fact that too much information may have the effect of confusing rather than clarifying. Emphasis must also be placed on the quality of the information being communicated and what a reader needs to know to make an informed judgment, since reporting of different types of information may be critical to evaluation of a company. Examples of such information might be forecasts and projections, evaluation of control systems, and data regarding research and development programs, labor relations, marketing programs, and adequacy of plant and facilities.

Reporting on these matters will raise questions as to whether the auditor's attest function should be broadened to cover the reliability of such information. Judging from the present problems which the auditor encounters in the conventional financial statement area, it may be a long time before this can be achieved. Nevertheless, it would seem logical for the auditor to assume the responsibility for attesting to the fairness of the reporting of any factual data regardless of its nature, so long as it lends itself to independent and objective verification.

A second study group has been charged with a review of how and by whom accounting and reporting principles should be established. While the mechanics of establishing principles is not critical to the auditor's function, the nature of the principles and the manner in which he applies them are of great significance. For purposes of discussion of this aspect of the auditor's responsibilities it might be more accurate to refer to such principles as financial accounting and reporting standards.

The present short-form report of the auditor contains the wording, "fairly presents . . . in accordance with generally accepted accounting principles." Thus the report does not indicate whether in the opinion of the auditor the best accounting standard was applied in those areas where there are acceptable alternative standards. It is largely because there are alternative standards available and because the auditor does not always take a stand on what is the right standard under the circumstances that the profession is under heavy attack.

The auditor must accept the responsibility of seeing that the proper standards are applied. Where there are alternative choices, the proper standards are those which, in the auditor's judgment, will result in fair reporting. Even if there were no alternatives among the profession's approved standards, the auditor should ask the question whether application of the standards will result in fair reporting. No matter how extensive and how refined the accounting and reporting standards of the profession may become, they will never

be wholly appropriate under all circumstances. However, if the auditor finds it necessary to depart from such standards he should be required to clearly demonstrate that due to unusual circumstances their application would result in misleading financial statements.

The auditor has an obligation to express his professional opinion that the client's financial statements are fairly presented and are not misleading. This implies that the accounting and reporting are proper even though they may not conform to the profession's standards. However, departures from such standards and the effects thereof should be disclosed so the reader can judge for himself whether such departure is justified by unusual circumstances.

In summary, the auditor is beset by many problems in the area of technical standards. Practical economic limitations prevent him from auditing in sufficient detail to discover every defalcation or impropriety. In addition, the accounting and reporting standards have not been sufficiently developed to provide him with guidance in dealing with new and complex forms of transactions which are subject to abuse. At the same time, he has become the prime target for liability suits by all who have suffered losses either as a result of their own poor judgment or by the misdeeds of management. In the face of these difficulties, the profession is striving to find ways to meet those criticisms which are legitimate and to better meet the needs of the public. It is a formidable challenge.

Responsibilities to Clients

Private business entities have a fundamental right to retain the privacy of their affairs within the ranks of their owners and managers. For this reason the independent auditor has an obligation to treat his knowledge of his client's affairs as confidential. However, where this conflicts with his obligations to the public, he is faced with either persuading his client to permit full disclosure or resigning from the engagement. Under no circumstances should the auditor allow confidentiality to take precedence over his responsibility to see that the client's financial statements are fair and not misleading.

The auditor also encounters conflicts with confidentiality in connection with litigation and in response to inquiries by duly constituted disciplinary bodies either of the profession or under state statutes. The overriding public interest involved in such cases requires that he comply with any validly issued subpoena or reply to any inquiry of a disciplinary body. The client's right to confidentiality must not be allowed to thwart either legal justice or the disciplinary machinery which supports the integrity of the auditing profession.

In spite of these overriding obligations to the public, the auditor must exercise caution to avoid disclosing more confidential information than is necessary to meet his responsibilities. In all cases he should inform his client before making any required disclosures.

In addition to confidentiality, the auditor must be candid with his client and be concerned with the client's best interests. He must never hide his true opinion for the sake of pleasing his client. Neither should he exploit his relations with his client for his own personal advantage. For example, he should not accept a commission or fee simply for the referral of goods or services of others to a client.

In general, auditors have an obligation to be completely fair both with their clients and in meeting their responsibilities to the public. Where conflicts exist, the public interest must take precedence. Meeting this dual responsibility to clients and the public requires a high degree of ethical conduct on the part of the auditor.]

General Responsibility to Meet Public Needs

[The needs of the public for confidence in the reliability of financial reporting require that there be a strong public accounting profession. To create strength within any profession it is necessary to maintain harmony among its members. Accordingly, the accounting profession has adopted a number of behavioral rules which are designed to avoid the types of internal strife which would tend to destroy its ability to serve the public.

Principal among these are rules prohibiting encroachment by one auditor upon the practice of another and soliciting or advertising for professional engagements. While auditors may respond to any requests for services, it is often extremely difficult to distinguish between a solicitation and a legitimate request.

Closely related to these rules are the problems which stem from competitive bidding for engagements and from clients shopping among auditors to find one who agrees with his views as to the proper accounting or reporting standard to apply. All of these practices enhance the danger that the auditor who succumbs to them will be tempted to cut corners or will be beholden to the client at the expense of meeting his responsibilities to the public.

Because these self-imposed rules of conduct contain the conflicting elements of restraint of competition and protection of the public they are very difficult to interpret and apply without tipping the scales too far in the direction of self-interest. Nevertheless, the profession must continue to police its members in these areas to avoid losing its independence and to avoid being torn by dissension. To permit this to happen would be to render its services useless to the public.

Members of the public accounting profession also have a responsibility to contribute their time and knowledge to advancing the state of the art of accounting and auditing. This requires being more than an outspoken critic of the failings of the profession. It involves a duty to make constructive suggestions for improvement so that the public can be assured that it is being served in the best possible manner.

If the auditor does not concern himself with the support of his profession and its knowledge he will not be helping it to meet the needs of the public. If his primary motivation is that of profit rather than service, the fundamental reason for his role will have been impaired.

Disciplinary Problems

Education and voluntary compliance with the ethical standards of the accounting profession are generally far more desirable than enforcement. However, disciplinary proceedings will always be necessary to police those who fail to meet the profession's ethical requirements and to provide impetus for voluntary observance of the rules. A comprehensive code of ethics and effective machinery to vigorously enforce it is the public's assurance that the profession will in fact be self-regulating and will maintain its reliability.

Unfortunately, under present circumstances, there are numerous defects in the enforcement machinery. The problems begin with the multiplicity of jurisdictions which results in confusion as to which will take the lead in disciplinary action. At the present time the CPA is subject to discipline by state boards of accountancy, state societies, the American Institute of Certified Public Accountants, and in some instances, by governmental agencies. The statistics indicate that the number of cases handled by each of the disciplinary bodies of these organizations is very low in relation to the total number of practicing CPAs. In addition, a majority of cases deal with violations of behavioral rules and very few involve failure to comply with the technical standards of the profession.

It is probably safe to conclude that with few exceptions, the state boards of accountancy and state societies are ill-equipped to carry out disciplinary action and are largely ineffective, particularly in the area of technical standards. This leaves the job primarily in the hands of the AICPA, which also has significant problems with enforcement.

In the enforcement of technical standards, which is of primary importance to the public, three main problems are encountered by the AICPA's division of professional ethics and Trial Board. The first consists of the natural reluctance of both practitioners and persons outside the profession to file a complaint when a violation is encountered. Even the Institute's practice review committee, which is specifically barred from instigating any disciplinary action, has a dearth of questionable financial reports referred for its review. While one might conclude from this that there are relatively few failures to observe technical standards, this seems highly unlikely.

A large majority of the cases involving possible violations of technical standards comes to the attention of the Institute's ethics division as a result of newspaper publicity regarding lawsuits against CPAs. These tend to involve publicly held companies where the plaintiff typically claims damages of large amounts. Because such cases are newsworthy they catch the attention of the

public and shake confidence in the reliability of the profession to the very core.

In coping with these cases the ethics division encounters a second major problem of enforcement. Where litigation is pending against the auditor, he is understandably reluctant to disclose any information to the ethics division since it is not privileged, and the information might well be subpoenaed and used to his detriment. Because the ethics division does not have subpoena powers, it has little choice but to defer its investigation until the litigation has run its initial course. To discipline a member for failing to disclose all the necessary information prior to the completion of litigation would not seem to be a satisfactory alternative. In most instances the litigation extends over a long period of time, and by the time disciplinary action can be taken the public has long since concluded that the profession is not interested in policing its members.

A third hurdle is encountered when the ethics division is finally able to proceed. Since it presently has a staff of only three full-time employees, exclusive of clerical and secretarial help, it must rely very heavily on members to voluntarily devote part-time to investigation, prosecution, and sitting on trial boards. Although members involved in the disciplinary process are generally well versed in the technical pronouncements of the profession, they are normally inexperienced in investigation and prosecution procedures and have a tendency to let sympathy for a fellow colleague take precedence over public interest.

Self-discipline by any profession is extremely difficult and is not entirely satisfactory in most cases. This is also true of the public accounting profession at the present time. However, strenuous efforts are currently being made to improve the Institute's disciplinary machinery to meet the increasing demands for better regulation of its members. A first step in this direction is a complete restatement of the Code of Ethics which more clearly specifies those technical standards which will be enforced. It is anticipated that the new code will be voted on by the members late in 1972.

In addition to a restated code, great emphasis is being placed on making continuing education a requirement for maintaining a license to practice. Also, new ways of achieving effective surveillance and enforcement are being studied both by the state and the Institute. These steps indicate that the profession is mindful of its responsibilities and is taking action to see that it continues to merit public confidence.

Summary

The role of the independent auditor today imposes a heavy burden of ethical responsibility. First and foremost he must be independent of his clients and be honest and objective in his work, both in fact and in appearance, in the eyes of reasonable men. At the same time he must be fair with his clients

and be concerned about their best interests. Meeting this dual responsibility to both clients and the public requires both strong character and an acute awareness of ethical concepts. Where there is a conflict between the two interests the needs of the public must come first, and in such circumstances, the auditor must be prepared to resign from an engagement rather than subordinate his position to that of the client. While there are many pressures which might cause the impairment of an auditor's integrity and objectivity, there are also very strong countervailing pressures which in most instances are sufficient in strength to eliminate the need for concern.

In addition to the need to be independent, the auditor is confronted with the need to be aware of and understand the technical standards of his profession. These are nonexistent in some areas, ill-defined in others, and in some instances are so complex as to defy application without extensive study. Besides being faced with these uncertainties, he must carry out his work in an environment that bristles with exposure to lawsuits which are frequently based more on the fact that he is covered by indemnity insurance than on any malpractice on his part.

With increasing frequency the courts are making it clear that auditors cannot escape the responsibility of seeing that financial reporting is fair and not misleading. This imposes the need for the auditor to make judgments about whether the profession's accounting and reporting standards are appropriate in all cases, or whether unusual circumstances and the test of fair reporting require a departure from such standards. In short, he is expected to exercise good judgment, and if he fails to do so, he is faced with an overwhelming exposure to financial liability.

Less visible but also important are the auditor's responsibilities to support his profession by observing the rules of behavior and applying the golden rule in his relations with his fellow practitioners. He is also expected to make his contribution to the knowledge of accounting and auditing through active participation in the profession's organizations.

In view of the foregoing ethical responsibilities and the many problems encountered in meeting them, it would be reasonable to assume that the performance of the profession is less than perfect. Although the number of disciplinary actions are relatively small, this fact is more likely the result of the difficulties inherent in self-regulation than an indication of perfection.

Despite any shortcomings of the profession in its present form, the alternative means of meeting the public need for the attest function appear to have even greater flaws. Under these circumstances the goal should be to continue, through education and discipline, to tighten up the ethical restraints of the auditing profession and to eliminate those practices which run counter to the objectives of fair financial reporting.

There is reason to be optimistic about the future since the American Institute and others are continuously studying the problem areas and seeking better solutions. Examples of these efforts are the two special study groups on financial statement objectives and accounting principles, a proposed re-

statement of the Code of Ethics, and reviews by ad hoc committees as well as the ethics division of how the disciplinary machinery can be made more effective.

When viewed in the light of its unique role and the many conflicting pressures in today's environment, the public accounting profession has displayed a surprisingly high level of ethical conduct. Auditors have reason to be proud of their past record, but they must continue to improve their technical and ethical standards if they are to successfully meet the ever increasing demands of the public for higher standards of performance. There are many reasons to believe that auditors will be equal to the challenge.

Ethical Issues for the Financial Analyst

By C. Reed Parker, *Duff, Anderson & Clark, Inc.; past President, Financial Analysts Federation, representing the Financial Analysts Federation*

The first portion of this paper presents a brief review of the function of the financial analyst. Although probably all of those attending the symposium are familiar with what analysts do, it seems important in this background discussion to recall these fundamentals so that they can be kept in mind as specific ethical issues are outlined. The following analysis of ethical issues is dealt with under four broad topical headings: (1) inside information; (2) communication with clients, customers, and employers; (3) buying and selling of securities; and (4) communications with corporations. The final section of the paper comments on the enforcement and educational aspects of promoting adherence to ethical standards.

What Constitutes Professional Financial Analytical Performance?

Perspective—What is the function of the financial analyst? At root, the financial analyst is involved in the economic process of apportioning capital. In politically democratic and economically free-market oriented societies, a very large role in the capital apportionment process rests with individuals and nongovernmental institutions. The theory, in simplistic form, is that the enlightened self-interest of individuals and institutions operating within a system of a relatively free flow of information and open markets will achieve optimum efficiency in directing the society's capital resources to their most satisfying use.

Financial analysts operate at a number of levels in the capital apportionment process. Perhaps the most familiar is the securities analyst. Prior to World War II the person performing this function was called a "statistician," but perhaps a more universally recognizable title would be investment research analyst. Research analysts are the men and women engaged in collecting data, and reasoning to specific conclusions about relative investment values. In local societies of the Financial Analysts Federation, those

engaged in the research function are the largest single group of members but account for little, if any, more than half of the total.

A nearly equal-sized group of FAF members[1] are portfolio managers. These are the people making the final capital commitment. Some have a relatively small degree of authority in security selection such as is often the case for managers of individual portfolios in trust companies. Others include the key policy makers and deciders as to securities for trust companies, insurance companies, mutual funds, investment advisers, self-administered pension, charitable or endowment funds, and the like. The professional portfolio manager or final investment-decision-maker type of financial analyst is also found in the brokerage-dealer firms in investment advisory departments and in the underwriting decision-making area.

In summary, the financial analyst works at many levels of the capital apportionment process either as a principal or as an adviser to or agent for principals—with the principals being both individuals and institutions.

Methodology of investment research and portfolio management. In essence, investment research—like any kind of research—involves three basic processes: (1) collecting information; (2) selecting the most relevant information and reasoning to a conclusion; and (3) communicating the conclusion to the decision-maker.

For the portfolio manager, the basic processes are two: (1) determining the purpose of and the appropriate performance and risk-tolerance goals for the funds being invested; and (2) selecting securities which best fit these performance and risk-tolerance goals.

Setting Professional Standards of Behavior For the Analyst

In the first place, the mastery of specific facts and techniques is relatively less important for the financial analyst than it is for many professions. The analyst's basic frame of reference in securities analysis principles is of course a sine qua non, but it carries him less of the distance to appropriate final decisions than is the case for the physician, the engineer, the actuary, or the accountant.

Secondly, the analyst's relevant information base rests in an unusually large number of disciplines beyond financial analysis itself. Economics is key among these disciplines. Because capital apportionment is a primary macroeconomic function and because so much of the relevant data on issuers

[1] For this purpose, supervisors, often including chief financial or investment officials and even chief executives (of such investment institutions as mutual fund management companies, investment counsellors, independent investment research firms, financial publishers and the like) are counted as investment researchers or managers. The remaining small proportion of FAF members include such persons as teachers of financial analytical subjects, individual investors, and government personnel engaged in financial analytical work.

of individual securities is best organized within the discipline of economics, the professional analyst must be more than an amateur economist. Accounting is also crucial. The translation of the economic facts of individual corporate transactions into the language of monetary numbers provides another all-important tool for the analyst. The price paid for investment securities is denominated in money. Further, the final rewards of investment–interest or dividends and capital appreciation (or depreciation)–are also denominated in money. Accordingly, the financial statements of security-issuing corporations (and the principles underlying their construction) prepared for the owners (and their advisers) of these securities must be understood by the analyst.

Given the important role of government in business and the international nature of many securities issuers, the analyst must also have a professional interest in the discipline of political science on both an international and domestic scale. The list continues: because much relevant data is subjective and much comes via oral communication, human psychology is an important discipline to the analyst. And so is scientific technology and so is sociology. Indeed, because the end result of the analyst's work is essentially predictive and because private capital is employed pervasively in industrialized society, the analyst as researcher and portfolio manager approaches the government leader, the philosopher, and the theologian as the ultimate generalist.

Thus, the role of academic standards and formal professional credentials cannot be dominant, since the primary quality of excellence for the financial analyst is his reasoning ability and judgment. However, the professional credential is important in the field of financial analysis as it is in any endeavor with professional attributes (a definable body of knowledge, a high degree of public interest or fiduciary responsibility, and agreed-to standards of conduct).

The Institute of Chartered Financial Analysts was created by the FAF at the turn of the past decade. Since the first CFA designation was awarded in 1963, its importance and impact have increased enormously. The examination and experience requirements are generally regarded (both inside and outside the profession) as at least challenging and at most severe. Only one of the three examinations can be taken in any year, and the subject matter covered includes economics and accounting, as well as financial analysis and ethics. The experience requirement is five years. The grandfather clause provided award of *no* charters without passing at least the last one or two of the examinations. As the average of those taking the examinations has become younger and less experienced, "flunk ratios" have risen (25 to 40 per cent in recent years). Yet the current status (September 1971) of this nine-year-old program is: (1) number of charters granted totaling around 3,000 (of some 13,000 FAF members) and (2) numbers sitting for the examinations at an all-time high.

As suggested earlier, although the role of the CFA program is important and growing in importance, formal testing is a relatively weak tool for meas-

uring the analyst's key qualities of excellence–reasoning ability and judgment. Further, although the grandiloquent description of the place of financial analysis in the capital apportionment process is accurate (and understanding of it a prerequisite for optimum motivation of and performance by the analyst), it serves only as a broad framework within which the specific day-to-day problems of professionally ethical conduct can be examined.

Ethical Problems Faced by the Financial Analyst

Inside information. The sometimes confusing overlap of law and ethics is well illustrated in the doctrine of "inside information." In the earliest days of merchant law, "caveat emptor" was the key measure of legal responsibility, and nearly the entire area of fairness as regards relevant knowledge of buyer and seller was solely in the field of ethics. Today, securities law is embodying another significant area of ethical principle via the inside information doctrine.

The inside information doctrine also illuminates a principle common to the law and to ethics—boundary marking to resolve conflicts of interest. The conflict involved here is the profit motive of the investor and the fiduciary duty of portfolio managers to customers, clients, and employers on the one hand and, on the other, the public interest in fair and open securities markets.

Further, via inside information, financial analysts are learning more about our common law judicial system since the inside information doctrine is taking shape entirely in the judicial sector rather than in the more familiar legislative arena. First, the common law system unfolds new legal rules piece by piece, as judicial decisions are typically related to the facts of the case at hand and do not promulgate standards for deciding issues not directly raised in that case. Second, the inside information doctrine involves an apparent conflict of laws. Fiduciary investment law in the U.S. (largely interpreted by state courts) says the fiduciary investor ought to use every legal means to serve (obtain good investment performance for) his beneficiary or principal. The inside information doctrine, initiated in the U.S. by the Securities and Exchange Commission and interpreted largely by the SEC and in federal courts, seeks to establish the legal boundary of fiduciary responsibility some distance from where many have long believed it to lie.

At present, it would appear that these are the elements of a violation of the doctrine of inside information:

1. The information is of "bombshell" variety; that is, it is such that its dissemination in the investment community would all but assuredly result in a sizable and sudden change in the price of securities to which it relates.
2. The information has not yet been widely disseminated in the investment community.

3. The information is used in buying or selling securities.

Beyond these basic elements come questions of how the information is received (i.e., the relationship of the "tipper" and "tippee") and who is liable, and to what extent, when a breach occurs.

Since the Circuit Court of Appeals decision in the *Texas Gulf Sulphur* case in the summer of 1968, the FAF has published a growing body of literature on the analyst and inside information.[2] However, one senses that some (and perhaps many) analysts have yet to grasp the elements of the inside information doctrine and its implications for their work. In the meantime, members of FAF societies are parties in a number of inside information actions before the SEC and in the courts.

Conflicts of interest. The inside information doctrine has also focused attention on a number of conflict of interest problems within the financial community. These involve institutions performing more than one function, with one part of the business accustomed to receiving and using inside information and another being an investor or adviser to investors. The best known examples are: (1) banks–commercial lending versus trust investing; and (2) broker-dealers—underwriting versus brokerage and investment advisory.

Some cry at once for the divorce (by legislation if necessary) of such potentially conflicting functions. Most are seeking improved salutary procedures for preventing the flow of inside information from areas where its use is legitimate to those where its use would violate the inside information doctrine. It is hoped these potential conflicts can be solved on the basis of increased sensitivity and of reason, without drastic surgery. However, the gravity of the problems can hardly be overemphasized. For example, once inside information is "inside the house," not only does the problem of its proper containment exist but also, should a violation be alleged, the practical problem of proof of the facts arises. For example, if one and the same person legitimately has inside information and is also an investment decision-maker as to securities of the related issuer, how is it to be proved that the inside information did not affect the investment decision even if, in fact, it did not? Or, once inside information reaches very senior officials of a firm, how can it be proved that investment decisions were not affected even if these officials do not directly make the investment decisions?

In any case, the writer (and to his knowledge, most analysts) has no fear whatsoever that the inside information doctrine threatens the utility or the worth of the financial analyst. Basically, the public interest in fair markets is shared by the analyst for, in a democratic society, if the public should

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[2] In the writer's opinion these articles are the most important:
The so-called "Loomis Panel" on Corporate Disclosure and Insider Information transcribed at the FAF Fall Conference in Atlanta in October 1968; Alan R. Bromberg, "The Law of Corporate Information," *Financial Analysts Journal,* March-April 1969, pp. 26-31; "Trouble at Quigley," *Financial Analysts Journal,* July-August 1969, pp. 171-181. John Gillis, "The Tippee in Transition," *Financial Analysts Journal,* January-February 1971, pp. 6-14.

become convinced that securities markets are palpably unfair, those markets (and analysts' jobs) would very likely be legislated out of existence. Further, it takes no professional expertise to reason from inside information to an appropriate investment recommendation and decision. Given the "bombshell" definition of inside information (and clearly the alleged inside information in every case to date is of this variety), even the proverbial Aunt Minnie should know instinctively what to do with it once received. Thus, the analyst's stock-in-trade–his specialized knowledge, reasoning ability, and judgment–logically allies him with the public as a foe of unregulated use of inside information. Viewed another way, the analyst has no need for inside information. The inside information doctrine purports to in no way fetter the analyst's reasoning and judgment processes; and, his very reason for being is to use his abilities to anticipate and to set odds on the happenings which in the future might, for a time, become inside information.

Communication With Clients, Customers, and Employers

The ethical caveat for the research analyst regarding communications with his "boss"–the portfolio manager or the investor who hires him–derives mainly from the aphorism "a day's work for a day's pay." Refinements of communication include: adequate homework, proper labeling of sources, and adequate disclosure of assumptions. The recipient of an analyst's recommendation is entitled to know the general scope of his work. The recipient also is entitled to know how much of the work is the analyst's own and to what extent he has relied on the work of others (and who the others are). Perhaps most important of all, the recipient of a research analyst's recommendation is entitled to know the key assumptions upon which the recommendation rests. For example, what economic assumptions has the analyst used? Also, what qualitative assumptions has he made: where and to what extent does he disagree with management expectations and why; in predicting earnings some years into the future, what assumptions has he made as to financing and as to the number of shares expected then to be outstanding? Further, what are the risks involved in individual assumptions and in the final conclusion?

The section of the FAF Standards of Professional Conduct applicable to this topic states: "The financial analyst shall be objective in his opinions in advising his customers, clients, and employer, and when making a recommendation, must have a basis which can be substantiated as reasonable. He must be accurate and complete when reporting facts."

For the research analyst reporting to an in-house investment committee or portfolio manager, much of this is understood, and the analyst's obligation is simply to live up to house norms. This may also be true of research work going to the public in standard form. Temptations come, however, and they are hard to resist. An unexpected question may be asked about a company which the analyst feels he is expected to be able to answer and without think-

ing, he passes on the "general feeling of the Street" as his own. A report is nearly finished, and some missing details should be checked with company management; but, there doesn't seem to be time, so one is tempted to guess and decide it couldn't be all that important anyway. As to risk assessment, naturally, accepted assumptions and the final investment conclusion are predictions of the most likely outcome. But there is a vast difference in reliability between a "most likely outcome" being three chances out of ten assured and being seven or eight chances out of ten assured. The former indicates poor forecasting climate and alerts the investment decision-maker of above average risk. Television and radio weather forecasters use this technique. One may well carry his umbrella when the forecast is for rain six chances out of ten, whereas the lesser insurance of the plastic raincoat in a pocket of his briefcase may suffice when the forecast is three chances out of ten, and one may dare no protection at all when the forecast is one chance out of ten.

The portfolio manager faces the dual ethical problem of (1) perceiving for himself the purpose of the account, and determining basic policy as to the types of securities that will best fit the purpose within acceptable risk limits and (2) reaching a meeting of the minds with the investor whose portfolio he is managing as to the purpose of investment and the appropriate kinds of securities.

A typical problem is a conflict between the investor's reward desires and the risk-taking ability of the portfolio. For example, an educational endowment fund might decide that it intends to realize ten percent a year from its funds using income plus realized capital gains, but insist that all of the funds be invested in common stocks whose year-to-year price volatility is relatively high. The years 1969 and 1970 reminded us of the potentially high cost of such a mismatching of securities with the portfolio's risk-taking ability. In a period of rapid inflation, the need for the expected income was greater than ever, and the forced sale (of what could well have been excellent long-term holdings) of such common stocks at severely depressed prices would cause permanent damage to the portfolio's future performance potential.

What is the duty of the portfolio manager when a serious conflict appears in the investor's reward desires and the account's risk-taking ability? A related and highly topical question is: What does the portfolio manager do when the investor requests highly improbable levels of short-term performance (and on a consistent basis), with the account to go to a competitor if the desired results are not produced or at least promised?

The following comments are suggestions as to where one might begin to look for definitive answers to such questions:

1. Give the investor (be he client, customer, or employer) the available facts on historic results of market averages and (to illuminate the odds on outperforming these averages *and by how much*) on groups of professionally managed investors. Show the investor the potential cost if excess risk-taking should result in short-term or permanent damage to the portfolio.

2. Exert maximum effort to agree in advance on mutually acceptable performance standards and risk-taking standards so that a base exists for reference if subsequently the client or employer seeks departure from these standards.

3. Presently there are no professionally agreed-to norms for the appropriate time span for measuring portfolio results. I find appealing the suggestion that the FAF sponsor research and eventual determination of suggested time norms for measuring portfolio performance.

Buying and Selling Securities

The FAF Standards of Professional Conduct speak eloquently to ethical requirements in this area as regards both the research analyst and the portfolio manager:

> The financial analyst shall conduct himself in such manner that transactions for his customers, clients, or employer have priority over personal transactions, that personal transactions do not operate adversely to their interests, and that he act with impartiality. Thus, if an analyst has decided to make a recommendation as to the purchase or sale of a security, he shall give his customers, clients, and employer adequate opportunity to act on such recommendation before acting on his own behalf.
>
> The financial analyst shall, in addition to the requirements of disclosure required by law and rules and regulations of organizations governing his activities, when making recommendations, disclose to his customers, clients, and employer any material conflict of interest relating to him and any material beneficial ownership of the securities involved which could reasonably be expected to impair his ability to render unbiased and objective advice.

A potential source of ethical conflict is the amount and kind of time a financial analyst spends managing his personal portfolio. Surely, there must be some limit to the total number of waking hours on which the employer or clients have a claim. But, the question could eventually arise as to whether the analyst is or can be appropriately serving his client or employer if he invests largely in types of securities that require day-by-day attention because of extreme price volatility (examples could be rights, "puts," "calls," new issues of small companies) or because his securities portfolio is extremely leveraged with debt.

Another potential ethical conflict in securities transactions is fairness in transactions among different accounts managed by the same portfolio manager or institution. The advent of computerized record-keeping and incentives for block transactions from sliding scale (and negotiated) brokerage fees have gone far in providing a solution to this problem.

Still another potential source of conflict of interest between the investor and the financial analyst is the traditional purchase of investment research via brokerage commissions. In many cases (such as mutual funds, trust accounts, investment advisory accounts), brokerage fees on securities transactions are charged directly to the investor, whereas the portfolio-managing institution pays for its own research efforts from its direct compensation from the investor. Direct brokerage "give-ups" have been outlawed and challenges have come in the courts against use of brokerage commissions from trust account transactions for commercial-banking customer development as well as use of brokerage commissions from mutual fund transactions to favor brokers engaged in selling mutual fund shares. Further, comment has been made that part of the reasoning of the SEC in pressing for negotiated brokerage commissions on large transactions is a desire to reduce or eliminate still other possible conflicts of interest (such as research for commissions) relating to brokerage commissions.

Communications With Corporations Whose Securities Are Being Analyzed

Availability of corporate officials to communicate orally with financial analysts suggests a quid pro quo on the part of the analyst. It is appropriate preparation for the "visit" so as to maximize its fruitfulness and to minimize the time involved and inconvenience of corporate officials. Enlightened self-interest of the analyst in the fruitfulness of his corporate contacts also strongly suggests observance of elementary rules of etiquette—punctuality, politeness, and the like. From comments by corporate officials, it is clear that numbers of analysts fail to do their homework and, on occasion, do not behave in accord with Emily Post norms.

Fair use of information received is another important aspect of analyst-corporate official relationships. This goes beyond the matter of accuracy and completeness in reporting facts mentioned above. It involves attention to degrees of importance. Also, it involves respect for confidences. Here one refers not to inside information but rather to information that is not of the "bombshell" variety but which if published (at all or inappropriately) could injure the corporation's competitive position or its relations with its employees, with its unions, or with government. An example might be a corporate official's analysis of the major issues to be faced in upcoming bargaining on a new contract with his company's major labor union. Less than "bombshell" type information—but easily hurtful to company-union relations if mishandled—could be such opinions as: "The new union chief has considerably less control over his locals than did his predecessor"; or "If we could change such and such work rules, we could reduce employment in such and such plant by ten per cent." The analyst has the opportunity to greatly increase his understanding of the company via frank and complete communication from

management by proving to management his ability to properly use background information, just as does the news reporter in relating to his key human sources.

As to inside information itself, earlier comments suggest the analyst has a duty not to seek it and certainly not to exert pressure to obtain it. Corporate officials have a corresponding duty to "blow the whistle" on any analyst whose behavior is distinctly improper in this area (or in any of the areas discussed above). If the analyst's misbehavior cannot be corrected by face-to-face communication, the corporate official could appropriately turn to the analyst's employer. If this route fails or is feared, the good offices of the FAF should be called upon. The Federation is on record (including publication in the *Financial Executive*) as being desirous of offering help in promoting appropriate behavior by analysts in their relations with corporate officials. Any action in such a case would be on a confidential basis and would contemplate discreet communication between FAF officials and the offending analyst's employer. In the opinion of the Federation, the stature and position of such financial analysts as are to be found among the FAF's executive director, other officers, and its directors suggest that such a behavior problem could well be resolved in this way.

Promotion of Adherence to Ethical Standards by Financial Analysts

Enforcement. The FAF first adopted a code of ethics and standards of conduct in 1962. During 1968, work began on a revision of this code. After intensive committee work, study, and discussion during several meetings by the boards of directors of the FAF and of trustees of the Institute of Chartered Financial Analysts, the new code and standards (see Exhibit I, pp. 48-49) were adopted unanimously the following year by the FAF delegates and the ICFA trustees. In related action, the FAF required its member societies to adopt the new code and standards or ones substantially similar, and to adopt appropriate enforcement provisions.

For Chartered Financial Analysts, the ICFA has jurisdiction over individual charter holders as regards ethics code and standards enforcement. The ICFA has adopted comprehensive grievance procedures. The writer is aware of one case being processed before the board of trustees.

As the FAF is literally a federation, its members are the local societies with the societies having jurisdiction over individual members for ethics infractions. The FAF has prepared sample grievance procedure language for use by local societies where desired. Most of the 42 societies have adopted the new code and standards (or the equivalent), and many have adopted formalized grievance procedures. A number of cases have been processed or are pending in the local societies. The FAF's counsel and its ethics committee are available to advise and to consult with officials of the local societies in ethics matters.

Although grounds for satisfaction exist in developments regarding ethics enforcement over the past two to three years, there has also been time to perceive the nature of common problems. First is the difficulty of proceeding with an ethics case based on behavior which has already resulted in institution of legal proceedings. For example, FAF society members, including some CFAs, are parties to some well-publicized cases. Pending settlement of these cases, the local FAF societies and the Institute of Chartered Financial Analysts have deferred any action. Second, analysts are becoming acquainted (through experience) with the cost problems (monetary and time) of dealing with ethics cases, particularly in the development of satisfactory proof of code or standards infractions. Also, analysts are learning about the human reluctance involved in any self-policing activity. Hoary arguments are heard: "We had better leave this alone, we might get sued. Lots of others have gotten away with this, why single out this person?"

Genuine hope for progress in ethics enforcement exists, but analysts are beginning to learn about the inherent limitations in ethics enforcement long since discovered in such other professions as law and medicine.

Education. With the ultimate goal being adherence to high standards of conduct, enforcement is naturally only one tool. Both the FAF and ICFA are committed to improving and intensifying existing educational programs. Finally, however, perhaps the most powerful force for promoting adherence to high standards (as one perceives it to be in other professions) is personal example. FAF volunteer and staff leaders and those in the local societies have special opportunities in this area. But, in the end, it will be the effort of each of us in his own work that will decide the issue. This effort must have a dual focus: (1) developing sensitivity to the obfuscating effects of self-interest and past practice so as to perceive ethical issues when one is involved in them and (2) motivating ourselves to speak out to clients, fellow employees, and employers on these issues when they arise. Perhaps the term witness (in its religious sense) is an appropriate description of the behavior goal as regards ethical standards of the analyst or any other professional.

Why ethical standards? Perhaps no discussion of ethical standards (for financial analysts or for members of any other profession) is complete without suggesting answers to the basic questions: Why should ethical standards be established, and why should the practitioner live up to them. One of the standard answers is: So that one may have optimum pride in the quality of service being provided to clients and employers; the second is: Monetary self-interest. The monetary self-interest argument was offered earlier in this paper in discussing the inside information issue and the commonality of interest of the public and financial analysts in the fairness of securities markets. Applied more generally, the argument runs: Given the specialized knowledge and experience of the professional which puts him in a position of advantage vis-à-vis his client or employer, unless the members of a profession hold themselves to high ethical standards, their clients, employers, and ultimately

the general public will no longer accord the professional the trust and the freedom of action (absence of regulation) which permits the quality of service to be as high as it is, the numbers employed in the profession to be as large as they are, and the level of compensation to be as generous as it is.

EXHIBIT I

Code of Ethics and Standards of Professional Conduct of The Financial Analysts Federation

CODE OF ETHICS

WHEREAS, the profession of financial analysis has evolved because of the increasing public need for competent, objective and trustworthy advice with regard to investments and financial management; and

WHEREAS, those engaged in this profession have joined together in an organization known as The Financial Analysts Federation; and

WHEREAS, despite a wide diversity of interest among analysts employed by banks, brokers and security dealers, investment advisory organizations, financial relations counselors, insurance companies, investment companies, investment trusts, pension trusts and other institutional investors and corporate bodies, there are nevertheless certain fundamental standards of conduct which should be common to all engaged in the profession of financial analysis and accepted and maintained by them; and

WHEREAS, the members of The Financial Analysts Federation adopted a Code of Ethics and Standards on May 20, 1962, and it is now deemed appropriate to make certain amendments to this Code.

NOW, THEREFORE, the members of The Financial Analysts Federation hereby adopt on October 19, 1969, the following Code of Ethics, and Standards of Professional Conduct:

A financial analyst should conduct himself with integrity and dignity and encourage such conduct by others in the profession.

A financial analyst should act with competence and strive to maintain and improve his competence and that of others in the profession.

A financial analyst should use proper care and exercise independent professional judgment.

STANDARDS OF PROFESSIONAL CONDUCT

1. The financial analyst shall conduct himself and encourage the practice of financial analysis in a manner that shall reflect credit on himself and on the profession. The financial analyst shall have and maintain knowledge of and shall comply strictly with all federal, state and provincial laws as well as with all rules and regulations of any governmental agency governing his activities. The financial analyst also shall comply strictly with the rules and regulations of the stock exchanges and of the National Association of Securities Dealers if he, or his employer, is a member of these organizations.

2. The financial analyst shall ascertain that his employer is aware of the existence and content of the Code of Ethics and of these Standards of Professional Conduct.

3. The financial analyst shall conduct himself in such manner that transactions for his customers, clients, or employer have priority over personal transactions, that personal transactions do not operate adversely to their interests, and that he act with impartiality. Thus, if an analyst has decided to make a recommendation as to the purchase or sale of a security, he shall give his customers, clients, and employer adequate opportunity to act on such recommendation before acting on his own behalf.

4. The financial analyst shall, in addition to the requirements of disclosure required by law and rules and regulations of organizations governing his activities, when making recommendations, disclose to his customers, clients, and employer any material conflict of interest relating to him and any material beneficial ownership of the securities involved which could reasonably be expected to impair his ability to render unbiased and objective advice.

5. The financial analyst shall be objective in his opinions in advising his customers, clients, and employer, and when making a recommendation must have a basis which can be substantiated as reasonable. He must be accurate and complete when reporting facts.

6. The financial analyst shall inform his customers, clients, and employer of compensation arrangements in connection with his services to them which are in addition to compensation from his employer or from the customer or client for such services.

7. The financial analyst shall not pay any consideration to others for recommending his services unless such arrangement has been appropriately disclosed.

8. The financial analyst shall not undertake independent practice for compensation in competition with his employer unless he has received written consent from both his employer and the person for whom he undertakes independent employment.

9. The financial analyst shall not, in the preparation of material for distribution to customers, clients, or the general public, copy or use in substantially the same form material prepared by other persons without acknowledging its use and identifying the name of the author or publisher of such material.

Ethics of Corporate Reporting And the Corporate Financial Officer

By Paul C. Nagel, Jr., *Executive Vice-President—Finance, Household Finance Corporation; Vice-President, Financial Executives Research Foundation, representing the Financial Executives Institute*

The subject of ethics is one which has been studied over the centuries by philosophers and others in the broad context of interrelationships between people. The use of the term in relation to a highly specific subject such as corporate financial reporting can be misleading because it suggests that there may be a predetermined set of philosophical standards which should apply. In fact, there is no such specialized set of standards, nor can there be. Rather, ethics in corporate reporting must be expressed in such fundamental terms as honesty and consideration of others' needs. Because there is almost always more than one right alternative, there is an element of subjectiveness to honesty as applied to reporting. Certainly there are conflicts between the interests of users, but a course must be selected, a course which is as equitable as possible among the variety of interests in the corporation. Therefore, consideration of what others' needs and rights really are in financial reports involves subjectivity as well.

There is an ethics problem for corporate financial officers, just as there is for other people in a complex world, but, in many respects, it is no different from the ethics question faced by other members of the corporate team. The unique ethics question for the corporate financial officer arises because he participates in the corporate decision-making process and also directs the preparation of the financial statements which, in effect, report on the results of those corporate decisions.

The fundamental purpose of published financial reports for the corporation is to inform the investor. The term "investor" as used herein will be defined and further discussed later. Whatever others may think, the interests of the general public, customers, labor, and others in financial reports must be

regarded as definitely secondary to those of the investor or owner of the enterprise.

The corporate financial officer can and must assume the financial reporting responsibility as his special obligation to the stockholders of the company parallel with that of the chief executive; it is also part of his assigned organizational responsibilities. In the exercise of these separate responsibilities, ethical considerations are most certainly involved, especially honesty and consideration of others' rights and needs, which is represented in the context of this paper through financial disclosure. As stated, the financial officer reports to investors the results, in financial terms, of the corporation's activities. Although the financial officer must report to a variety of financial statement users, this paper does not deal with reporting to persons or institutions other than investors.

The ethics of corporate reporting and of the other activities of the corporate financial officer will be discussed in three parts: (1) the obligations of the corporate financial officer to the chief executive officer of the corporation and his interrelationships with other members of the senior management group, (2) the interpretive differences resulting from conflicting objectives on the part of various types of investors, and (3) the professional responsibilities of the corporate financial officer.

Obligations of the Financial Officer Within the Firm

The key relationship between the management of a corporation and its shareholders focuses on the chief executive officer, who reports to the board of directors, who, in turn, are elected by the shareholders. It is the chief executive who has the responsibility of shareholder relationships and thus for the annual report and the financial statements of the corporation. The corporate financial officer reports to the chief executive officer and through this relationship he provides the financial and statistical data which the chief executive publicizes.

The management organization of a corporation is established by the chief executive officer to deal most effectively with the business or businesses of the company. As the corporation grows or changes, its management organization must be modified to meet changing needs. The organization of the financial function also changes to be responsive to the needs of the corporation.

Preparation of financial reports can be done in a number of different areas of that financial organization, although generally it is assigned to the controller's department; the issuance of financial reports to the public also can be accomplished through different departments. However, development of the financial statements for the published reports is the responsibility of the corporate financial officer, and it is incumbent upon him to be sufficiently familiar with the goings-on in his organization to make soundly based decisions regarding the application of underlying accounting principles to the bus-

iness judgments and transactions, both completed and in process, in order to provide adequate information in the published financial reports. The remainder of the report—that is, any material outside the financial statements—represents the report of the chief executive to his shareholders. Of course, the financial statements, too, are part of the chief executive's responsibility, but the financial officer has a parallel and special responsibility in these reports, whereas he has a lesser responsibility for the so-called nonfinancial sections of the report.

The financial department is a part of the overall management team, and its members participate in the conduct of the business in a way designed to make the other departments most effective in meeting their objectives. Another special function of the financial department is to obtain the funds with which the corporation operates, assuring adequate liquidity without excessive idle funds. Keeping abreast of credit conditions and interest rates and maintaining adequate sources of funds requires constant attention and expertise. Literally, no significant corporate decision is made without financial consideration, and the corporate financial officer is expected to represent this view in all corporate councils.

Knowledge of the ultimate outcome of a given course of management action cannot be known until the action is complete or nearly so. If a financial report is to be published while a major program or product or new invention is in the developmental stage, the management team will take the view that the program will be successful, unless there is strong evidence to the contrary, because that is the focus of their effort. This view unavoidably affects the financial statements. In most dynamic businesses new programs, products, or ventures are constantly being developed, and at any reporting point something will be in process. There are risks in every program; no management team always can be expected to be successful in every project. Hence, some projects reported optimistically in one set of financial statements may require later adjustment.

The financial officer, as a part of this team, is as dedicated to the success of the corporation's programs as any other officer; however, he must take a critical viewpoint of the overall potential impact of programs, new and old alike, on the financial affairs of the business. He must bring to the attention of the chief executive officer his thinking in this regard, particularly as it may influence the contents of any financial reports to be issued to shareholders.

Disclosure Obligations

The disclosure obligations of the corporate financial officer are different for financial statement content than for nonfinancial statement material. The body of the annual report, press releases, and interviews are primarily the responsibility of the chief executive, although the financial executive may contribute to or even prepare them in certain cases. With regard to these nonfi-

nancial statement disclosures, the corporate financial officer is only one of the corporate executives providing information to the chief executive to help to determine the nature of what should be said publicly. Generally the corporate financial officer would be in the best position to assist in deciding on appropriate emphasis so as to avoid publicizing a subject out of proportion to its financial import to the company. Likewise, he is in the best position to argue for adequate disclosure of adverse circumstances and developments.

When financial reporting must deal with the status of a development or the potential impact on the business of a project in process, the outcome of projects in process is unavoidably subject to judgment. At some point in time the outcome becomes crystal clear; but during the interim, there are subjective evaluations which must be made by various people such as engineers, production specialists, and marketing men within an organization, and the chief executive officer must balance all opinions—including that of the chief financial officer—in reaching his conclusions. By establishing accounting policies such as asset life for depreciation purposes, capitalization policies, etc., the corporate financial officer can provide direction that will maintain the integrity of the statements as well as provide guidelines to the management group in their operations. His first responsibility is to see that management does not mislead itself to the ultimate detriment of shareholders.

There always will be differences in judgment between members of the management teams on matters of this kind. A variety of questions will arise, such as: Can inventory which has been on hand longer than is normal be sold to realize its cost, or must a writeoff be taken? Is a new product going to be successful, or should certain production and material costs be charged off? The answers to these questions involve not only judgment, but the application of accounting principles and practices as well. In questions such as these, the corporate financial officer must exercise a greater degree of authority than is the case with the questions which merely deal with accounting policy.

In summary, it must be understood that the corporate financial officer is first an active member of the management team and is every bit as much involved in the conduct of the business as the other principal members of that team. His loyalties are to the chief executive officer and are directed to making the efforts of the corporation successful. Where projects or developments in process are involved, the responsibility for reporting publicly on those subjects must lie with the chief executive, and, therefore, should be differentiated in the normal quarterly and annual reports from the financial statements also contained therein.

The corporate management team works long and hard to establish its priorities and keeps its effort in focus with those priorities. The outsider can never be completely familiar with the priorities of the management team; he is limited to information in corporate reports. The amount of disclosure concerning individual corporate undertakings must then reflect management's best judgment. The corporate financial officer, as a member of the management team, must represent not only the corporation, but also the interests of

the investor in such disclosure, and he should encourage the publication of information concerning events which are sufficiently significant to be of real importance to the investor. Where matters involve accounting principles and practices and affect financial statements, the corporate financial officer must see to it that treatment is accorded the subject which is in keeping with the posture of the company as well as the interests of the investor.

Financial analysts tend to view corporations as having accounting personalities based on the adequacy of financial disclosure, the use of reports to influence or inform, conservatism in depreciation and inventory accounting policy, and the like. To a considerable extent, the corporate financial officer is responsible for that personality. He must see that the corporation's accounting to the public helps maintain rather than reduce its sources of funds.

Conflicting Objectives of Various Types of Investors

At the beginning of this paper it was stated that the responsibility of corporate reporting was to inform the investor. That would be simple if there were only one investor with a single interest. However, the "investor" is a heterogeneous group that has a wide range of interests: from the widow with her shares in the safe deposit box, forgotten, to the professional speculator, who deals in daily market price fluctuations. There is another whole class of investors who lend money, either long-term or short-term, as individuals or as institutions.

The preponderance of investors have as a primary interest growth in the market price of their stock, and therefore, in continued increases in corporate earnings. Their interests may range widely in terms of the length of the holding period, but by and large, that period is for more than a year at a minimum and open-ended at a maximum.

The professional speculator and that segment of the general public who choose to speculate for a very short-term period—in some cases as short as a day or two—have little concern, if any, for the long-term growth of the company. Their interest is in those factors which affect the market price of the company's stock on a day-to-day basis.

Lenders as a class are more interested in the financial position of the corporation than they are in its earnings. The potential buyer of a debenture offering has as his primary concern the solvency of the company, the liquidity of the company's assets, and the conservatism indicated by the corporation's balance sheet. Any long-term lender most certainly has a long-term concern for the company's growth as he is dealing with a long-term obligation. The short-term lender places emphasis on liquidity, on the conservative statement of assets, and on continuing profitability—probably in that order.

The divergence between the interests of lenders, speculators, and investors in equity securities is sufficiently great that decisions affecting the financial reporting of a corporation could be made in quite different ways

depending upon which category of interest is involved. For instance, if primary attention is given to a long-term lender's interests, that lender would as soon see all possible costs written off, depreciation taken at the most rapid allowable rate, slow-moving inventories written down at an early date, and bad debt reserves maintained at the highest possible level. In this way he would be presented with what he would refer to as a conservatively stated balance sheet on which to make his loan decision. On the other hand, such treatment might not be desirable from the standpoint of the ongoing interests of the longer-term investor in the common stock of the corporation whose interests are best served by stability of earnings and a consistent growth trend over a long period of time, rather than the sharp up and down fluctuations which would result from the writeoff of a project one year and its reinstatement in the following year.

Clearly, the problem of the financial executive becomes one of preparing financial statements with a balanced viewpoint. The interests of all classes of investors must be kept in mind and be given equitable treatment, but if one class of investor is to be considered by the corporation to be more important than other classes, it probably would be the investor with the longer-term interests who wants to see continuing growth in earnings so that over a period of time the market value of his equity in the corporation would grow. The viewpoint favoring the long-term investor also requires adequate reserves, proper writeoff policies in keeping with the corporation's experience, realistic depreciation policies, and other policies sufficiently conservative to create an acceptable reaction among lenders so as to insure adequate sources of borrowed money.

From the viewpoint of the chief financial officer, the question of amount of disclosure may be a difficult one. It constitutes a balancing of the desires of investors for detailed information, from which they can pick and choose what they think they will find useful, with the financial officer's desire to report only in terms of total profit performance in order to avoid disclosing information helpful to adverse interests.

While ethical considerations are not the primary determinant of a corporation's disclosure policy, they are nevertheless important. Certainly such matters as widespread and equal disclosure of significant information to all parties and prompt timing of disclosure bear importantly on investor regard for a company.

There are also ethical considerations which relate to the financial stance of a company, i.e., conservative or nonconservative. In what way should the company convey to the investor the fact that it is conservative, other than by performance?

In summary, the corporation must, to an extent, identify with a class of investor and must adopt financial policies consistent with that identification. The financial executive must keep a balanced posture with regard to the informational needs of all classes of investors and encourage the adoption of disclosure policies which are proper to the circumstances.

The Professional Responsibilities of the Corporate Financial Officer

It is in the area of professional responsibility that the matter of ethics comes into play most extensively, particularly because in this area there is the semi-common law of accounting principles and practices and very real government law and regulation. Within the framework as set down by the SEC, the stock exchanges, and the Accounting Principles Board, the corporate financial officer must exercise his professional judgment.

The SEC requires that the chief financial and accounting officers of the corporation, as well as the members of the board of directors, sign a registration statement filed with the Commission under the Securities Act of 1933. All signers are responsible for the contents of the registration statement. By this means, the board, the chief executive, and the chief financial officer have a legal obligation to see that all significant information has been disclosed and that the financial statements are fairly presented.

In keeping with the foregoing, professionalism seems to relate primarily to accounting. By no means are all corporate financial officers accountants. In fact, a majority probably are not. Those who are not must rely on their chief accounting officer for much of the professional understanding of accounting. However, even the corporate financial officer without accounting training must accept the responsibility for adequate disclosure, for honest reporting, and for accurate financial statements. Certainly these three elements constitute a basis for the use of the term ethics in referring to the work of the corporate financial officer.

As a part of the management team participating in the decision-making process, the corporate financial officer does have a stake in the evaluation placed on the company by outsiders. In that sense, it is to his advantage to portray the company in a favorable light. In fact, he may have a financial interest through stock ownership, in which case it is directly to his financial advantage to see the price of the company stock move upward. Again, however, the requirements of accounting professionalism, of adequate disclosure, honest reporting, and accuracy are the legal and personal constraints placed on him. However, over and above these legal and personal constraints on the financial officer, public accountants, independent from internal company pressures, perform an audit in accordance with requirements of their professional society and through a certification join in taking responsibility for the fairness of presentation of the financial statements.

The key questions for the financial officer concern adequacy of disclosure and the quality of the subjective judgments made about the condition of programs currently going on within the corporation's activities. In a few cases the answers are clear, and when they are, the only ethical question facing the corporate financial officer is one of honesty. However, so much more often an answer is not clear and a quality judgment must be made to determine how the matter should be treated in the financial statements of the corpora-

tion. As a professional, the corporate financial officer knows the current standards of disclosure; he must make the best subjective judgments he can, and accept responsibility for them along with his fellow executives.

Over the longer term, the quality and accuracy of these subjective judgments is eminently clear to investors and outsiders through the company's record. It is only in the short run that the accuracy of these judgments is subject to any question.

Constructive Use of Financial Information by Commercial Bank Lending Officers

By Thomas F. Creamer, *Executive Vice-President, First National City Bank, representing the Robert Morris Associates*

Commercial bank officers assume multiple responsibilities in the proper and constructive use of financial information. In carrying out their functions, a bank officer encounters many possible conflicts which do not have simple, clear-cut answers.

To begin with, a bank officer's first responsibility, after his community, is to his stockholders. To this end, he is dedicated to the preservation of the quality and liquidity of the bank's assets. This is particularly true of loans. To maximize income, a bank officer must continually appraise the yield versus risk tradeoff in his credit decisions. Essential to this process is a solid grasp of accounting practice and statement analysis common to a client's industry. A bank officer has to understand the businesses of his borrowers as well as the principals' philosophies of management, which are the underlying forces creating the figures in the financial statements. In today's highly competitive atmosphere, the loan officer is required to be a constructive consultant—not merely a yes or no reactor. He has to call on his experience and training to help get the best job done for his customer's business. The optimum performance of these requisites contributes to the health of his bank, maintains investors' confidence, and attracts the essential raw material of deposits.

Confidential Information

Woven into this performance mix is the proper use of confidential information to which he is privy. He must be sure that he obtains good and reliable financial information on his customers and interprets that information properly. This applies when he extends credit to a borrower or, where appro-

priate, when he passes this information and his interpretation to others for their use. Without proper use and interpretation of these figures, the bank might end up either with a bad loan which would affect stockholders, or might give poor or even improper guidance to others.

When an officer asks for sufficient information on which to base his judgment, he also assumes the responsibility to use that information properly from the borrower's standpoint. In other words, he must not divulge any confidential information which might directly or indirectly affect the reputation and standing of the borrower. Another responsibility is in the use of these figures with respect to other creditors of the bank's customers including other banks which may be either competitors or participants in the extension of credit to the common borrower.

Obviously, in the use of this information the bank officer could mislead, one way or another, other creditors. He should use the information where necessary, but only to the extent necessary, and not divulge information which is not relevant or required. On many occasions the information given to a bank officer, unless published in an annual report, is of a strictly confidential nature and, therefore, not made available to the public at large. This must be confidentially respected. Occasionally the government, for one reason or another, may inquire of a bank regarding the financial position of one of its depositors or borrowers. This also requires judgment on the part of the officer, depending, of course, on issues of national security.

Illustrations

For purposes of illustration let us consider the loan officer's posture in some typical situations:

Case I—Privately Held Corporation X. Bank *A* receives an interim unaudited financial statement from *X* that indicates a $2 million loss for the recent quarter's operations, which comes as a shock to the banker. He has an unsecured $5,000,000 loan that comes up for renewal in 30 days. Bank *A* investigates further and discovers inventory has been written down to reflect price reductions, and sales are down 20 per cent due to the loss of several large orders. The outlook is not good, and continued unsecured credit is hard to justify.

QUERY:

1. What should the loan officer say in response to trade creditor inquiries?
2. Bank *A* has participated $1 million on an overline basis to its city bank correspondent because of legal limit problems. What should *A* say to the city bank? Does the city bank receive the same story as trade creditors?
3. Bank *B* has had preliminary discussions with *X* for unsecured credit. Bank *B* asks Bank *A* about its experience. What should Bank *A* say if

there is a possibility of a "take-out" by unknowing Bank *B*? Should it "let the buyer beware"?

Case II—Public Corporation. Bank *A* is Agent Bank in a $15 million revolving credit with six other participants for Borrower *Y*. Bank *A* learns that *Y* may lose an important contract (source of information is *Y's* financial officer, or it could very easily be some outside source, such as a competitor). This has not been disclosed publicly. Corporation *Y* may also face a large writedown of deferred R & D on the lost contract.

QUERY:

1. Should Banker A notify the six other bank participants prior to public disclosure by *Y*?
2. What does he say to trade inquiries?
3. Should Banker *A* be entitled to talk directly with the auditors regarding the writedown?

Case III—Finance Company. Bank *A* is one of several line banks which provide short term loans to the *X* Finance Company. Tomorrow, Bank *A* is scheduled to be given a cleanup of the $5 million loan by rotation to Bank *B*. Banker *A*, this morning, learns that *X* Finance Company suffered a severe fraud loss that could cause all creditors to reevaluate their positions. This afternoon, Bank *B* calls to make a routine revision.

QUERY: What does Bank *A* tell Bank *B*?

In each case mentioned above there are potential conflicts of ethics and possibly of interest.

Within the bank's organization there usually is an investment management group which is handling investment accounts for others on discretionary or nondiscretionary bases. In our own institution, as an example, these two groups, the lending officers and the investment officers, are kept completely apart and the information made available to the lending officer is not made available to the investment officer to avoid interest conflicts. The internal "whipsaw" could be considerably more troubling, however, in a medium-sized bank where the chief loan officer might possibly, because of his financial expertise, be involved to some degree in the investment management process and thus must decide which of his two hats to wear. In this frame of reference let us take the first two cases a step further.

Case I—Privately Held Corporation X. Bank *A* is named as trustee under the will of the deceased owner of Borrower *X* to hold the stock of the business with the aim of preserving it for the benefit of the deceased's widow and five children. Does a conflict of interest loom on the horizon? Where is the Bank's first responsibility—to its stockholders as lender to Borrower *X*, to the deceased owner and his wishes, or to its fiduciary relationship to the widow and five children?

Case II—Public Corporation Y. Bank *A* holds in its various discretionary investment management accounts 300,000 shares, or two per cent, of Borrower *Y's* outstanding shares; Banker *A* learns that the investment management officer happened to hear of *Y's* loss of the contract at lunch from one of *A's* junior associates who was unaware of the investment management officer's interest.

QUERY:

1. Should the investment officer be stopped from selling some of *Y's* stock?
2. Suppose either or both bankers or their families own some of *Y* stock. How do they react?

Again, within a bank, the loan officer sometimes is faced with the question of conflicts that may stem from the acceptance of corporate appointments by borrowing or prospective borrowing corporations, especially in the case of trusteeships. His quest for earnings has to be tempered by strenuous efforts to prevent his bank from entering a potential compromising or conflicting position should legal action eventually evolve from future financial problems of the borrower.

Necessity for Accurate Interpretation

The loan officer's basic rules of character, capacity, and capital involve seeking out the facts on which to appraise the honesty, judgment, and ability of the borrower's management. The initial information he sees is generally the borrower's financial statements. Where necessary, the banker invariably will try to impress his customers with the values provided by the services of a good CPA to help him track his business. Statements prepared by the CPA provide the banker's customer with credibility and consistency for management decisions, tax information, and to secure credit. There is no question that creditors take considerably greater comfort from a CPA's audit, especially when its scope is unlimited and opinion unqualified, than from financial statements prepared by others of uncertain independence or professional ability.

The lending officer's interpretation and use of all these data obviously is an art and not a science. This suggests the importance of a close relationship with the CPA fraternity which, in practice, seems to vary with the type of industry and size of the companies involved. In the garment industry, particularly, many of the firms look on the CPA as an important financial consultant and, often, as virtually the principal financial officer of the company, with the result that credit arrangements, including negotiations, are often set up with the company on a joint basis with the CPA firm. Therefore, in such cases the lending officer works very closely and intimately with the accounting firm in the review, understanding the interpretation of the financial figures. I, for one, think this is most desirable.

On the other hand, there are many large corporate relationships where the lending institution is not given free access to the borrower's auditors. The relationship is restricted to the borrowing customer and the bank is not invited or encouraged and, in fact, is often not permitted, to discuss the figures with the customer's auditors. As a matter of fact, in such cases the outside auditors might not discuss their client's figures with the bank without their client's permission. I think this is wrong in many cases, and I believe a closer relationship between the bank and the auditors makes for much more constructive, intelligent use of the financial figures by the lending officer. In addition, it makes for a stronger relationship with the customer. This, then, suggests perhaps a responsibility of the accounting firm as to how it relates with its client and discusses its client's affairs with the bank or banks.

The foregoing are only some of the many ethical responsibilities to others confronting the loan officer in his handling of the ebb and flow of financial information he gives and receives. But there is no prescribed pattern in the way he must fulfill these obligations to all parties. The Robert Morris Associates' Code of Ethics probably best approximates any guidelines for determining his prospective posture in discharging these responsibilities, and his optimum understanding of the Code should be a prominent part of his professional education.

The inside use of privileged information also seems to be a subject of much current interest, according to the frequent articles in the press. Would spinning off trust or investment departments into subsidiary or affiliate relationships, as some would recommend, insure the desired separation of privileged financial data? I submit that interested bank officers would still be faced with similar ethical conflicts regardless of the corporate facade under which they operate and would still have to handle the information they are privy to with a scrupulous sense of moral responsibility to their total environment.

Discussion With the CPA Firm

With respect to dialogue with the CPA fraternity, why shouldn't the banker, who in some cases is lending more to a company than the stockholder's investment, be encouraged by his client to discuss the financial reporting he sees with the company's accounting firm regardless of the size of the borrower? Size or public ownership does not make a company invulnerable to fiscal problems.

I believe that the customer should attend meetings between the banker and the CPA during which the CPA can discuss the "facts" presented in the financial statements and can explain footnotes and accounting policies, while the customer can interpret the financial statements and give opinions. In the matter of inventories, for example, the CPA can discuss inventory control, pricing policies, audit procedures, and approach to obsolescence. The

customer must give his opinion about the salability of the items in inventory; but, in the final analysis, the banker must draw his own conclusions after meeting with the customer and the CPA.

The continuous education of the lending officer should include familiarity with and frequent updating of his exposure to the evolving generally accepted accounting principles adopted by the American Institute of CPAs to enable him to discuss intelligently with the accountant the bases on which values are expressed in audits. Bankers are continuously taking courses given by schools such as the Rutgers Graduate School of Banking, as well as specially designed courses within their banks.

Conclusion

I am reminded of a two-week seminar sponsored by the Danforth Foundation which I attended several years ago at the Harvard Business School, in which the subject of the session was "Morals and Ethics in the Business World." While the subject matter or case studies at the seminars were primarily concerned with personnel problems, we encountered exactly the same type of question which is dealt with in this paper. The seminar was attended by representatives from theological seminaries, educational institutions, and the business world. We in the business world appreciate that many of the questions raised at the seminar, like the questions raised in this paper, are not always easy to answer with a flat yes or no. Therefore, the businessman comes to the answer to any question intuitively and comes up with what he feels is the best, if oftentimes not the perfect, answer. This was quite a revelation to many of the theologians and the professors who thought most business questions were of a black or white nature and did not assume varying shades of gray. So, in turn, the same thing applies to the proper use by bank lending officers of financial information. It is a matter of judgment on the part of the bank officer and he must come up with the best answer, which may not necessarily be the perfect one. He must, however, make certain, to the best of his ability, that the effect is constructive and not destructive to all concerned.

Critique

Of the Olson, Parker, Nagel, and Creamer papers

By Ivan O. Bull, *Partner, McGladrey, Hansen, Dunn & Company; member, Committee on Professional Ethics, American Institute of Certified Public Accountants, representing the American Institute of Certified Public Accountants*

As evidenced by the previous papers, the responsibilities for a financial report which is to be used by a third party are clearly shared by a number of people. However, each individual tends to view his responsibility for a financial report as if he were functioning in a vacuum. This is true regardless of whether the individual deals with collection, preparation, or review of the financial report. However, the aggregation of these myopic views apparently does provide for a total package of responsibilities which should prove satisfactory to third-party users.

Dissemination of financial data about a business enterprise, at the level we are discussing, clearly requires the transmittal of information through a chain of individuals prior to its receipt by the ultimate user. If the chain is to operate effectively, each individual in it must adhere to a high level of ethical conduct to fulfill his responsibility to the system. Therefore, each individual should understand the total environment for communication of financial information and, further, he should relate his own segmented responsibilities to the total package.

In this paper I shall discuss the interrelationship between individual parties in the preparation, presentation, and use of the financial reports. Within this context, the importance of the chief executive officer in determining the level of corporate disclosure is highlighted. The nature of the problem involved in preparing financial reports for third-party users will be identified by examining the comments of the four writers. Together, these comments form a composite based upon honesty, competence, independence, and professionalism; individually, the presentations offer certain unique or unusual views relating to the particular professions represented at this symposium.

Absence of a Critical Element

In attempting to formulate the total package of responsibility for preparation of a financial report, it became apparent that one critical element to this process had been excluded. The critical exclusion to which I refer is the failure to have comments proffered by the chief executive officer of a corporation.

The chief executive officer exerts great influence over corporate financial reports prepared for third-party use. More than any other individual, he effectively determines the highest, I repeat, highest level of reporting.

The chief financial officer (treasurer or controller) and the independent auditor effectively determine the minimum level of financial reporting. To perform below this level subjects both the financial officer and the auditor to personal exposure to possible censure and criticism. But, above this minimum level of reporting, the extent of disclosure, understandability of the communication, and the degree of objectivity and consistency in interpreting inconclusive evidence are determined, in large part, by the chief executive officer. The chief financial officer and the independent auditor may exert their influence toward obtaining a higher level of reporting; but, if he chooses, the chief executive officer will determine the ultimate disposition of most questionable items of significance.

One might question how ethical conduct for a chief executive is to be determined. Financial reporting is but one of his responsibilities; however, financial reporting to owners and creditors is an inescapable and important responsibility of the chief executive. Shouldn't his views have been presented at this symposium? Can the total package of financial reporting be effectively examined when such a critical element is missing?

Enforcement of Ethical Standards

In the development of this critique, it was necessary to consider the purpose and problems of enforcing ethical standards. Rather than discussing enforcement as it related to each of the papers, it seemed more appropriate to discuss the topic separately. Since enforcement is the subject of a separate session of this symposium, my observation will be very brief.

Enforcement of the minimum standards of ethical conduct should be mandatory for all links in the chain of financial reporting. Ethical standards are ineffective without active enforcement. Third-party users of reports probably want disciplinary action to be swift, well-publicized, and sufficiently severe to thwart future ethical departures. Unfortunately, there is some evidence that enforcement is inadequate. Confidence in the reliability of financial statements may be directly related to the confidence of statement users that unethical practitioners will be decisively disciplined. Enforcement must cease to be delinquent and timid.

The Nature of the Reporting Problem

The purpose, and therefore the problem, of financial reporting might be stated as follows: A financial report should communicate relevant financial information about an entity to a third-party user. This requires those involved in the preparation of a financial report to undertake a diligent search for related evidence, and an objective interpretation of all known factors, which can be made intelligible for the intended user, without omission of a fact which is significant. Further, this communication must meet the exigency of timeliness without disclosing vital information which would impair the competitive position of the corporation.

This critique assumes there is agreement that this stated purpose reasonably reflects the objective of financial reporting for third-party use. A comparison of the ethical conditions of the four disciplines described by the four papers falls within the definition framework.

Agreement on Ethical Topics

An overview of the papers presented seems to indicate the following ethical components of corporate financial reporting: honesty, competency, independence, and professionalism. Generalizing on each of these elements from the specific or special treatment presented by the four represented disciplines, their written or unwritten codes seem to say:

1. HONESTY. Be honest with yourself, with your employer, with the entity being reported on, and with the user of your information.

2. COMPETENCY. Develop and maintain competence at a level which will meet or excel the recognized standards of performance.

3. INDEPENDENCE. Conflicts of interest between each of the four disciplines and the user of financial reports can easily arise. At the very minimum, the preparer should subordinate his personal interest to the interest of the statement user.

4. PROFESSIONALISM. Maintain the dignity and respect of the profession by complying with the three previous ethical standards; encourage and demand that peers also comply; increase the value of the profession to society by improving professional techniques.

Each of these points could be amplified; however, in one way or another, each representative of his profession examined these topics from his unique viewpoint. Some expanded one or more of the topics while others were silent about these same concepts. A comparison of the relative treatments is informative and leads to some interesting observations. However, I would prefer to highlight those items on which there was not a common understanding.

Creamer

I addressed myself to Mr. Creamer's paper first because I can understand the difficulty he had in developing a paper concerning ethical conduct in preparation of a financial report. He was asked to comment on ethical conduct in preparing, presenting, and dealing with the reporting entity while he, in fact, represented a user of financial information—for whose benefit this seminar is being conducted. The Code of Ethics of Robert Morris Associates does not deal with corporate reporting problems because it is not relevant to their concerns. I do observe, however, that only the first and fourth statements of the RMA Code (see p. 220) seem to recognize the need to protect the public. The other ten statements appear to me to protect those who are exchanging information, presumably against unethical acts of other members.

Parker

With respect to Mr. Parker's presentation, I would raise the following questions:

1. Aren't different ethical standards needed for an individual analyst doing investment research for third-party use than for the analyst serving as a manager of an investment portfolio?
2. Don't analysts, either individually or collectively, do more to influence the results they predict than do other financial information preparers, whether they work individually or collectively?
3. The analyst's view of independence or conflict of interest is unique. It appears that it is possible to establish independence by waiting a "sufficient" time after making a recommendation. Further, disclosure of material beneficial ownership of recommended securities appears to be sufficient to reestablish independence with respect to a recommendation regarding that security. As an investor, I find that disclosure of a conflict of interest does nothing for me. An analyst discloses that a fund affiliate owns $\$X$ worth of the recommended investment. Does this mean that he wants to artificially raise the price by increasing demand so he can liquidate at a profit? Shouldn't the analyst, his employer, and fund affiliates be precluded from making transactions in that security for some weeks before and after publishing a recommendation?

Nagel

I take issue with Mr. Nagel's original assumption that ethical standards cannot be established for financial reporting. He has presented a view which requires total knowledge and a coherent set of principles. Why not rely prag-

matically on standards based upon their correspondence to known facts? Why not rely on standards because they work?

I raise two other questions concerning his excellent paper. The first concerns the question of coexistent allegiance to the chief executive and to the statement user. The statement user might attach more credibility to financial statements if the chief executive subscribed to a code of ethics. The second question relates to his relationship to the auditor. Can the third-party user be well served if full disclosure of facts, assumptions, evidence, etc., is not made to the auditor? Is it the sole responsibility of the auditor to search for relevant evidence on which he gives his opinion? Doesn't the financial officer have ethical obligations to the auditor?

Mr. Nagel's observation that the financial officer's first responsibility is to see that management does not mislead itself to the ultimate detriment of shareholders is a perceptive one. When that responsibility is fulfilled, ethical problems involving honesty do not arise.

Olson

Since I have been intimately involved in the development of the AICPA's Proposed Restatement of the Code of Professional Ethics, my objectivity has inevitably been compromised. My biased view of my committee chairman's presentation is that he has done an excellent job. I share his concern about the obstacles for effective enforcement of technical standards.

The effort to view ethics in corporate financial reporting as a total process can perhaps identify significant opportunities for improvement. We must remember that the value of the reports we prepare and analyze is dependent on the degree of user confidence we have earned. We are continuously confronted with opportunities to either increase or erode that confidence. Let's hope that, individually and as a group, we may exploit these opportunities to better serve the consumer of our product.

Critique

Of the Olson, Parker, Nagel, and Creamer papers

By Walter P. Stern, *Senior Vice-President and Director, Burnham & Company; President, Financial Analysts Federation, representing the Financial Analysts Federation, and*

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The papers presented here have given statements of ethical considerations in four different professional areas. While each author states that, in general, more progress is needed in the ethical standards in each of these areas, we believe each author would also agree that what is considered acceptable ethics today is somewhat changed from the acceptable standards of thirty, twenty, or even ten years ago. And if some imagination were applied, it would seem likely that what will be acceptable ten, twenty, or forty years in the future may well be quite different from the standards of today; for, ethical codes of behavior have been changing over time, and this trend may well continue.

Each of the papers has presented an excellent view of some of the present ethical questions and the means by which present standards are determined and in some cases enforced. I would like to highlight and interrelate some of these ethical questions and then go a step beyond, discussing some areas of future change that I foresee.

Ethics and the Financial Analyst

Turning first to my own profession, that of the financial analyst, I will note that it is a profession that is itself new, emerging as a significant entity only with the end of World War II and the beginning of the postwar market in equities. Thus, the ethical standards of the financial analyst have had only a short period of time in which to gain an element of maturity. However, because the analyst works within the framework of a highly regulated industry,

the changes in ethical standards have in part been guided and directed by the changing positions and regulations of the Securities and Exchange Commission. In fact, in recent years the SEC has taken great leaps forward in determining proper ethical standards beyond what most of us in the industry would have imagined. I am referring here, obviously, to the McDonnell-Douglas case where the SEC took a quite different stance regarding fiduciary responsibility than most of us would have anticipated, stating, in essence, that the responsibility of the "tippee" was to the community at large rather than, more narrowly, to the investors in his charge. Interestingly, the SEC position places federal regulations regarding fiduciary responsibility in conflict with most state laws.

Outside of the particular ramifications of the McDonnell-Douglas case, the SEC has been moving rapidly in the area of defining inside information. In times past many so-called security analysts and money managers existed on advance and inside information from corporate officers and friends in business. While I would hesitate to even suggest this was considered ethical behavior, it was in many cases standard operating behavior. Today the situation is quite different. Not only has the giving and receiving of inside information been proscribed, the analyst has been told by the SEC that should he be given by management, information he believes has not been made public, and which is significant, that information must be publicly disseminated by management before he can utilize it. As Reed Parker points out in his paper, the significant criteria here is the impact such information would have on the price of a stock.

While the purpose of the SEC position has been to increase the flow of information to the public in general and to eliminate a flow of inside information to just a few select analysts, the net result has been a great deal of confusion and, in my view, has in some cases also reduced analysts' access to some companies. Due to the possibility that inside information might be revealed to a single analyst, many companies have chosen as an alternative meeting with analysts in large groups only. There has even been the question of whether members of the press should be allowed to attend such mass meetings.

Historically, many a good analyst has, in company interviews, placed great importance on his ability to "psych out" or to "read" management, when leading them through an interview on a one-to-one basis. Often as a consequence of his interviewing technique he can find out more about the company, and particularly, about areas of problems or potential problems than a company may wish to reveal. In a mass audience this technique is lost, and, ultimately, management ends up running the session, likely revealing only those things it chooses to reveal, and thereby possibly reducing the amount of information ultimately available to the public. I shall discuss the relationship between the company and the analyst at some length later.

The ethical considerations displayed in terms of the quality of analytical work and concern with the consuming public have come a long way in the

last twenty years, although at times such as the superheated speculative market of 1968-69, one wonders. By and large, analysts no longer buy stocks in advance of their own purchase recommendations; in many instances they will have no ownership positions in the industries or companies they follow. In time, analysts may be prohibited from owning the stocks of companies they follow. There is a growing use of primary sources for inputs rather than reliance on someone else's printed material, although there still appears to be a degree of plagiarism, unfortunately. In my view, the institutionalization of the market with higher quality research demands resulting, has made a significant difference. By and large, institutions simply demand more and better detail on recommendations. In addition, as professionals they have a level of understanding of securities analysis far beyond that of the retail customer. And if the brokerage community is to gain access through research to the commission dollars available from institutions, it must meet their quality requirements. However, again recalling the "hot stock" market of 1968-69, one sometimes wonders how much progress has actually been made as a result of the institutionalization of the market. In any event, many ethical problems remain.

Ethical Conflicts and Questions

Often discussed is the potential conflict that arises when a firm acts as investment banker for a company. Problems here include the availability of inside information and the difficulty of preparing objective research reports. At Burnham, our solution to the investment banking relationship problem is to draw a curtain between the investment banking and research departments. Companies are covered separately by the two departments. Furthermore, we do not issue research recommendations on companies where we have an investment banking relationship; we merely issue information reports. However, even when these two functions are separated within firms, the difficulty is not completely resolved. If, for example, an analyst truly believes a stock is overpriced, is he free to say so if that company is an investment banking client? As a compromise he can remain silent as to his views on the stock, but is this appropriate if the firm's customers own the stock?

An area which will be subject, in my opinion, to growing discussion also involves the underwriting function. First there is the question of whether a brokerage firm applies the same standards when recommending stocks in which a firm has an underwriting position as are used when the firm develops a recommendation independently within the research department. Second is the variation in the kinds of information that are available in conjunction with an underwriting. In a public offering, a prospectus is filed with the SEC, but certain important comanagers of the offering may also have the advantage of an underwriting memo containing information which the SEC will not allow included in the prospectus. Doesn't this put these comanagers in the position

of having more information than those investors seeing the prospectus? If a European prospectus is written, those having access to this particular document may also have an advantage over the domestic investor without access to this information. When a company is in the process of making a private placement, it may compile for these potential private investors a great deal of information on the company, including earnings projections, that it does not ordinarily make available to the public. If, while such a private placement is in process, a company changes its earnings projections, this change can have important impact on the price of their stock, with the individual investor unaware of the reason.

Subject to much present discussion is the position of the mutual fund or investment management accounts managed by the brokerage firm. How arm's-length can the relationship be? Who receives adverse information first, the in-house client or those outside? In my view the importance of this issue has been exaggerated, for the greatest motivation of any money manager is the performance he achieves. At Burnham we have no particular problem with the question of who receives information first; it is easily handled by our own internal rules.

Another question which has been raised, but which I think is unlikely to become an ethical problem of importance is that of block positioning and crossing of stocks when the firm's research department has a negative or positive attitude toward the stock. I believe that the trading function is sufficiently separate from the research function to prevent any real ethical conflict here.

Some other questions which I believe are of interest are these:

1. What are reasonable ethical standards to be applied when a brokerage firm makes a market in an over-the-counter stock and feels, legitimately, that the stock is a sound research recommendation?
2. On the institutional side, how many expensive dinners, baseball or football tickets, and Broadway shows constitute special compensation or a give-up for brokerage commission business?
3. Does a company sponsored and paid analysts' junket to visit their ski resort complex or their Florida land development company jeopardize the objectivity of analysts in working on that company?
4. What is the analyst's responsibility when he believes strongly, on the basis of his analysis, that a company is in serious difficulty, but can't prove it decisively? To publish his views could drive the price of the stock down sharply and could, in fact, totally undermine whatever is left of the viability of the company, indeed put the company out of business. Not only does the analyst put in jeopardy his future relationships with that company, he can perhaps be a causal factor of the very thing he was anticipating.
5. How far should an analyst go in analyzing a company's social responsibility posture? To date, this is still a very subjective matter, yet ultimately it may weigh heavily on a company's costs and its competitive position.

These are, in my view, some of the many areas of ethical consideration which are presently undergoing change regarding the financial analysts. Within five years, some of the actions currently regarded as acceptable ethical behavior may be so no longer.

The Analyst and the Company

The analyst does not work in an intellectual vacuum. Changes in ethical standards in the world around him will very much impact upon his own position. Perhaps the area with which the analyst is most closely tied is that of the corporation, ultimately the source of much of his information in company analysis.

The analyst has two primary responsibilities—to his company and to his customers or those for whom he has fiduciary responsibility. But because in part an analyst's capabilities are judged in terms of his digging out and disseminating sound information (in a brokerage firm environment) he is under much more pressure to reveal than to conceal. This, I think you will agree, is not necessarily true for the corporation executive. He also has two masters to serve, his management group and his stockholders; but stockholders are, to date at least, a relatively ineffective pressure group, so that by default the corporate manager's primary allegiance and responsibility is to the management group and the maintenance of its viability. Consequently, there is a natural tendency to show himself in the best possible light and to avoid, if possible, any indication that the management group is not functioning properly.

For many years in the history of the publicly owned corporation in the United States, any stockholder other than one in a position to dethrone management was treated as a nuisance and know-nothing. And, by and large, stockholders have accepted this subservient classification. Most of the SEC positions dealing with inside information, requirements for expanded reporting in prospectuses, proxies, annual reports, quarterly reports, 10-Ks, and press releases have been designed to require companies to reveal more about their operations. Much of the debate within the public accounting profession within recent years has been concerned with the same subject—providing accountants with guidelines so that management is made to reveal more information about the true details of their operations.

Corporation ethics have come a long way since the entrepreneurial days of watered assets, outright stock manipulation and sparse, at best, financial reporting. But there is still, I believe, a long way to go. Here also I think that the growing institutionalization of the market has been a major factor in pressuring companies to reveal more of their operations. Granted that at times it has been an adverse factor when institutional investors have sought short-term performance and have pressured managements to achieve short-term gains in earnings at the expense of the longer-term health of the company. But

on balance, I believe that the institutions' drive for more and more information and their great ability to provide needed bond and equity financing to companies has been beneficial in terms of pressure they have applied on companies directly, and indirectly through the SEC.

In earlier days management and ownership of the company were by and large the same. Today management is usually a group of hired professionals with only limited direct ownership of the company. Yet the shift is incomplete. The board of directors, having overall responsibility for the direction of the company, is only in theory elected by shareholders as the limited numbers of proxy fights would indicate. Individual stockholders have rarely had either the strength or the will to introduce a second slate of candidates for the board of directors, and thereby gain anything. Professional investment groups have usually taken the view that unless they agreed with management they should not own the stock, and thus, have chosen to sell stock holdings rather than attempt to change management. Thus, in reality the board of directors and the management of the company have become largely self-perpetuating. It is only in very recent years that the Lewis Gilberts, Wilma Sosses, and Ralph Naders have begun to vocalize about management policies, and they have done little more than nudge management. The Financial Analysts Federation has, through the work of its corporate information committee, attempted to upgrade the quality of corporate reporting through granting awards for excellence each year. But I am afraid that even here the results, in terms of getting managements to do a better job of corporate reporting, have been relatively meager. We have awarded the excellent, but, beyond reporting problem areas to the SEC, have done little in terms of punishing the difficult.

The Financial Officer

Mr. Nagel writes at some length about the various audiences for company reports and the difficulties of satisfying all of them. While there are many different groups having claims upon the financial information a company can provide, I would think the company's primary responsibility is to the owners of the company, the shareholders. In most instances these will be long-term investors, seeking, as Mr. Nagel says, steady long-term growth generally coinciding with the goals for the company established by management. However, to take the subject to its absurd limits, what if a major portion of the stock were owned by two-day or six-week traders, would not the company's responsibility at that time be to their needs (recognizing that in both instances the position of the SEC becomes an intervening factor)?

Certainly the requirements of the company's creditors cannot be ignored. But they are not owners, merely lenders. The apparent strengths of the banks and other lending institutions vis-à-vis company managements have, in my view, developed as a consequence of the relatively weak positions of the company owners; the lenders have, in the past, exercised much more muscle.

But, one can certainly raise the question of whether they have an inherent right to obtain more information about a company than its owners.

Companies have long claimed that the need for secrecy is a function of competitive position. Yet my experience has been that a company is often more willing to discuss new developments which reflect well on their managements. This even occurs when one might assume that such announcements might enable competition to react more quickly. I am thinking here of such things as new products only in the prototype stage and new store locations. It is human nature to be more reticent to disclose adverse developments or to postpone recognizing and announcing a difficult decision until the last possible moment. Analysts frequently complain that information which is already known to competitors or is readily discernible to someone within the business such as market share, or profit margins by product line, has been very difficult to obtain.

Logically there are, as Reed Parker points out, always some areas which a corporate officer may be willing to discuss with an analyst but which if attributed or even emphasized in a report would be damaging to a company. In my view this is not really a question of ethics but of good manners. Just as one would hardly reveal a personal confidence such as a report of a friend having marital difficulties, a management statement that weak union leadership would allow for an easy labor settlement should come within the same category of confidence.

The Accountant Enters the Picture

The relationships between the corporate financial executive, the public accountant and the securities analyst are becoming increasingly intertwined. The securities analyst seeks to develop a knowledge of the true results of a company's operations; the corporate financial executive usually desires to show his company in a good light; and the public accountant must certify that the reported financial results are proper. As new industries develop in the United States economy and as corporate managements become increasingly sophisticated in the management of capital, the job of the certified public accountant has become increasingly complex. In recent years the AICPA has had to come to grips with the growing use of quasi-equity instruments such as convertible debentures and warrants, the mushrooming acquisition movement, and franchise accounting, among others. Currently under discussion are land development accounting, leasing, marketable securities, overstated sales prices, and many other measurement problems. One of the great difficulties faced by accountants is that they are invariably working after the fact, dealing with abuses of present accounting regulations.

The position of the public accountant is today undergoing rapid change in my opinion. Whereas formerly he was held responsible merely for attesting that corporate reports were made in accordance with generally accepted ac-

counting principles, increasingly he is being required to point out that while accounting treatment may be in accord with generally accepted accounting principles, the financial results are not all what they seem to be. The most obvious example is the *Penn Central* case where the accounting firm of Peat, Marwick, Mitchell & Co. is being sued for failing to indicate that the Penn Central was in serious financial jeopardy. Recently we have seen, in a few instances, accountants noting in their statements that a firm was, on the basis of present capital structure, in serious financial jeopardy—an important step forward in my opinion. And I find increasingly that analysts are, in fact, reading the auditors' certifications to determine if there are any exceptions.

One of the serious strains upon the ethical position of the certified public accountant is, as Wallace Olson indicates, the relationship of the CPA firm to the corporation. Theoretically hired by stockholders, the CPA firm is, in fact, paid by the corporation which, realistically, wields the power to hire or fire the auditing firm. Just as few stockholders have seriously challenged a slate of directors proposed by management, I know of no instance where they have suggested, much less successfully elected, a different accounting firm than the one proposed by management. Thus, if an accounting firm chooses to take a tough stand vis-à-vis a reporting method desired by management, it faces the very real possibility of being replaced as the firm's accountant. In realistic terms this places too great a burden upon the accountant. Prior to the new SEC regulations which will require companies to notify the SEC whenever they change accounting firms and also require a letter from the resigned firm stating the reasons for the change, the debate between company and accounting firm was very much one sided. The company had nothing to lose, the accounting firm everything—the account. I would not want even to suggest that the accountant invariably knuckles under to the company position. I am suggesting, however, that there are inevitably a great many compromises along the way. Even though none of these compromise decisions in and of themselves would be regarded as material, in fact none of them may be in the best interests of the shareholders.

In negotiating sessions with company managements, the accountants work under another handicap. While they are expert accountants they often have relatively little awareness of the impact that the final financial statements have upon the investing public. Company managements which deal almost constantly with the securities analyst are well aware of this impact and thus are in a position of strength of knowledge in terms of framing the financial statement to maximize their image with the analytical profession. Hopefully, as the FAF and the American Institute of CPAs work more closely together, this knowledge deficiency will be ameliorated.

As consumerism moves into the area of corporate reporting the threat and fact of sizeable lawsuits against accounting firms will definitely help to strengthen the backbone of the accounting firm in its dealings with corporate management. If the costs of a potential lawsuit will be more burdensome than the possible loss of income from a corporate account, the choice is much simp-

lified. This threat is very real. Since accounting firms are partnerships, any financial liability of the firm becomes a personal liability of the partners. While liability insurance has been sufficient to date to meet most or all such settlements, premiums for such insurance are on the increase. Although higher premium costs can be incorporated into the fee structure paid by company managements, any accounting firm whose premium costs got out of line would be pressured to eliminate the causes of those higher costs. Being held truly accountable to the shareholder will help considerably in establishing the fact of independence for the public accountant.

I find that I must take serious issue with Mr. Olson's statement that "the auditor's opinions on financial statements do not relate to the quality of management but rather to the fairness of presentation of financial position and operating results . . . . It is difficult to demonstrate how the auditor can cover up bad business decisions simply through application of accounting or reporting techniques." So long as auditors are stuck with a "Napoleonic Code" of specific generally accepted accounting standards rather than a "common law" standard, they will probably accept too many judgments from management as to how results are to be determined and presented—judgments which are in too many instances designed merely to obscure bad management. I am not suggesting that there is any altering of accounting records by collusion. Rather, there is frequently the need for an application of *judgment* as to whether the financial statements do *truly* present fairly the results for the period. Some obvious past examples come to mind.

1. Franchise accounting where sales of franchises were not segregated from results of ongoing operations.

2. Allowing deferred expenditures to reach major proportions. Here, I am thinking specifically in terms of one company in which deferred lease acquisition, marketing, and research and development expenses totaled $32.6 million at the end of 1970, compared to the company's total net worth of $39.1 million. This particular company has had some areas of major disagreement with its auditing firm, and the auditors have prevailed in forcing sizeable changes. They have not, however, gotten around to this, in my opinion, very questionable deferred expense item.

3. Treating marketable securities held as either current or long-term assets, apparently at the whim of management, depending on whether it was more favorable to carry them at cost or market. This abuse will, hopefully, be dealt with in the forthcoming APB Opinion on marketable securities.

4. Questions of materiality. A company management can scrape together a good-looking annual statement merely by making a number of changes in accounting procedures or estimates. No individual change is of sufficient significance to require disclosure, yet together they can add up to be quite favorable.

One of the great challenges to patience and endurance faced by an analyst occurs when he believes a company's earnings are being significantly overstated and that, sooner or later, the accounting profession will catch up with this overstatement. In the meantime, however, the stock may perform very strongly on the appearance of a very good earnings record. In such situations a kind of Gresham's law of securities analysis comes into play—bad analysis drives out good. This is one of the reasons why analysts are so concerned with the elements of accounting.

Fortunately, the accounting profession is moving very rapidly and with great dedication to resolve many of these difficulties. Anyone who is aware of the great amounts of time and money being expended by the accounting firms, not only in terms of their membership and support of study groups and the APB, but also in terms of the intracompany decisions required almost daily, recognizes the multitude of changes going on within the profession. An excellent indication of the profession's own concern is the two study groups currently in process on (1) determining the objectives of financial statements and (2) a review of the very means by which accounting principles are established. Because both groups are heavily weighted by individuals outside the accounting profession, it is possible that some important new concepts will come out of these two groups. It is obvious that the accounting profession is rapidly coming of age.

The Banker

I have left the discussion of Mr. Creamer's paper on banking ethics last for two reasons. First, because the ethical considerations are somewhat outside the very closely intertwined relationships between the securities analyst, corporate financial officer, and accountant and second, because it is the area in which I have the least personal knowledge.

Mr. Creamer raises some very interesting questions regarding the responsibilities of the banker to his banking clients, his banking associates, and his principals. The ethical questions here are probably the most difficult to tackle because in each case he has a great responsibility, with no one area demanding prior consideration. Clearly he has a responsibility not to divulge confidential and nonpublic information provided him as a lender, yet at the same time he is serving as a credit reference on companies where he is a lender. The bank that serves as a lending institution, with access to privileged information in support of that function, may also manage hundreds of millions of dollars in portfolios invested in bonds and equities. Any seepage of this privileged information between the lending operations and the portfolio operation grants the portfolio managers an advantage through the use of inside information. While in the past this was merely an ethical question, with the recent McDonnell-Douglas decision, it is now patently illegal.

However, of even greater concern to many is the question of how much is too much. I am speaking here of the more than $300 billion in investments managed by banks, the largest single pool of investments in the world. With that kind of power, the banks are obviously in the very difficult position of bearing the responsibility for acting in the best interests of their principals without at the same time, because of their power, acting very much in their own interest. The ethical challenges are enormous.

In the recent APB Opinion on accounting for equity interests it was determined that, in the case of corporate ownership, a 20 per cent stock interest in another company was sufficient to be deemed control. While banks have as yet been reluctant to publish their fiduciary holdings in corporations, so that facts cannot be ascertained, I would venture that there are instances where a bank may have control over the voting authority of 20 per cent or more of the stock of a company.

There are the very real questions raised: Can a bank act in a dual capacity, as both a fiduciary and lender? And, even if in its own view the bank can fill both of these roles independently, will it be so regarded by a third party—the company? In other words, the appearance of the ability to exercise power may be more important than the decision to exercise that power.

In my judgment, many of the ethical questions being raised in regard to banks will, before long, be answered either through new legislation or judicial interpretation. And we may find that when ethics are regulated the changes required can be much greater than might have been expected.

Conclusion

As a securities analyst I can safely say that whatever regulation has been imposed in regard to ethics has been in the long-term interests of the investment world, certainly for the consumer and ultimately for the firms themselves. Raising the level of ethical standards cannot hurt the responsible firm or individual; it can only sanction and strengthen the positions that they have already taken in the past. Higher ethical standards will, however, drive out of the business those unsavory unethical elements in its ranks. Therefore, I feel very strongly that whatever we can do to bring about improved ethical standards for the business we represent will be of benefit to all of us.

Critique

Of the Olson, Parker, Nagel, and Creamer papers

By Donald P. Jones, *Senior Vice-President—Finance, Sun Oil Company (retired), representing the Financial Executives Institute*

The topic of the symposium is a broad, almost nebulous one, and it will be difficult to effect a reconciliation of the four viewpoints in this paper. However, I will approach the assignment by showing that the requirement for more emphasis on ethics in financial reporting, an area of commonality in the four papers, can be resolved through better disclosure, honesty, and integrity on the part of financial statement preparers, and a better understanding of financial reporting objectives and problems on the part of the financial statement users.

First of all I would like to address myself to some specific points made in the papers. There seems to be no controversy among the four authors over the assumption that the responsibility for the preparation of reliable financial reports rests with corporate management. However, some differences in thinking are evident regarding the question: To whom is management primarily responsible for honest and reliable financial reports?

Whose Interests Take Precedence?

Mr. Nagel starts out in his paper with the statement that the interests of the general public, customers, labor, and others in financial reports are definitely secondary to those of the investor or owner of the enterprise. Mr. Creamer takes a different position by placing the bank officers' responsibility to their stockholders in a secondary role to that of the community. Mr. Olson indicates that the auditors have an obligation to be completely fair both with their clients and in meeting their responsibilities to the public. He goes on to say, however, that where conflicts exist, the public interest must take precedence.

I agree that management's responsibility for financial reporting runs first and foremost to its stockholders, but at the same time we must recognize management's obligation to the public for honest and reliable reporting. The ques-

tion then is how we can meet this dual responsibility. First of all, we, as corporate management, must be willing to take a hard look at ourselves to make certain our reporting practices are honest, reliable, fully informative, and in tune with today's requirements. Then, each of the disciplines represented at this symposium must reach a better understanding of its individual responsibilities relative to financial reporting.

Mr. Parker states that the analyst's relevant information base rests in an unusually large number of disciplines beyond financial analysis itself. Accounting, he says, is crucial. I agree that it is an absolute necessity for analysts to have a complete understanding of accounting, financial reporting practices, and the related responsibilities of corporate managements. Such an understanding would support the analysts' responsibilities of properly interpreting financial information for their clients and would quiet much of the criticism made by analysts themselves. The same advice applies to bankers and is borne out by Mr. Creamer's admission that a bank officer has to understand the businesses of his borrowers as well as the principal philosophies of management which are the underlying forces creating the numbers in the financial statements.

The Need for Adequate Guidelines

The auditor's responsibilities, according to Mr. Olson, are based on his obligation to express his professional opinion as to whether or not his client's financial statements are fairly presented and not misleading. He points out, however, that the present auditor's report does not indicate whether, in the opinion of the auditor, the best accounting standard was applied in those areas where there are acceptable alternatives. I believe that this is a weakness and when corrected will firm up the auditor's responsibilities and help settle the argument over alternative accounting principles.

Mr. Olson goes on to state that no matter how extensive and how refined the accounting and reporting standards of the profession may become, they will never be wholly appropriate under all circumstances. I say amen. Also, I am thoroughly convinced that the members of the Accounting Principles Board could not be more aware of this. However, in their overreaction to adverse criticism, they have chosen to disregard this philosophy and concentrate their efforts on the development of rigid, inflexible, and highly detailed rules which would seem to virtually assure their inappropriateness to specific situations.

I strongly urge that the APB stop reacting drastically to outside pressure, breathe life back into flexibility, and commence developing broad, general accounting guidelines (standards). This will enable companies to apply the accounting principles which are most appropriate to their situations. In order to prevent unethical application of accounting principles, companies should

be required to fully disclose the justification for any departures from those standards which are most appropriate for their circumstances.[1]

Mr. Nagel states that the divergence between the interests of lenders, speculators, and investors in equity securities is sufficiently great that decisions affecting the financial reporting of a corporation could be made in quite different ways depending upon which category of interest is involved. I agree with Mr. Nagel when he goes on to say that the problem of the financial executive becomes one of preparing financial statements with a balanced viewpoint. Full and fair disclosure meets the criterion for a balanced viewpoint and clearly takes care of the needs of all interested parties.

Insider Information

Admittedly, cases will arise where additional information will be required by various classes of statement users. While there is no requirement that the financial executive, as the source of information, do the work for them, it is part of his responsibility to make available to the certified public accountant, the financial analyst, the commercial bank lending officers, and others sufficient information to permit them to properly discharge their responsibilities. This information can be divulged at group meetings, at individual conferences or otherwise, but always with the purpose of satisfying the real needs of the user while conserving to the greatest extent possible the time and energy of all parties. If these disclosures include anything new or startling, they must be made available simultaneously to the general public.

There is, of course, the problem of insider information and whether certain types of information having to do with the change in status of a company should be revealed upon request or otherwise, but these deal with basic matters of personal honesty and integrity. It seems to me that it *is not* the responsibility of the financial executive to paint a picture which portrays his corporation in the most favorable light but rather, it *is* his responsibility to give full and accurate knowledge of the precise situation in which his corporation finds itself to those who are interested in it. While it is appropriate for him to maintain the highest possible credit rating in the event of the need for outside sources of funds, it is his responsibility to achieve this objective by seeing to it that his corporation conducts itself in such a manner as to deserve the rating and that the existence of this condition is duly impressed upon the financial community. It is not his responsibility simply to live within the letter of the law or by any specific rules of professional conduct or generally accepted accounting principles. These should be guidelines and should not be ignored, but his primary

[1] In this regard I should like to refer to the excellent approach set forth by A. Carl Tietjen, "Financial Reporting Responsibilities," *The Journal of Accountancy,* January 1971.

responsibility is to portray a true and accurate picture even though the means are new and revolutionary. Such conduct on his part will not only achieve the results desired but, in the process, will contribute toward the development of superior financial reporting.

Agreement Among the Professions

A review of the papers presented by Messrs. Creamer, Nagel, Olson, and Parker clearly indicates that these gentlemen have restricted themselves to their own particular field and, happily, have not added in any degree to the disagreement and, indeed, acrimony which has sometimes characterized the relations between the disciplines which each represents. While I would not expect to agree with all points made in the papers, I do think that the various ethical problems are clearly delineated and provide much food for thought. Each supports the thesis that the practitioners in his area are generally of high moral character and need little detailed surveillance. With this I concur and, moreover, I believe the same concept is applicable to people generally once they recognize the *general* rules of the game. However, I commend the AICPA, the FAF, and the Robert Morris Associates for their real efforts at self-regulation, including the adoption of standards of ethical conduct, even though those manifestations of the aim for perfection are helpful chiefly in providing the *appearance* of adherence to high ethical standards which, in this cosmetic age, sometimes seems more important than adherence itself.

In general, it is my thesis that practically all of the problems expressed by these gentlemen as they concern interdisciplinary matters are related to the assumption of inevitable conflict whereas, in my opinion, this assumption is invalid and inappropriate. If this critique is to have one simple theme, it is that no basic conflict exists between financial executives, certified public accountants, financial analysts, or credit grantors and that the purpose of all is to provide full and adequate disclosure to their various publics so that those publics are fully informed and in a position to make appropriate judgments for themselves.

We would do well to recognize, however, that there are two situations which make the achievement of these objectives extremely difficult. One of these is the fact that the language of accounting deals specifically with dollar-and-cents figures with which the layman considers himself fully familiar and completely competent to analyze. It is common belief that the income statement should reflect the "true" income of the company for the period indicated and that the balance sheet should truly set forth the value of each of the assets enumerated. Since there is little recognition of the fact that each individual has a different idea of what constitutes "true" income or the proper valuation of assets, even the most meticulous and ethical practitioner will necessarily fail to produce results which fully satisfy the preconceived, but largely unexpressed, views of the public generally or even of his particular clientele. Were

we able to express our financial statements by the extensive use of algebraic symbols or other means less familiar to the public, there would be a greater willingness to admit the need for definition, intelligent interpretation and analysis, and much of the communication gap now present would disappear.

The second problem has to do with what I would describe as the general moral decline which has been especially noticeable during the past thirty or forty years. This is particularly evident over the entire span of this period through the increasing acceptance of the philosophy that an individual is entitled to get all he can regardless of the merits of the case when he is dealing with the government and with large companies, particularly insurance companies. I believe this same moral decline has been evidenced even more noticeably in recent years by the irresponsible attacks on institutions of all kinds without relation to the facts and apparently chiefly for the purpose of obtaining notoriety or personal gain for the individual attacker. While these somewhat extraneous situations may have little impact on the ethics of corporate financial reporting as such, they do severely influence what can be accomplished in the area of improving the credibility of financial reporting.

From my point of view, corporate financial reporting is the sole responsibility of corporate management. The responsibility of the certifying public accountant is basically limited to the attest function, indicating that, in his professional judgment, the financial reports certified are correct and do accurately portray the financial results of operations during the reporting period. Insofar as financial reporting is concerned, it is then the responsibility of the financial analysts and the credit grantors to properly interpret these statements for their individual publics and to assist those publics in making appropriate judgments based upon the financial results of operations in whatever areas their clients may have interests. Since we all seem to agree that no one type of reporting and no single form of financial reporting will satisfy all interests, management must decide how best to acquaint its stockholders with the true nature, status, and prospects of its affairs and pattern its financial reporting to achieve that end. It then has the responsibility to make available whatever additional information is necessary to satisfy all other legitimate interests as previously discussed in this paper.

Toward the Goal of Professionalism

While it is the prime responsibility of management to provide the means by which these various ends may be accomplished, it needs to, and should, encourage suggestions and assistance in accomplishing its objectives from many other sources, specifically including the other participants in this symposium. It should be clearly indicated, however, that this goal of achieving a complete understanding on the part of all concerned is quite different from the impossible dream of providing a foolproof system to catch or call to account all nefarious activities. This means that all elements in this symposium should per-

form their functions in a highly professional manner, welcoming further suggestions as to improvement rather than attempting to prove their expertise by devising specific, detailed, and rigid rules by which our less talented or less highly motivated associates should be held in line. It should be recognized that rules which are too strict and confining breed the desire to beat the system and that human ingenuity, in time, will in fact achieve that aim regardless of the quality of the restrictive edicts. In such cases, it would be far superior to assist the constituted legal authorities in prosecuting those who conduct themselves improperly. It perhaps follows that it is impossible and probably even undesirable to protect people from their own folly, but it is most desirable and possible to provide the tools whereby they will be able to make competent judgments in what they consider to be their own interests.

As a final philosophical comment, let me add that the search for perfection is commendable, but our enthusiasm for attaining this end should not blind us to our individual inabilities to achieve it, and we should be ever mindful of the absolute necessity of maintaining a healthy climate in which progress may continue toward that ultimate goal.

Critique

Of the Olson, Parker, Nagel, and Creamer papers

By Norman J. Collins, *Senior Vice-President, The South Carolina National Bank; 2nd Vice-President of the Robert Morris Associates, representing the Robert Morris Associates*

This was a highly interesting although rather disparate group of papers to critique. My reactions ranged from agreement, through shared perplexity, on to disagreement, and back. In general, let me commend these four writers for the depth and perceptiveness of their convictions and the persuasive manner in which they set them forth. Because of the varied content of the papers, my comments are directed primarily to the papers individually.

Olson

Mr. Olson's is an exceptionally well-reasoned paper. The accountant does, indeed, have many conflicting demands which tug at him—perhaps a greater number in an absolute sense than most of the other professions represented—and Mr. Olson and his profession are to be commended for expressing them so openly. Change has not always been as rapid as we (and they) would like, but progress has been made and determination for further improvement comes through strongly.

Despite this progress, and after noting the many opportunities, which Mr. Olson identifies, for an accountant to behave unethically or unwisely one could conclude that attacking these opportunities as individual problems would be almost impossible. A solution would seem to call for a restructuring of the whole environment. While Mr. Olson never did pose this possibility as such, he seems almost to have anticipated it in that in a number of critical areas he does pose radical alternatives to the present way of doing things. But, without exception, he provides logical reasons why these are even less desirable, on balance, than present practices.

Nowhere is this undesirability more striking than in those several areas where, if the present system continues unimproved, government intervention may be the next step. This alternative more than any other should provide strong incentive to all parties represented at this symposium to work for im-

provement. There is no reason whatsoever to believe that bureaucratic intervention in this area would be any less rife with inefficiencies and conflicting demands than in other areas where control has already shifted.

Ethics is a concept highly oriented toward the individual, and most examples of ethical conflicts ultimately get down to a choice between some action which is proper or "noble" in the eyes of almost everybody else, but which runs counter to the responsibility which every individual has to himself and to his own materialistic well-being. A good example of this is pointed out by Mr. Olson in his discussion of "independence, integrity, and objectivity" where he discusses instances in which completely ethical behavior on the part of the accountant would undoubtedly result in the loss of both the client and a substantial fee. Olson was both wise and practical in introducing this point; it indicates how quickly a discussion of ethics in *any* profession can switch from a comfortable setting of hypotheses and generalities to areas which can be truly "gut-wrenching."

At any rate, we can wonder whether there is some way to spare the accountant this awful "either-or" dilemma. Perhaps the problem could be partially solved through greater insistence that the auditor report only to an audit committee composed of outside members of the board of directors, particularly in areas as sensitive as this one. Another approach might be to require that accountants make public statements when they choose to drop an engagement. (Of course, such an action would itself raise ancillary problems which would require a careful balance between frank disclosure and the laws of libel and defamation.) The question here is basic: If loss of income is at times a deterrent to wholly ethical conduct, could we not find some way to mitigate such losses?

Elsewhere in that same section, Mr. Olson discusses contingency fees. There can scarcely be disagreement that such arrangements should be prohibited in connection with the expression of opinions on financial statements. Consider, for instance, an accountant preparing a statement on a contingency basis whereupon a loan is to be obtained or a new equity issue is to be subscribed completely. Such a situation would have heavy potential for professional compromise. Yet, admittedly, there are gray areas. The author mentions one—tax matters. Others which come to mind are finders' fees for money, property, or personnel. But, in general, if the accountant does not receive, on the basis of his usual fee schedule, adequate compensation for work done, then bankers, among others, should be willing to support a legitimate increase.

Olson next discusses competence and technical standards. A discussion of the competence of accountants is difficult for at least two reasons. First, the degree of competence of any professional person is almost always a matter of judgment rather than of fact. Second, competency—or incompetency—refers to individuals and not to a profession as a whole. Most accountants are thoroughly competent professionals. However, perhaps he should not go so far as to state that there is no "serious public concern about the profession's competence." The number of recent law suits against major accounting firms

alone—and we must assume they have some reasonable basis in fact—would seem to contradict this assertion.

Competence, of course, involves far more than judicious adherence to a code of ethics and the possession of unassailable honesty. It even goes beyond the consistent application of those accounting and reporting standards which are most appropriate in each case. It is so broad, in fact, as Mr. Olson states, as to require a complete understanding of all the peculiarities of the client's business. With this in mind, we can only wonder whether there are instances where accountants have accepted an audit assignment which by most reasonable standards is "over their heads." An editorial in the July 24 issue of *Business Week* treats rather directly of this subject; to quote in part:

> Members of the New York Stock Exchange, understandably annoyed at having to ante up $100,000,000 to pay off debts of busted members, have filed suit for $5,000,000 against the partners of Orvis Brothers & Co., one of the fifteen Wall Street firms that failed last year. By including the Orvis firm's auditors, Haskins & Sells, in the suit, the Exchange has given the public a glimpse of one of the messiest problems in the securities industry: The audited statements on which everyone depends for information about member firms sometimes conceal weakness rather than reveal it.
>
> Auditing a brokerage firm is a very complex and difficult job. But that is no reason to let the auditor off the hook. No law compels the accountant to take on a job he cannot handle. If the accounting profession has bitten off more than it can chew, it has done so eagerly. It has oversold the capability of the independent auditor. It has represented that accounting is a matter of fact when clearly it is a matter of opinion. And, by carrying balance sheet figures to pennies, it has implied an exactness that never exists.

It is not a purpose of this critique to agree with or rebut these harsh words. Rather, the point to be made is that it is the accountant himself, and not a client or third party, who is in the best position to judge his own competence, and that one of the most highly ethical practices in which an accountant or any other professional can indulge is this very type of self-examination *prior to* accepting an engagement. It is better to prevent a suit than to win one.

In discussing technical standards, Mr. Olson and his profession are to be commended for the efforts which they are making, including two highly important study groups, to eliminate alternatives and establish principles in areas where they may be lacking. Particularly noteworthy was his statement that "the degree of sophistication and the needs of users vary so widely that it seems inevitable that multiple types of financial statements must be designed to meet the specific needs of each user group." This is based on the premise that the same form of financial statements cannot be all things to all people, and we bankers would agree with that.

How rapidly such special types of financial statements will come into

being is, of course, not known at this time. Meanwhile, we bankers would continue to press for sufficient detail and comment in the traditional format to give us a complete picture of a borrower's operations. We encourage the CPA to be as detailed and meaningful in his reports as his fee arrangement with the client permits.

In his discussion of how and by whom accounting and reporting principles should be established, Olson summarizes the significance of the wording of the short-form report in a succinct and laudable manner. If the profession can ever get to the point where users of short-form reports can consistently assume that the type of considered judgments and sorting of alternatives which he describes have indeed been applied, a giant step will have been taken.

In this same area, and also commendable, is Olson's forthright stand on the auditor's accepting responsibility to choose the best accounting standard when alternatives are available. In the face of client pressures and competitive forces, it is sometimes all too easy to permit a sort of Gresham's law to prevail, resulting in the adoption of auditing standards and generally accepted accounting principles which, by more objective standards, are far from optimal.

His acknowledgement of the profession's ethical responsibility to develop accounting and reporting standards for new and complex forms of transactions —many of which are subject to abuse—is critical. Examples readily come to mind: computer leasing, franchising, land development businesses and, as alluded to earlier, securities dealers. But with this responsibility goes the concomitant one of avoiding rules which are entirely too complex, confusing, ambiguous, and even conflicting. What have we gained, if, in an effort to resolve one problem by setting out rules and guidelines, interpretive problems are created in other areas not foreseen or anticipated?

Olson concludes by observing that to the extent that education and voluntary compliance with the ethical standards of the profession fail, to that same extent recourse should be had to enforcement through disciplinary proceedings. This is certainly the proper relationship of the cart and the horse: voluntary compliance, as he pointed out, is generally better than forced compliance. And in the special area of voluntary compliance through education, perhaps we bankers have our own special ethical obligation to the accounting profession—that being to work with the profession in discovering and eliminating, through various professional review mechanisms, allegedly substandard audit reports. We bankers haven't done too good a job in this area for a number of reasons, including inertia. We seem, rather, to be all too content to categorize the work of a given accountant as something less than desirable, and, therefore, sort of "work around him" in any future dealing, and/or to rely upon our ability to cope with each instance of incomplete or unsatisfactory audit information on a case-by-case basis, ferreting out on our own whatever additional information or background circumstances we have a hunch we need. This works or does not work in direct proportion to the analytic skill of the banker, but it is at best a short-run, symptomatic approach and does not work toward the betterment of both professions in the long run.

Nagel

Mr. Nagel states right at the beginning of his paper that "there is almost always more than one right alternative" in corporate financial reporting. While one might question the "almost always" condition, it is true that options are offered in a number of areas. Evaluation of inventory and depreciation practices are prime examples of this, as they afford numerous alternatives perfectly acceptable in accounting. But it also appears to be true that in some areas, even though options are available, one appears to be more proper than others for the best financial reporting, and an ethical responsibility exists to find and apply it.

The presence of alternatives also points up rather forceably the need for more explanation as to the methods used in, and the rationale behind, the preparation of reports to be used by many different classes of people. Documentation as to what method was used as well as why it was used would be highly desirable.

A bit later Nagel states that, "whatever others may think, the interests of the general public, customers, labor, and others in financial reports are definitely secondary to those of the investor or owner of the enterprise." The problem with this statement is that he never does define "investor" in a consistent manner. The general tone of the paper is that he is speaking of investors in the sense of equity purchasers. Later, however, he does indicate that an investor can also be one who lends money—but even here he appears to be thinking less of the commercial bank lender and more of the purchasers of debentures or bonds. The obvious point to consider, of course, is that whenever creditors have more money in the firm than the equity interest, they certainly should not take a back seat to the investor or owner in the area of getting full information.

Although there is a passing mention of lenders needing his reports, the general thrust of Nagel's paper is emphasized where he says that "this paper does not deal with reporting to persons or institutions other than investors." Who is, then, responsible for reporting to creditors? Why does he believe his reports are not ever for the use of creditors? What about interim reports under term loan or revolving credit agreements prepared by management? Does this indicate that the comptroller or accounting function reports to someone other than the financial officer?

Through his paper, Nagel treats of a number of points in the relationship as he sees it between the corporate financial officer and his chief executive. Two of these areas are worthy of comment. At one point the author says that "interviews are primarily the responsibility of the chief executive. . . ." Has this been his experience as a practical matter? Interviews with bankers, for instance, are more often handled by somebody in the financial area than by the chief executive himself. In another area, Mr. Nagel remarks that the corporate financial officer supplies the chief executive with all of the information and the latter assumes full responsibility for its publication. Perhaps—but if somewhere

the financial officer's name is connected with the report, then he must also assume personal responsibility for what is disclosed.

Particularly in the first third of this paper, the chief financial officer comes through again and again as a "company man"—so strongly that one hesitates to envision a conflict between that posture and ethical decisions which may have other good effects on the company. (We might go on to wonder in the same situation what the financial officer's ethical posture might be vis-à-vis the outside auditor.)

Throughout much of the paper Nagel puts much stress on the financial executive's rôle in reporting on the status of projects in process, and rightly so. For instance, several years ago a large computer manufacturer got a temporary black eye in the financial community because, in the interest of beating one or more of its competitors to the punch, it announced a broad new series of third generation computers before they were truly ready for sale and while there were still bugs to be worked out. Was this unethical behavior? By way of another example, consider the business in which there is some honest doubt about the ultimate outcome of a major undertaking—there is a hint of dark clouds on the horizon. Hypothesize further that the business is being audited, and though the auditors review the circumstances, they fail to pick up the potential problem. Suppose further that even though management is of the opinion that things will work out ultimately, they know that if the matter is brought to the attention of the auditor it could materially affect the outcome of the engagement. What ethical obligations, if any, does management have in this situation to share its concern with the auditors?

In discussing the responsibilities of the corporate financial officer, Nagel says: "He must see that the corporation's accounting to the public helps maintain rather than reduce its source of funds." In this statement, he has highlighted a very serious potential conflict of interest, and one which may be contradictory to part of what else he has said. Such reporting must above all be honest, *regardless* of what affect it has on the source of funds for the company. There are multitudinous opportunities for the corporate financial officer to play up one aspect of the company's potential or play down another in order to keep creditors or the investing public or financial analysts or the government in a certain frame of mind. Perhaps that's his job. But if it is, and if he subscribes to the statement made, he is admitting a very serious potential conflict of interest as soon as the company's fortunes begin to wane even on a temporary basis.

There is a situation which is related to both the preceding points (reporting on projects in process and reporting so as to maintain a source of funds), and that has to do with the decision to maintain or drop a product line which has seen only limited profitability. Are there ethical overtones in facing this decision, in costing the product, in assessing its past versus its potential, or in considering the impact on the company's total posture and reputation? Scott Paper Company, for instance, has recently, and quite abruptly, gotten out of the disposable diaper business, with a significant writeoff in the April-June

1971 quarter. A large bank, with equal suddenness and finality, recently withdrew from the credit card business. Can we say with certainty that the fact situations in both cases were so incontrovertible as to leave management with no choice but abandonment? Did Scott, for instance, have any ethical responsibility to its stockholders and to certain of its management "diaper-devotees" to slug it out with Proctor and Gamble, its major diaper competitor? Did the bank have any similar obligation to stick with the credit card and determine to turn it around? These are rhetorical questions only in the context of the two specific fact situations. In a general sense, they are far from rhetorical: ethical considerations can well be present in product-line decisions, and management, including the financial executive, must recognize and reconcile them.

Another related area is what might be called "managed earnings." In an effort to continually show better per-share results, many publicly held corporations are inclined to include next year's expenses in this year's earnings report if business is going extremely well, and vice versa if profits are under pressure. There is a related problem in some closely held corporations whose managements want to understate earnings on a regular basis. The question becomes whether such shifting is adequately constrained by current accounting and reporting standards. And if so, is there a gap between theory and practice? Is not the size of this gap a good measure of the ethical considerations involved—both for the financial officer and the accountant?

(Incidentally—and getting back to Mr. Olson for a moment—does the *auditor* have at least an *ethical* responsibility of, if nothing else, discussing with management the adverse implications of its decisions? Law suits filed by the public indicate that the auditor should probably take on more responsibility in weighing corporate judgment and, in effect, corporate management. Or does this go too far beyond the auditor's prerogatives and the scope of his engagement relative to his fee?)

To continue, Mr. Nagel says that "lenders as a class are more interested in the financial position of the corporation than they are in its earnings." Sometimes, yes. But the pendulum has swung considerably in the other direction, and long-term lenders today are more concerned with cash flow and long-term profitability than with historical financial information. Granted, they want a reasonably sound position, but their primary stress is on earnings, because to do otherwise would be to encourage the company to siphon off some liquid assets which are needed in the working capital cycle in order to meet the current portion of term debts. (Of course, the Penn Central situation might be another matter. It perhaps would tend to move the pendulum away from emphasis on the earnings statement because, obviously, a truly illiquid or undercapitalized situation can prove to be disastrous in cases where the cash generation capacity of the borrower, while substantial under normal circumstances, simply cannot keep pace with the rate of deterioration.)

Nagel sums up the posture of the financial officer by stating: "The key questions for the financial officer are adequacy of disclosure and the quality of the subjective judgments made about the condition of programs currently

going on within the corporation's activities." Unfortunately, there seems to be a dilemma here because, being a company man, the financial officer doesn't necessarily have full authority over the first of these two questions, and by his own admission, very little authority over the second one. In other words, even though he himself may be very ethical, he may be overridden by the chief executive officer of his company. And in this respect he is a bit unique in that, while the accounting firm can drop its engagement, the banker can refuse the loan, and the financial analyst can "call 'em as he sees 'em," the financial officer seems to have little choice but to, shall we say, persevere.

The question of the desirability of the development of specialized reporting forms for specialized users could perhaps have been given more attention by Nagel. He apparently doesn't see the need for this to the same degree that, say, Olson does. Yet he does suggest that lenders' needs are markedly different from investors' needs. In many cases this is so, and perhaps specialized reports for each would be desirable. But we must again observe that in some of our truly long-term credits, we bankers, like investors, are very interested in cash flow and long-term profitability. Our loans to many companies—public utilities, for instance—are based almost completely on the borrowers' ability to refinance our loans in the capital market. The result is that our analytical approach in this instance is identical to the "Wall Street" approach.

If one backs off from the detail of Nagel's paper and ponders it as a whole, one could get the impression that everything is essentially well under control. The ethical problems of the financial officer don't appear to be too great in number relative to those facing some of the other professions, and furthermore, they seem to be reasonably clear-cut. He seems to suggest that the only class of financial statement user who is concerned about the short term is the speculator, and that he can be ignored, and that everybody else "with long-term needs" will be properly taken care of. Perhaps, but how much solace would this be to the lenders and investors in companies like Penn Central, A. S. Beck, Mill Factors, Ling-Temco-Vought, Inc., and so on?

Parker

Mr. Parker gives quite a lesson in what the financial analyst does. We bankers can have a certain empathy because we too are "users." Certainly an analyst, being in a position of trust in connection with important financial information regarding a firm and its anticipated performance, should treat this information discreetly and report it to others on a factual and impersonal basis. In making judgments concerning recommendations for investments in one specific security, the analyst should present the facts and allow those in control of the funds to make their decision. In general, if an analyst is a "recommender," then he is charged with the responsibility of developing facts and communicating those facts to the decision-makers. If the analyst followed his professional code of ethics—for which, incidentally, the Financial Ana-

lysts Federation is to be commended—he would apparently be in good stead with his employer as well as with those firms from which he gathers information to help make decisions.

Turning to some specific items, it was good to see Parker treat with the development of the inside information doctrine; this cannot be emphasized too highly. However, he said that this doctrine is taking shape entirely in the judicial section rather than in the legislative area. Largely, perhaps, but not entirely. Witness, for one thing, Congressman Wright Patman's Banking Reform Act of 1971 which, among other things, does indeed try to legislate out of existence certain areas of potential insider conflicts in banks. We bankers are feeling this now. We are convinced that the violations and lapses involve only a very few, isolated banks, and that the industry as a whole is aware of the potential conflicts and avoids them assiduously. Congress, we hope, will be as convinced of this as we are. The point is not to anticipate this particular outcome so much as to warn of the threat itself. Don't ever take lightly the possibility of legislative intervention.

There are still other elements of similarity between bankers and analysts in this same general area. For instance, a statement is made by Parker which indicates that there is a great cry for "divorce" between areas of financial institutions which might have conflicting uses for the same information. In commercial banks there is a great interest on the part of the customer in knowing about the uses to which his information is put. He wants to know who routinely sees it, who has access to the credit files, what individuals are on any approving committee for loans (particularly outside directors), what protective measures are taken to guard the storage of that information, and how long this material stays in the file before it is disposed of, as well as the method of disposal. Commercial bankers will, if anything, be receiving more and more of these types of questions, and we should be prepared to give those people who trust us with their private financial data proper answers. If your client asks you these questions, can you answer them in such a manner that he is assured your skirts are clean?

The point is raised that the financial analyst would instinctively shy away from insider information because it would make his job too easy, so to speak: it would be a sort of insult to his professional competence if he were to use insider information to arrive at conclusions which he could instead have developed "the hard way." This observation runs counter to human nature. The analyst, in the final analysis, is interested most of all in giving opinions and making recommendations which are sound. Furthermore, if he's at all efficient, he's *not* going to instinctively try to do things the hard way. Or to put it another way, he's certainly going to be tempted by the promise or possession of insider information. That's why a question of ethics arises here in the first place.

Mr. Parker goes on to speak of the "conflict between the investor's reward desires and the risk-taking ability of the portfolio." Certainly a balance must be struck in this area, but this appears to be a question of executive

competence and judgment, not of ethics. Nor is it unique: the commercial loan officer faces a similar situation every day where he's balancing his interpretation of the bank's loan policy on the one hand versus the risks inherent in the loans under consideration on the other.

A neat question of ethics is posed, however, with Parker's later observation that "a related and highly topical question is: What does the portfolio manager do when the investor requires highly improbable levels of short-term performance . . . with the account to go to a competitor if desired results are not produced. . .?" He then proceeds to give three areas where one might *start* to look for definitive answers to that sort of question. The word *start* implies that there may be more to it than even these three areas can cope with. This in turn means the question is still going begging: there indeed exists no way of determining whether the analyst's performance was incompetent or the client's demands unrealistic. This unsettled climate, with its unethical temptations, is nurtured by the same vital loss of income threat which Mr. Olson raised. Further work, including a mutually determined time-span standard, does seem called for to provide relief.

As noted earlier, the wording and intent of that portion of the FAF ethical standards quoted by Parker is to be commended. It is easy, also, to appreciate and sympathize with the problems he airs in discussing the difficulty of enforcing the FAF's ethical standards, especially during the process of litigation. (Understandably, Olson made the same points with respect to accountants.)

Creamer

One could gather from Mr. Creamer that bankers are less canonized, less coded, more free to react to individual circumstances than perhaps members of the other three professions. He states it in his summary thus: "There is no prescribed pattern in the way [the banker] must fulfill these obligations to all parties."

The other three writers all took a broader view of the subject than Creamer did. He limited himself largely to the ethical problems related to the acquisition and treatment of "information" per se. He indulged less in defense and justification of his industry's purity than did the others. He posed more open-ended questions and situations—including an interesting albeit perhaps too brief series of mini-case studies.

The statement at the beginning of the paper that the bank officer's allegiance is due first to his community, and only then to his stockholders, is arguable. The community is an important part of the very being of a bank, but is a bank not first of all an economic entity responsible to its investors and only secondly a participant in the market place at large on their behalf?

Perhaps the single biggest ethical responsibility of a commercial banker—and one which, unfortunately, Creamer didn't treat with to any extent—

stems from the banker's role as allocator of funds. The banking industry as a whole is a rather efficient gatherer of funds and has an awesome and unique ability to disperse these funds through reallocation as well as the creation of credit. This process is under way at all times, and particularly heightened during periods of tight money. This money is dispersed within the parameters established by the bank's loan policy, which in turn is a function of many variables and considerations such as safety, liquidity, profitability, social consciousness, community needs, and so on. Unfortunately, these parameters are relatives and not absolutes—which is to say that many, many times in the weighing of them in the face of a particular loan request, decisions must be made which, in large measure, can turn as much on subjective—yes, ethical—considerations as on objective analyses. A recent, but already classic, case in point stems from lending to new minority enterprises. How best can the banker balance the greater risks which run to most of these loans against his long-term obligations to his community and against the profit goals of his department and his bank?

We might note also, of course, that this problem spills over into the areas of the preparers of statements: if the financial statements supporting the requested credit are misleading in any respect, this could also lead to poor judgment in the allocation process.

The ethical considerations involved in the allocation of funds by banks are accentuated by the changes in the industry itself, which has grown from an unimaginative, unaggressive entity which got its money at a very low cost to a highly competitive, profit-motivated industry. Certainly the banker who is hip-deep in the profit center concept is faced with a different atmosphere in which to make all sorts of decisions, including ethical ones, than his counterpart of, say, two or three decades ago. (This is not to say that today's banker is any less ethical, but just that the milieu in which he operates is different.)

A potential conflict of interest is probably the most classic business situation involving ethics, and as Creamer points out, bankers should always bend over backwards to avoid such conflicts, particularly in the trust versus commercial areas. No one would disagree with this statement. It can, however, get muddied by details and by sobering consideration of some of the possible end results of a literal separation of the trust and commercial departments. Perhaps the primary difficulty stems from the valid assumption that a person employing a fiduciary is entitled to the best it has to offer. Is it possible, then, that spinning off the trust department, while giving the appearance of good intentions, might not really accomplish too much and even prove detrimental by depriving it of perfectly legitimate management expertise and business information existing on the commercial side? As a case in point, consider the instance in which the owner of a business, borrowing from a given bank, places with that bank his personal trust, the principal assets of which are the majority ownership in his closely held, family corporation. Further assume that the reason he gave this bank his trust business is his assumption that the bank has the best financial contacts in town and thus might be able to do a

better job of selling this business, thus increasing the value of his estate, than any other available bank. Would this bank be giving this customer the best service it can if it absolutely closes off communications between the trust department and its probable best source of ultimate purchasers, namely, the commercial department? Should not this customer and thousands like him be able to assume that his bank, in order to do its job best, must have access to the widest possible range of bidders for the trust assets which will be available for sale upon his death? The general question becomes, of course, whether complete "insulation" (the trend since the Merrill Lynch decision and since accentuated by Representative Patman) does indeed serve the bank *and its public* in the best possible manner. Would it be possible to have one (and only one) authorized information conduit between these departments which would at least let both sides know of possible opportunities available?

The paper writers from the other three professions all mentioned or alluded to the canons or standards or codes of ethics which govern their ethical conduct. For a number of obvious reasons the banking industry *as a whole* does not have one single code or set of standards. The several functional areas of banking do, however, and in the very important area of commercial lending and the exchange of credit information, a code of ethics set up over a half century ago by Robert Morris Associates does clearly set criteria for bankers to follow in this area. (A related, highly similar document deals with the exchange of information between bankers and nonbank business entities.) This brief but comprehensive code has survived almost unchanged over time, and without exaggeration it has done a great deal to foster economic progress and growth through the realistic and confidential flow of information. Since it is so brief, a copy of it appears on page 221.

Conclusion

Even given codes of ethics—even given the whole body of legislative, regulatory, and judicial constraints under which we must all operate—so much of the matter of handling business information and the ethics therein evolved to the common sense concept of what else but *common sense*. Since all business entities are different, the question of ethical handling of the information will be different in all circumstances. How much information we divulge must be considered in the light of each specific situation. Clearly what would be prudent practice for the handling of information concerning a large national corporation might not be prudent for the handling of information concerning a small, local, closely held company. It is common sense, also, which helps one achieve an optimal tradeoff between the amount of information requested from a present or prospective borrower versus the amount of information actually needed to arrive at the proper decision. Obviously, we are not doing our job if we make a decision based on insufficient information, whether the motivation is reluctance on the part of the borrower, competitive

forces, or our own laziness. The reverse, while perhaps less harmful, is also true in that it might be considered unethical to require the borrower and his accountants to provide excessive information.

Now, add to the concept of common sense the essentiality of *education,* and we go still further along the road to a full understanding and appreciation and perhaps even solution of the problem. Each of the writers has mentioned this, often in general, and often in a specific sense such as an ethical responsibility to fully understand the business of one's client or borrower. Similarly, the writers all mentioned what respective professions are doing to improve the educational competence of their members. Banking has recognized and is attempting to meet this also, of course. Specialization abounds; continuing education programs are in effect all over the country, sponsored by many different entities. RMA itself has a loan management seminar at Indiana University, several regional schools, and dozens of smaller meetings throughout the country each year, all of which in general stress the importance of current knowledge in banking and business.

Common sense plus continuing education, operating in tandem with whatever objective guidelines and criteria are available, particular avoidance of conflicts of interest, self dealing, and insider trading, constant mindfulness of the high roles and responsibilities which are ours in the financial community, determination never to be a party to aiding those who want to violate these high standards—do all these things, remember all these things, and you're not only on the right course, but the only course for ultimate improvement and, hopefully, resolution.

As a concluding thought, remember that good ethical practices are contagious. But, so, unfortunately, are bad ethical practices. Perhaps this is one of the "great truths" which can emerge from this symposium. The only way to improve the ethical conduct of our four professions in their interactions with each other is if everybody is resolved toward that common goal: the golden rule principle. Similarly, nothing is more conducive to sharp practices on one's own part than knowing that he is dealing with someone who is unethical or quasi-ethical. In the successful interaction between groups with goals which are at times disparate, ethical improvement becomes possible only to the degree to which each of the parties is willing to see the other fellow's point of view, and, most likely, subordinate a portion of his own interests and independence as a contribution to the commonweal.

The RMA Code of Ethics
For the Exchange of Credit Information

Preamble

The Robert Morris Associates, recognizing the importance and value of the interchange of credit information in the conduct of business, adopted (1916) the following Code of credit ethics and, subject to the requirements of the Fair Credit Reporting Act (Public Law 91-508) and/or other applicable Federal or state law, urges adherence to the Code in order to maintain the exchange of credit information on the confidential and ethical basis that this phase of credit activity warrants and requires.

The Code

1. The first and cardinal principle in credit investigation is to respect the confidential nature of the information received.
2. The name of the inquirer, in whose behalf the inquiry is made, should not be disclosed without permission.
3. In answering inquiries, the source of the information should not be disclosed without permission.
4. Any betrayal of confidence stamps the offender unworthy of future consideration.
5. Each letter of inquiry should indicate specifically the object and scope of the inquiry.
6. When more than one inquiry on the same subject is sent simultaneously to banks it should be indicated that information from their own files is sufficient as other checkings are being made.
7. All letters, including form letters, should bear the manual signature of the inquirer to establish responsibility.
8. The recipient of a credit inquiry is negligent in his duty if he does not read carefully each letter of inquiry and answer frankly, to the best of his ability, its specific questions.
9. In answering inquiries, it is advisable to disclose all material facts bearing on the credit standing of the subject, including the basis upon which credit is extended.
10. Indiscriminate revision of files, when there is no real need for information, is wasteful and undesirable.
11. Where periodic revision of file information is made, it may be desirable to give your own experience in the letter of inquiry, in order that duplication and unnecessary correspondence may be kept to a minimum.
12. In soliciting accounts, it is not permissible nor the part of good faith for the soliciting bank to make inquiries from a competitor without frankly disclosing the nature and object of the inquiry.

This code was originally adopted in 1916; revised in 1921, 1948, 1954 and 1971 (Preamble only).

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Forecasting: Ethical And Other Problems

Ethical and Other Problems In Publishing Financial Forecasts[1]

By R. Gene Brown, *Vice-President of Corporate Development, Syntex Corporation*

> I could give you facts and figures—I could give you
> plans and forecasts
> Even tell you where I'm going . . .
> But why should you want to know? . . .
> If you knew the path we're riding you'd
> understand it less than I.
>
> "JESUS CHRIST TO THE APOSTLES"
> FROM THE ROCK OPERA, *Jesus Christ, Superstar*

Uncertainty about future events, whether it is associated with our personal lives, professional careers, or business investments, is something we must all live with. In business management, the recognition that any statement about future transactions or events contains some element of risk has led to the relatively recent development of some interesting management science and economic tools for recognizing, measuring, and analyzing uncertainty.

Why this interest in uncertainty? Many answers might be suggested, but as a more sophisticated breed of managers has developed, formally educated in their discipline, and as the investor and his professionally trained counselor have increased economic and other pressure for financial performance, interest in analyzing the future has intensified. Managers and investors increasing-

[1] The controversial content of this paper, together with a strong desire to remain gainfully employed, encourages me to make the usual disclaimer, associating the thoughts herein solely to the writer, personally. I would also like to acknowledge the help of Mr. Roger Salquist, who assisted in researching the literature as background for this paper.

ly recognize that expected future performance is what is relevant, that not a single historical transaction or event is relevant to decision-making except insofar as it might directly influence a future cost or revenue, or provide a direct predictive base for estimating a future cost or revenue.

Financial executives and CPAs are beginning to recognize the irrelevance of past transactions in financial statements through attempts to report current costs (such as market values for marketable securities) as a closer approximation of present-day values or as opportunity costs of asset retention. Many accountants and members of the investment community are pushing for further progress in financial reporting, some advocating the extension of current cost (in the sense of replacement cost or net realizable value) measurements to other assets, some advocating reporting future costs or revenues through a discounted cash-flow vehicle, and some suggesting the publishing of budgets or other forms of financial forecasts.

Disclosure of Future Plans Proposed

In the summary report of the last Seaview Symposium in 1968, Professor John Burton reported that the most significant new idea discussed for corporate reporting was the suggestion that corporations disclose future plans and expectations.[2] At that conference a number of financial analysts argued that investors are interested in the future; that management allocates significant resources to preparing financial forecasts; and that the benefits of disclosing these forecasts would far outweigh the legal and practical problems which would arise. As one might imagine, the conference participants representing the internal financial officers and the CPA profession were not altogether enthusiastic about such proposals. Because of the interest in (and controversy surrounding) financial forecasting, it was felt important to include the topic as one of the principal papers of this second Seaview Symposium.

I was intrigued by the invitation to consider the subject from an ethical and, to a lesser extent, a behavioral viewpoint. A fairly extensive review of the literature reveals a fair number of published works dealing with the advantages and disadvantages of publishing financial forecasts, but the preponderance of printed material addresses the legal and auditing aspects of such public pronouncements, interspersed with a smattering of appeals for such information from the investment community.[3] No published works were found which more than peripherally dealt with the ethical or behavioral aspects of publishing financial forecasts.

An intriguing, but hazardous, inclination facing anyone addressing ethical aspects of certain business behavior is to devote a considerable amount of

[2] John C. Burton, "The Seaview Conference on Financial Reporting," *The Journal of Accountancy*, January 1969, p. 37.

[3] A selective bibliography is provided at the end of this paper.

time and words to attempting to define ethics, ethical standards, ethical behavior, business morals, or other pertinent terms. The difficulty is that one can devote unlimited time to reading not just from the business and quasi-business literature, but from varied other disciplines and writers varying from Margaret Mead to Descartes. Although I must confess to having committed some time to this, I shall avoid burdening you with any esoteric thoughts developed on the subject. I should like to define ethics as those standards of conduct which are generally accepted at a given time by a given population.

Financial Forecasting Defined

Although the ethical and behavioral problems associated with publishing financial forecasts are the main thrust of this paper, it is impossible to ignore certain more formal legal and accounting (American Institute of Certified Public Accountants and Securities and Exchange Commission) constraints. Prior to addressing any of these problems, it would be worthwhile to zero in on exactly what is meant by a "financial forecast."

Financial forecasts can take many forms, ranging from simple comments such as "the company expects to maintain its historical growth rate" to detailed financial projections in the form of income and funds statements as well as balance sheets. For purposes of this paper and our discussion, I should like to define a financial forecast as any published quantitative or nonquantitative statement which provides *direct* information about the entity's expected future performance or *data complementary to historical financial statements* in such sufficient detail as to permit interested parties external to the firm to make their own reasonably reliable financial projections.

In one sense, it is surprising that there should be so much controversy over publishing financial forecasts, since certain forms of forecasts are now commonly published, available in the form of "public information," or supplied to special interest groups. Examples of forecasts now commonly made are:

1. Corporate pronouncements of an expected or "goal" income growth rate.
2. Forecasts of expected earnings per share for the next ending accounting period.
3. Projections of cash flows, income flows, and return on investment in proposals for initial offerings in certain real estate ventures.
4. Proforma financial statements or forecasts issued to illustrate the effects of a desirable (friendly) merger or to combat an unfriendly proxy battle or tender offer.
5. Estimates of physical quantities expected to be realized from reserves in reports issued by the extractive industries.

6. Publication of sales forecasts, including an occasional attempt to provide various possible sales levels.[4]
7. The submission of proforma cash flows and supplementary information to banks and other creditors. (This falls into the "restricted information" category of forecasts.)
8. Preparation and presentation of projected financial performance for certain new venture activities seeking capital.
9. Forecasts provided by companies hoping to qualify as a government contractor for a particular project. (This occurs when the company is subject to a contractor's financial capability evaluation and/or is seeking larger or earlier than normal progress payments.)
10. Proforma financial statements required by certain large prime defense contractors from companies hoping to land subcontracts. (As one might expect, such forecasts are given reluctantly, or not at all by the larger subs; it is the smaller company which complies for fear of being cut out of the competition.)

A less obvious, but nonetheless common form of publishing financial forecasts occurs each time we prepare the usual corporate financial statements based on so-called historical transactions. The whole process of matching costs and revenues and assigning those measurements to accounting periods is based on estimates or assumptions as to future transactions. Certain obvious examples come to mind, such as inventory measurements based on cost or market, whichever is lower; the newly established current market reporting for marketable securities; deferred federal income tax; all cases where asset, liability, or equity reserves are created; and long-term asset measurements which are based on assumptions as to the timing and amount of expected future economic benefits. In fact, one could assert that virtually every measurement (with the possible exception of cash) on a balance sheet and income statement makes some assumption as to a future value or as to future transactions; even cash in a large multinational corporation is an estimate relying on assumptions as to currency revaluations, exchange restrictions, dividend policies, and future tax rates.

Problems With Existing Forecasting Practice

That financial forecasts are now frequently made available outside of the firm cannot be denied. The degree to which such forecasts are public (by design), semipublic (by design or leak), or highly restricted varies significant-

[4] John J. Willingham, Charles H. Smith, and Martin E. Taylor, "Should the CPA's Opinion Be Extended to Include Forecasts?" *Financial Executive,* September 1970, illustrates an annual report of the Micro Engineering Corporation which included a three-year sales forecast by major product category with optimistic, median, and pessimistic expected sales for each category.

ly. It is also fairly obvious, at least to me, that there is no consistency in practice. About the only reasonable conclusion that one can reach is that at present it is not accepted practice to publish detailed budgets or proforma financial statements, even though the single most important financial measure of performance, projected earnings per share, is frequently made public.[5]

The inconsistency in practice, the fact that forecasts are being made without SEC or stock exchange blessing, and the total lack of any external control or attestation as to the forecasting process should give rise to discomfort in the financial community. Indeed, in discussing the problems inherent in corporate disclosure, George Bissell, the former president of the Financial Analysts Federation, asks, "Have previous moral, ethical, and legal standards in disseminating corporate information changed, and if so, by what rules am I now to be guided?"[6]

In view of the current situation with respect to financial forecasts, it seems more appropriate to ask whether such forecasts should be formally recognized as acceptable current practice (hence, made ethical) and what form the projections should take, rather than ask *if* financial projections should be accepted or permitted.

A number of major questions should be considered prior to reaching any judgment as to the advisability of encouraging publication of forecasts: What constraints now exist which discourage publication of financial forecasts? What are some of the ethical and behavioral advantages and disadvantages of publishing financial projections? What form should the financial forecasts take if they are deemed advisable? The balance of this paper will consider these questions.

Legal Implications of Forecasting

Three of the major constraints delimiting publication of financial forecasts are *legal, ethical,* and *behavioral* considerations. I shall not dwell on the legal aspects, since that is outside the scope of this paper. However, it should be pointed out that there appear to be at least two legal aspects worth mentioning. The first relates to the Securities and Exchange Commission's expressed strong policy not to permit projections in prospectuses filed with it.[7] The second deals with the potential civil liability of management to out-

[5] I do not wish to be drawn into the argument as to whether or not net income or earnings per share are overemphasized; I would simply observe that from a behavioral standpoint, we seem to be stuck with "earnings per share" as a simplistic, shorthand performance measure.

[6] George S. Bissell, "Corporate Disclosure and Inside Information," *Financial Analysts Journal,* November-December 1968, p. 9.

[7] An excellent discussion and critique of the SEC position on this subject appears in an article by Kenneth I. Solomon, "Proforma Statements, Projections and the SEC," *The Business Lawyer,* January 1969.

side parties, together with a similar potential liability of CPAs should the attest function be extended in any fashion to cover forecasts, and/or assumptions or processes underlying the preparation of forecasts.

With respect to the SEC position, it has been pointed out that "if projections were not required but only permitted. . . problems of civil liability would be insurmountable unless projections in prospectuses were expressly granted immunity from Sections 11 and 12 of the Act."[8] When one considers (1) that the SEC position on forecasts is inconsistent since financial projections are now required or permitted by the SEC in certain initial offerings (real estate), extractive industry reports, and in the so-called "giving-effect" balance sheets (to reflect the impact of proposed capital transactions), and (2) that the civil liability alluded to above relates to permitted but not required financial projections, it appears that a legislative change in SEC regulations would wipe out the "legal" complications insofar as the SEC is concerned.

The questions of potential management and audit liability remain. With respect to individual liability of management and CPAs, it is worth emphasizing that, should financial forecasting be expanded, such financial forecasts must certainly be representations of management just as are today's historical financial statements. It is also worth noting that proposals to extend the auditor's role to cover projections usually are limited in such a way as to preclude a direct expression of opinion as to the reasonableness of the forecasts themselves.[9] The wording of the Council of The Institute of Chartered Accountants in England and Wales on this matter states:

> It should be clearly established that the reporting accountants' instructions and responsibility for reporting under the Code are confined to the accounting bases and calculations for the profit forecasts, as distinct from the assumptions, including the commercial assumptions, upon which the directors have based their forecasts.[10]

The Council points out in the above cited document that when profit forecasts are published, it is also required that the economic, commercial, marketing, and financial assumptions underlying the forecasts be also published and that the reporting accountants should report whether or not the forecasts are consistent with the assumptions.

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[8] The Wheat Report, "Disclosure to Investors—A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts," *ICH Federal Securities Law Reports,* p. 95.

[9] A notable exception is Yuji Ijiri, "On Budgeting Principles and Budget–Auditing Standards," *Accounting Review,* October 1968, pp. 662-7, who argues that auditors should express an opinion on the budget estimates as well as the inferences made in preparing the budgets.

[10] Council of The Institute of Chartered Accountants in England and Wales, "Accountants' Reports on Profit Forecasts," *The Accountant,* May 3, 1969, p. 629.

If the auditor's role is limited to attesting that forecasts are prepared in accordance with the assumptions underlying the calculations, and detailed with the published forecasts, and if the auditor takes no responsibility for the assumptions themselves, it is difficult to see any *greater* legal exposure than now exists. In fact, one might speculate that the legal liability associated with attesting as to the reasonableness of calculations made in accordance with specified assumptions is less than that which now accompanies an expression of opinion following a standard so-called "balance sheet audit." This, however, would be for the courts to decide.

With regard to the legal liabilities of management and boards of directors, the publication of formal projected financial statements cannot help but increase legal exposure. Financial performance significantly better or worse than that projected seems clearly to be a source of action for damages. In any situation where a deliberate intent to mislead were established, the same avenues for redress as now exist would be available to third parties. The murky area is when performance differs significantly from plan and there has been an honest attempt to (1) plan properly, (2) make full disclosure, and (3) manage the company as efficiently as possible in a dynamic environment. The recognition of this potential new source of legal complication is one of the reasons why management is not particularly enthusiastic about publishing detailed forecasts in the form of projected financial statements.[11]

Ethical Aspects of Publication

The two other constraints on publishing financial forecasts, ethical and behavioral questions, are interrelated. Earlier in the paper, I defined ethics as those standards of conduct which are generally accepted at a given time by a given population. At present, we face a somewhat strange situation, for it is not unusual for some form of financial forecast to be published by management or made available to special interest groups, yet the SEC and the AICPA want no part of it. The oft quoted Rule 2.04 of the AICPA Code of Professional Ethics states that, "a member or associate shall not permit his name to be used in conjunction with any forecast of the results of future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast."

It is important to recognize the fact that although it is unethical, *by code,* for any AICPA member to in any way associate himself with a financial forecast, and although forecasts are specifically discouraged by SEC regulations, management does not seem to feel similarly bound by any such restric-

[11] An informal discussion of this point with Robert Ward, former president of ULTEK, now a division of Perkin-Elmer, prompted the following response: "Man plans; God decides!"

tions in their public pronouncements. There are no *ethical* barriers, in terms of accepted practice, preventing management from making public certain forecasts; the SEC and AICPA constraints are quasi-legal and ethical by decree, and any change in SEC regulations and the AICPA professional code would simply recognize a de facto situation and permit CPAs to participate as deemed necessary or desirable. Indeed, one might argue that from a macro-social standpoint, the users of financial statements would be better off if current practice were recognized and controlled, and the forecasting methods were subjected to independent review.

Presumably, the AICPA and SEC are concerned over the legal exposure arguments and the assumed lack of verifiability of forecasts. However, this does not in any way relate to the ethical considerations of publishing forecasts. In fact, if adequate disclosure of the assumptions underlying forecasts and forecasting techniques are made, verification that the forecasts were prepared in accordance with the disclosed assumptions and techniques can occur. It would be difficult to see that the public interest would be improperly served by such a move.

To summarize then, I fail to see any major ethical considerations which would be so sufficiently severe as to preclude a recommendation to recognize and extend current practice in publishing financial forecasts.

Behavioral Difficulties of Publication

It is in the area of behavioral constraints that I find the greatest concern, and behavioral implications exist not only for management, but also for the accounting profession, the professional financial advisor, and other qualified users of financial statements. To cite the major ones of concern, as well as some of the related advantages and disadvantages:

1. Managers will tend to play the so-called "budget game" and underestimate real projected performance, since the costs of underestimating are significantly lower than of overestimating.

2. Managers will tend to reveal the absolute minimum summary information required, for the greater the detail in projections, the more areas of exposure to criticism exist. In addition, the self-canceling effect of plus and minus fluctuations in individual components of a summary will obscure poor performance in certain specific areas.

3. Financial analysts who now have to *guess* as to earnings, will have to *second-guess* management. This cannot improve relations between the two.

4. Management will tend to manage resources and take certain discretionary actions which influence costs and revenues in order to legitimatize previously announced earnings.

5. In situations of uncertainty where actual performance toward the end of the year would be materially above projections, there could be the

tendency to suppress earnings for the current year and transfer them to the following year.

6. Management could easily be tempted to act contrary to the best interest of the company and shareholders by suppressing desirable expenditures in order to meet the forecast.

7. When facing a near term problem such as economic and federal pressure to hold or reduce prices, or a major labor contract negotiation, a tendency might exist for management to paint a different picture than actually expected.

8. Audit/management relations could be strained in the event that financial projections were in fact prepared in accordance with the stated assumptions and acceptable forecasting techniques, but the auditor found himself faced with one or more poor or unacceptable assumptions.

9. It has been argued that if CPAs express opinions on forecasts (presumably this also means any of the back-up work necessary to prepare a forecast) and actual performance is significantly different than planned, third parties might tend to question the credibility of CPA opinions, not only on forecasts, but on more factual statements as well.[12] The behavior of the user group toward CPAs would thus be affected.

10. Publication of an unsatisfactory expected level of achievement, when management action is under way on a number of fronts to preclude the projected from happening, might prejudice the alternatives open to management or preclude them from behaving or conducting business in such a fashion as to take preventative action. In this not unlikely case, no one benefits from the forecast; in fact, management and investors will suffer. It is easier to project the future based on an assumption of operations continued roughly as they are now conducted than to attempt to build in unknown events which might relate to product or company acquisitions, spin-offs, changes in product pricing or mix, and so on. In fact, to reveal such plans in advance of very high success probabilities can be disastrous to employee morale, contrary to the maintenance of a stable marketplace, and prejudicial to a firm's competitive position.

Behavioral Advantages of Publication

There are some favorable behavioral arguments:

1. Relations between management, investors[13], and the financial community should improve since the information deemed most useful in investment decisions would be provided.

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[12] Howard F. Stettler, "CPAs/Auditing/2000±," *The Journal of Accountancy,* May 1968, p. 58.

[13] In this paper, the term "investors" includes those making equity and debt investment decisions.

2. Given an opportunity to compare actual to planned performance, management could more easily isolate the controllable from the noncontrollable influences on results and do a clearer job of explaining "what went well or poorly this year."

3. It is possible that total management would improve, for it might be presumed that a more careful job of planning would be performed (indeed formal planning might be induced where it is now nonexistent) in view of the public nature of the forecast.

4. Advice to investors would be improved, since the professional analysts would have added valuable information on which to base their recommendations; it might also be argued that advice will be improved since the large amount of time now spent trying to guess as to near-term earnings could be devoted to other analytical tasks.

5. Because of the emphasis on forecasts, there will be an enhanced interest in improving existing financial reporting practice, including further departures from historical cost measurements.[14]

The list of ethical and behavioral implications as well as the related advantages and disadvantages could be larger, but the listed ones above are representative of the longer list. Two criticisms of the disadvantages above could be expected. First, with adequate professional auditing, the managerial freedom for discretionary acts to shift the timing and amount of income should be reduced. Second, if it were possible to publish some form of flexible or variable forecast, the unfavorable managerial behavioral aspects tied to the public dissemination of only one set of numbers would diminish. Both of these criticisms are partially valid, but the problems remain.

On balance, I would conclude that if there were ways to minimize some of the legal, ethical, and behavioral difficulties inherent in publishing forecasts, such publication is a highly desirable step forward. It should enhance communication between management and external users of financial statements, improve investor decisions, and conceivably strengthen the management process itself. The question is, Is there some form or method of publishing financial forecasts which can achieve these objectives? I think there are several possibilities of which one approach is superior.

Financial Forecasts: Content

It should be recognized that any given approach to forecasting has disadvantages, including the theoretically superior technique of simulation built on a foundation of subjective probabilities (which would undoubtedly over-

[14] W. W. Cooper, N. Dopuch, and T. F. Keller, "Budgetary Disclosure and Other Suggestions for Improving Accounting Reports," *Accounting Review,* October 1968, pp. 640-648. An interesting related argument presented in this article is that publishing budgets will draw greater attention to the opportunity costs of retaining assets, thus improving the management process as well as the information made available to outsiders.

whelm the financial statement users). At the other extreme, the worst form of forecast is the single value/point estimate prediction. Some of the common concerns of those responsible for *internal* planning for companies are:

1. *Timing.* How many periods should one include in the forecast?
2. *Reported values.* How much information should be provided about possible fluctuations about a given case or how many cases should be presented?
3. *Probabilities.* Should the forecasts build in or include probability statements about the likelihood of a certain event occurring and/or should probabilistic values be computed (expected monetary values, etc.)?
4. *Uncertainty.* Should specific reference or treatment be given to risk (uncertainty) independent of probability statements?
5. *Discount factors.* Should forecasts include discounted value computations or a range of calculations based on alternative discount rates as an aid to examining opportunity costs and evaluating investment alternatives?
6. *Presentation.* How should the results of the forecasting process be displayed, given a varied user or reader group?

Financial Forecasts: Suggestions and Examples

Most of the same questions are directly applicable to preparing and publishing financial forecasts to *external* users. To answer these questions and to attempt to minimize some of the disadvantages which exist in publishing financial forecasts which do not exist when internal use alone is made, I would suggest that companies publish with each annual report a schedule of events and/or transactions which are reasonably expected to occur in the near future, and which, if experienced, would individually have the potential for changing the reported earnings base by an amount in excess of plus or minus ten per cent.[15] Some of the implementation suggestions would be that:

1. Each event or transaction be accompanied with an expected high and low financial impact indication.
2. Probabilities of occurence of the events or transactions not be provided.
3. The possible earliest and latest occurrence date be provided.
4. The time horizon be flexible; no short-term, one-year constraint should be imposed, nor should a long-term cutoff, such as five years, be arbitrarily established.
5. The events or transactions should usually be limited to those factors which directly arise from and influence normal operations—factors such as acquisition plans, major corporate personnel reorganization, divestitures, etc.,

[15] An interesting alternative strategy would be to report events and transactions expected to influence reported income in the next succeeding year by ± 5 per cent, and use ± 10 per cent for projected years beyond the next succeeding year.

should be omitted unless the probability of occurrence is extremely high and disclosure costs are minimal.

It would be helpful to give some examples of the kind of events and transactions I have in mind.

Example 1. Your company expects to embark on a major expansion of its physical plant sometime during 1973. Preliminary engineering estimates place the costs (adjusted to reflect expected 1973 prices) at $40 million, of which $5 million is for land. The building is being planned to accommodate our normal growth of sales of existing products and modifications thereof, and should have an expected useful economic life of 20 years. Straight-line depreciation will be used for financial reporting; accelerated depreciation for tax purposes.

Example 2. Our labor contract with the UAW expires in June of next year. We expect to enter into negotiations prior to its expiration. In our opinion, if the tentative demands of the Union are met, our cost of sales is expected to increase by 4 per cent in 1972 (one-half year) and between 10 per cent and 12 per cent in the years following. We do not expect to be able to raise prices.

Example 3. Our product patents on the Metali-X-ray-opto-gyroscope expires in 1974. Due to our predominant market position, it should be some time before domestic competition becomes a factor; however, immediate foreign competition is expected which could cut sales by 5 per cent to 15 per cent. This product now accounts for 20 per cent of our sales dollar.

Example 4. Continued sales growth of our existing UL approved water bed heaters (thermostatically controlled) should occur at 20 per cent per year for at least two years. Beyond that we cannot speculate as to product growth because of the unusual nature of the product and the market. Last year we sold 5,000 units and realized a net profit after all related costs of about $6 per unit. We expect prices to hold and profits to increase at the approximate rate of sales increase due to the efficiencies of greater volume.

Advantages and Disadvantages of the Suggested Program

The purpose of the above suggestions is simply to provide the sophisticated analyst and user of financial statements with the information necessary to make financial forecasts should they desire. In addition, sufficient information is available to permit calculation of a number of possible levels of future performance; indeed, some more sophisticated simulation might be feasible and desirable in some situations.

Such a program should satisfy the demands for financial forecasts by investors, analysts, and special-interest financial statement users: it should reduce any potential legal liabilities by management and avoid many of the behavioral disadvantages earlier cited. The question of audit participation is

open. In my opinion, it would not be necessary to extend the attest function to cover the schedule of expected future events and transactions: however, it could be so extended if a useful purpose were served.

I see two major difficulties in the proposal presented. First, the latitude for managerial manipulation still exists; items can be omitted from the schedule and discretionary changes can be made in the timing of certain transactions. Furthermore I hold little faith in the so-called "self-policing" nature of the information marketplace.

It seems that any proposal for publication of projected financial data will be burdened with some disadvantages; in evaluating any proposal the investment community, managers and directors, the SEC, and the AICPA must compare the expected costs of the disadvantages with the real social benefits to be derived from more relevant information for decision-making.

The second major difficulty relates to the investor's decision process and the inputs to that decision. There is usually the presupposition that if the investor knew future income and dividend flows, he would be fully informed. However, it must be remembered that the investor is interested in financial forecasts and future income and dividend flows only insofar as it permits him to make estimates of future stock price. The moment that one departs from a theoretical model based on perfect information and confronts the real world, the more one must accept the fact that present and future income and dividend flow information is surrogate to the projected information that is really desired, i.e., future stock price. Nonetheless, since future market prices for stock are partly a function of income and dividend flows (or at least the investor's expectations as to future flows), it certainly makes sense to provide the users of financial statements with information permitting them to make reasonable forecasts. To deny access to relevant information because of quasi-legal, doubtful ethical problems and behavioral difficulties that can be minimized is a questionable financial reporting policy from the social viewpoint. Hopefully, meetings such as this, papers published on the subject, and individual and professional society pressure will continue to result in improved financial reporting.

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Critique

Of the Brown paper

By George S. Bissell, *Senior Vice-President, Massachusetts Financial Services, Inc.; past President of the Financial Analysts Federation; Chairman, Government Relations Committee of the Financial Analysts Federation, representing the Financial Analysts Federation*

Mr. Brown, a preparer of financial statements, presents a refreshing point of view in this statement from his paper:

> It is important to recognize the fact that although it is unethical, *by code,* for an AICPA member to in any way associate himself with a financial forecast, and although forecasts are specifically discouraged by SEC regulations, management does not seem to feel similarly bound by any such restrictions in their public pronouncements. There are no ethical barriers in terms of accepted practice preventing management from making public certain forecasts; the SEC and the AICPA constraints are quasi-legal and ethical by decree, and any change in SEC regulations and the AICPA professional code would simply recognize a de facto situation and permit CPAs to participate as deemed necessary or desirable. Indeed, one might argue that from a macrosocial standpoint, the users of financial statements would be better off if current practice were recognized, controlled, and the forecasting methods were subject to independent review.

Those preparers of financial statements who are reluctant to reveal to the investment community a sense of future expectation should be urged to do so. It is high time that the SEC should deal with the inconsistency in its registration requirements of dwelling on historical fact while the investment realities of life relate to future expectation. Independent bodies such as the American Institute of Certified Public Accountants should be given the responsibility of commenting on preparers' material to add a further sense of reliability and objectivity to the corporate reporting process. And finally, the professional financial analyst should de-emphasize his role as a reporter (What are you going to earn this year?) and concentrate more on the critical evaluation aspects of his responsibilities in the investment process.

I do not believe that it is necessary to dwell at length here on the advan-

tages of financial forecasting. I consider the process an extension of the broader responsibility of corporate disclosure. I further assume that it is a widely accepted assumption that buyers and sellers of securities today depend to a substantial degree on future expectation as a major aspect of the investment decision-making process. Therefore, it seems obvious to me that the more reliable information that can be disseminated broadly throughout the investment community, the greater the tendency of security prices to remain at or near a level of "true or investment value" and to contribute to a more stable price pattern. Thus, I concur with Brown that the issue today should be not *whether* but *how* to undertake appropriate financial forecasting, and I would add, *to whom* and *by what means.* This is the challenge.

Challenges for the Symposium

The challenges of financial forecasting are substantial, and the seminar discussion should be most productive. Each individual can bring to bear his own experiences on the problems and possibilities of forecasting which by the very nature of the seminar (talking and listening) should produce some areas of consensus.

To the issuer, the challenges may include those outlined by Mr. Brown such as appropriate time frames for financial forecasting, the amount of detail that should be divulged, the degree of probability of the forecast, and the reliability of the assumptions that are behind it. Further, what are the costs of preparation? What aspects might hurt a competitive position and to what degree are there increased legal liabilities?

Each corporation undoubtedly has its own internal forecast yardsticks and appropriately so, for each corporation's business differs, and the sophistication and reliability of its internal forecasting mechanism must vary widely.

To the user of financial forecasts the challenge is even greater, for in my view little thinking has been done as to how much information is actually needed to make an appropriate investment evaluation. For years analysts have sought increased disclosure under the (superficial) assumption that anything more is better. Thus it would appear to me that formal internal budget disclosure is probably substantially more than is necessary. Indeed I suspect that general discussion, through one media or another, of the elements involved in future revenue and cost assumptions underlying these forecasts and the probabilities that are involved in such assumptions may well be sufficient for investment evaluation.

Perhaps the representatives of Robert Morris Associates could shed light on this matter by their experiences. For instance, how much information in this area is generally disclosed for approval of corporate loans; and how much information is actually used by RMA representatives in initial decisions and in ongoing surveillance of the safety of the loans made.

It would appear to me that the auditors could well discuss the degree of

certification which can be economically undertaken and responsibility appropriately assumed at each level and degree of financial forecasting and disclosure.

Rather than discuss in detail the pros and cons of Brown's suggestions as to how financial forecasting might be undertaken, I think it would be more productive perhaps if I describe my views as a user of financial statements and leave the final argument and judgments on these issues to the seminar participants.

The User Market

Before discussing how to undertake financial forecasting, one should understand the user market and its needs. In terms of numbers and sophistication, the user market in my view resembles a triangle. At the top of the triangle are a few sophisticated securities analysts who have devoted a substantial part of their lives to the understanding and evaluation of a small number of industries and corporations. Formal education usually includes an advanced degree (M.B.A.) plus a sufficient number of years of study to thoroughly understand industry characteristics, corporate structure, and management capabilities. This level of professionalism in my view can be compared to a management consultant. The major value of this individual is not only his comprehension, but more importantly his interpretation and judgment of the information available which leads to a meaningful decision. Indeed, he should be aware of and be able to identify all of the possible unfavorable management behavioral patterns which Mr. Brown lists.

This specialist serves institutions of course, and their market force is overwhelming. The New York Stock Exchange's study of public transactions of 1969 reveals that there has been a substantial increase in institutional trading activity on the Exchange. This group, which in 1960 contributed only 40 per cent of all transactions on the Exchange, jumped to 62 per cent in 1969, and it is my understanding that a current estimate of 70 per cent would not be out of line.

At the bottom of the triangle are millions of individual investors (including former SEC Chairman Cohen's favorite, "Aunt Minnie"). Perhaps less obvious, however, is the fact that this broad investing public also has the professional analyst available via the broker-dealer community. In recent years this community has increased its research effort in terms of both quality and quantity. Thus, while it is important to direct attention to Mr. and Mrs. John Q. Shareholder (and I agree with the SEC thrust of equal opportunity to participate), it is nevertheless true that the desired results of appropriate evaluation and stability of securities price movements in the marketplace will be achieved most efficiently through communication with professionals in the investment community.

The conclusion I draw about the user market is that corporate disclosure,

including financial forecasts, should be made at *all levels* of sophistication in the marketplace on a continuing and regular basis at an appropriate level of comprehension. This would suggest the need for in-depth financial forecasting for the professional investor *and* disclosure of the potentially dangerous and oversimplified earnings-per-share expectations for the investing public.

Forecasting for Securities in Registration

I shall divide the forecasting responsibility into two categories: (1) material desired in conjunction with the issue of public securities and (2) suggested procedures for normal ongoing financial forecasting.

The material required for registration of new securities should include aspects of the future. Since investment decisions include to a large degree an evaluation of future expectations, it seems difficult to understand why forecasting is not permitted and indeed encouraged by the SEC at all times, even during a public offering. I fail to see any difference between day-to-day and new issue investment decision-making on the part of the investor. Indeed, it is ironical that a blackout period exists at the most crucial moment of a public offering in order to avoid "conditioning the public mind or arousing public interest in the issuer or its securities."[1] Such a posture, while laudable in the sense of trying to protect the unsophisticated investor, does not prevent the hard sell possibilities of the broker-dealer community which might be possible in light of increased financial incentives of an underwriting. Indeed such a blackout process actually favors the professional investor who, without helpful and controlled background information on future expectations, concludes more reliably the securities' probable future potential.

If the concept of forecasting for new public issues is accepted, consideration should be given to the British system. While by no means foolproof in protecting the public against Mr. Brown's management behavioral concerns, erroneous forecasts or a decline in stock value, nevertheless such disclosure should add to more appropriate investment decision-making and be of benefit to the investing public as a whole.

Exhibit I, pp. 246-255, includes relevant material of the *Accountant's Reports on Profit Forecasts,* July 1969, of The Institute of Chartered Accountants in England and Wales. I have also included several samples of forecast expectation paragraphs extracted from both English and Dutch prospectuses. Note that there is more detail in the English prospectuses than the Dutch. As far as the Netherlands is concerned, according to Article 15-1(f) of the Amsterdam Stock Exchange, an offering circular should contain "all further data desired for making a judgment on the state of affairs and the financial situa-

[1] SEC Release No. 5180, Securities Act of 1933 – *Guidelines for Release of Information by Issuers Whose Securities Are in Registration,* August 16, 1971.

tion of the issuing company in the past, the present as well as the near future."

In view of the diversity of corporate operations and variation in reliability and volatility of revenue and cost trends, it seems essential that management retain maximum flexibility in determining the degree of financial forecasting detail. Indeed the Financial Analysts Federation was most gratified that the Professor Robert Mautz study on divisional reporting sponsored by the Financial Executives Institute Research Foundation, recognized and emphasized the importance of this concept. With this flexibility it would seem appropriate for management to comment *in general* on expectations of the economy, markets served, industry conditions, and internal corporate progress to a maximum degree without injuring corporate competitive advantages.

As in the British system, responsibility for the economic, commercial, marketing, and financial assumptions underlying the forecasts should remain the responsibility of management. The accountant's verification relates to attesting that forecasts are prepared in accordance with the assumptions underlying the calculations, rather than the assumptions themselves.

A further aspect worthy of consideration is the development of an independent opinion as to the reasonableness of management's commercial assumptions. This responsibility might be assumed by a management consultant division of the auditing firm or some other independent source. A rare example of this concept (Exhibit II, pp. 255-260) was enclosed in the 1965 Pure Oil proxy statement for a special meeting called to consider a proposed merger with Union Oil. The firm of Duff, Anderson & Clark, Industrial, Investment and Financial Analysts, certified that in their opinion the proposal of the merger of Pure into Union was fair and equitable and in the best interests of Pure shareholders. They further stated that the merger arrangements were superior and preferable to any other proposals and that the investment quality of the security to be issued should, in their opinion, command a higher valuation than the market of the Pure Oil common.

Ongoing Forecasting

In regard to ongoing financial forecasting, emphasis should be placed on maximum flexibility in terms of content and timing. To me it seems impossible to establish detailed and inflexible rules regarding financial forecasting. The diversity and complexity of corporations today are such that appropriate procedures for one firm may be entirely inappropriate for another. For instance, utilities, by their very nature, are involved in three- to five-year financial forecasting because of the long lead-time required for capital expenditures.[2] Furthermore the stability of revenue and costs of the utility industry are such that one can attach a high degree of reliability to the long-range forecast.

[2] See Exhibit III, pp. 260-263, Public Service Company of Colorado Forecast.

By contrast, a company which is in the area of high technology may be involved with uncertain costs and unknown revenues so that detailed forecasts may be either meaningless or misleading.

In this latter sense then, I would certainly agree with those who are concerned about revealing budgets which are primarily designed for internal consumption. The professional analyst is well aware of these uncertainties and the low degree of reliability that may be incorporated in certain aspects of internal corporate budgets. Nevertheless, in my mind, this does not relieve the executive of his responsibility of discussing these factors in a more general way with the professional analyst so that he can understand the thought process contributing to management's expectations.

In view of the diversity of sophistication of the user market it is obvious that discussion should vary accordingly, i.e., conversation either in private or large groups of financial analysts should be substantially more detailed than press releases or shareholder publications. At the same time, however, carrying this theory to its logical conclusion, it is important for management to communicate with the general investing public at a level that is meaningful. In this respect, rather than being content with the argument that nondisclosure avoids confusion in the minds of shareholders, management should give some expectation of earnings per share. Perhaps the means to convey a sense of forecast uncertainty to the general investing public would be to issue a range of earnings-per-share expectations with the breadth-and-time frame of the forecast reflecting management's estimates of the degree of reliability.

Forms of Corporate Forecasting

In regard to *frequency,* I would tend to favor some comment at least on a quarterly basis. The investment community and shareholders are used to quarterly reports and, depending on the pace and volatility of the business, previous forecasts can be either modified or reaffirmed briefly. While there is no best method of communication, the following would be my suggestion for a typical program of forecast communication with the financial community.

Annual Reports. While the prime purpose of the annual report is to disclose to shareholders a review of the operations for the preceding year, of more importance to me is management's assessment of the near future. While the subject matter (materiality) and degree of detail should remain the prerogative of management, it is my view that most companies could expand on future expectations in their annual report. As a starter, why not at least discuss the divisional sales and earnings by category required in the Form 10-K. Furthermore, comments on expectations for the economy, as a whole, are appropriate as well as conditions in the industries served and specific corporate events which would tend to make corporate results either better or worse than that of the industry as a whole.

While it is not necessary to be specific in every detail, to my way of thinking it would be appropriate to put in an earnings range for the following calendar year. The major purpose of this disclosure is not for the professional analyst, but to establish a reasonable framework throughout the entire investment community of appropriate expectation for the company over the foreseeable future. Once this framework has become established and well known, it becomes less likely that private discussions among analysts throughout the year will lead to the possibility of disclosure of inside information. While some corporate executives feel that earnings estimates of this nature are dangerous in that they may increase legal liability, to my way of thinking the forecast, if handled with appropriate modifying conditions and clauses, will reduce the liability of misleading the investing public as well as disclosure of inside information.

Quarterly Reports. Quarterly reports, while essentially reviewing items of immediacy and containing a short time span in corporate history, should as a stabilizing factor address themselves briefly to changing or reaffirming earlier long-term forecasts.

Annual Meetings. Annual meetings are the most inefficient corporate obligation today; yet, with a little planning, annual meetings could be the cornerstone of communication with the investing public. I believe it is typical for management to spend hours in preparation for an annual meeting so that they might not be embarrassed by a question from a shareholder on the floor. A more positive and fruitful tack would be for management to address itself to the problems and prospects of the company particularly as they relate to the financial expectations for that particular fiscal year. General comments on corporate undertakings affecting future fiscal years are also helpful. While not discussing financial forecasts, some corporations today have utilized this time to great advantage (e.g., Polaroid, American Research and Development). Other corporations have invited analysts to attend not only the annual meeting but also special briefing sessions which follow (Gulf Oil, Continental Oil). The effectiveness of such a program is underscored by the enthusiasm of the financial community to attend such meetings.

Communications With the Press. While I do not intend to tread on the expertise of the public relations industry, the PR aspect relating to financial forecasting of corporations is indeed vital in this discussion. Management, possibly two or three times per year, may wish to present their views in front of the investing public by accepting a speaking engagement before one of the local Societies of the FAF or, if a larger corporation, perhaps a press conference would be more effective as a supplement to the normal flow of corporate releases. Such occasions may well be necessary to redirect the general area of expectation of corporate earnings to more appropriate levels than those previously predicted. Under these circumstances, a simple explanation of a new

range of reasonableness followed by a brief discussion of the factors involved in the change of the forecast proves most effective. Once this redirection in forecast is known, corporate contacts with the financial community are then freer to delve in detail on a day-to-day basis with the professional analyst without fear of divulging possible inside information.

Over the last few months I have kept a file of earnings forecasts reported in *The Wall Street Journal.* The file is so jammed full that it became apparent that there are sufficient examples in the newspaper almost daily for anyone to judge effective and ineffective examples of this procedure. However, for an illustration of the former, see the shareholder letter of Industrial Nucleonics (Exhibit IV, pp. 264-266).

A final measure to consider in this respect might be to hold a press conference near the end of the calendar year during which management could discuss expectations for the general economy and for specific industries for the following year (e.g., AT&T and General Motors). Such an undertaking prevalent in economic circles sets the stage for more detailed discussions in the annual report and the annual meeting typically three to four months hence.

EXHIBIT I

Excerpts from "Accountants' Reports on Profit Forecasts"
The Institute of Chartered Accountants in England and Wales, July 1969

6. Reporting accountants can, however, within limits which are further discussed below, properly undertake a critical and objective review of the accounting bases and calculations for profit forecasts, and can verify that the forecasts have been properly computed from the underlying assumptions and data and are presented on a consistent basis.

Preliminary considerations

7. Reporting accountants are advised to reach agreement with directors on the following fundamental points before accepting instructions to report in connection with profit forecasts:

(a) The time within which the accountants' report is required should not be so severely restricted that, having regard to the company's circumstances, and not withstanding their best endeavours, it would be plainly impossible for the reporting accountants to obtain sufficient information to enable them properly to exercise their professional judgement for the purposes of reporting (see also paragraphs 16 and 17).

(b) It should be clearly established that the reporting accountants' instructions and responsibility for reporting under the Code are confined to the accounting bases and calculations for the profit forecasts, as distinct from the assumptions including the commercial assumptions, upon which the directors have based their forecasts.

(c) Because profit forecasts are subject to increasing uncertainty the further forward they reach in time, reporting accountants should not normally undertake to review and report to directors on profit forecasts for more than the current accounting period, and, provided a sufficiently significant part of the current year has elapsed, the next following accounting year.

(d) Although reporting accountants can provide the board with some reassurance on the lines referred to in paragraph 6 above, they cannot relieve the directors of the responsibility for profit forecasts which are disclosed to and may be relied on by outsiders.

8. Before accepting instructions from boards of directors to review, and report the connection with profit forecasts the reporting accountants will also wish to establish the following main points:

(a) The purpose for which the forecasts have been prepared and the accountants' report is required.

(b) That the directors assume full responsibility for the forecasts under review (as required by the Code) and that they will signify such responsibility by formal adoption by the board and a statement to that effect in any relevant circular.

(c) The identities of the company's merchant bankers, advisers or other independent professional experts reporting in connection with the forecasts, with whom the reporting accountants will wish to consult and keep in touch. It will be recalled that in any document addressed to shareholders in connection with an offer the assumptions, including the commercial assumptions, upon which the directors have based their forecasts must be stated, and must be reported on by the company's merchant bank or other advisers, and revaluations of assets must be supported by the opinion of independent professional experts (Code, paragraph 15—see Appendix).

Main points to be considered in reporting accountants' review

9. In carrying out their review the main matters to which the reporting accountants will direct their attention are as follows:

(a) The nature and background of the company's business.

(b) The accounting practices normally followed by the company.

(c) The assumptions on which the forecasts are based.

(d) The procedures followed by the company for preparing forecasts.

10. *The nature and background of the company's business.* The reporting accountants will wish to review the company's general character and recent history, with reference to such matters as the general nature of its activities and its main products, markets, customers, suppliers, divisions, locations, labour force and trend of results.

11. *The accounting practices normally followed by the company.* The reporting accountants will wish to establish the accounting practices followed by the company so as to ensure that the principles normally adopted in annual financial statements are acceptable and have been consistently applied in the preparation of interim accounts and profit forecasts. Areas which may require particular attention include, for example:

(a) The methods followed, and the nature of overheads included in determining the amount to be carried forward for stock and work in progress, and the identification, judgment and accounting treatment of obsolete and slow-moving items.

(b) The bases adopted for recognizing profits and providing for losses on long-term contracts.

(c) Bases for calculating depreciation charges.

(d) The accounting treatment of research and development expenditure.

(e) The accounting treatment, and adequacy of disclosure, of exceptional items.

(f) The accounting treatment of taxation and investment grants.

12. *The assumption on which the forecasts are based.* If a circular includes profit forecasts, Rule 15 of the Code requires the assumptions, including the commercial assumptions, upon which the directors have based their profit forecasts to be stated. As noted in paragraph 3 above, it is not the responsibility of the accountants reporting on the accounting bases and calculations for profit forecasts to report on the underlying assumptions but the task of the company's merchant bank or other advisers, if any. However, it is fundamental that the reporting accountants should report whether or not the forecasts are consistent with the given assumptions, economic, commercial, marketing and financial, which underlie them.

13. *The procedures followed by the company for preparing forecasts.* In carrying out their review of the accounting bases and calculations for forecasts, and the procedures followed by the company for preparing them, the main points which the reporting accountants will wish to consider include the following:

(a) Whether the profit forecasts under review are based on forecasts regularly prepared for the purpose of management, or whether they have been separately and specially prepared for the immediate purpose.

(b) Where profit forecasts are regularly prepared for management purposes, the degree of accuracy and reliability previously achieved, and the frequency and thoroughness with which estimates are revised.

(c) Whether the forecasts under review represent the management's best estimate of results which they reasonably believe can and will be achieved as distinct from targets which the management has set as desirable.

(d) The extent to which forecast results for expired periods are supported by reliable interim accounts.

(e) The extent to which the forecasts are built up from detailed forecasts in respect of the main division or lines of activity of the business, distinguishing where possible between those which may be regarded as showing a proved and consistent trend and those of a more irregular, volatile or unproved nature.

(f) How the forecasts take account of any material exceptional items, their nature, and how they are presented.

(g) Whether adequate provision is made for foreseeable losses and contingencies.

(h) Whether working capital appears adequate for requirements as shown by properly prepared cash flow forecasts; and where short-term finance is to be relied on, whether the necessary arrangements have been made and confirmed.

(i) Whether the forecasts have been prepared and presented on acceptable bases consistent with the accounting principles and practices adopted by the company in previous years, and if not, whether the fact and effects of any material change of basis are made clear.

Main matters to be stated in accountants' report

14. The accountants' report under the Code will be addressed to the directors and will normally include statements dealing with the following matters, so far as appropriate:

(a) The fact that the reporting accountants have carried out a review of the accounting bases and calculations on which the profit forecasts have been based.

(b) Specific identification of the forecasts and documents to which the report refers.

(c) If, as will usually be the case, the reporting accountants have not carried out an audit of estimated results for expired periods, a statement to that effect.

(d) Whether in the opinion of the reporting accountants the forecasts have been properly compiled on the basis of the assumptions made by the board of directors, as set out in the circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

15. If the reporting accountants have reason for material reservations about the accounting bases and calculations for the forecasts, or if they have reason to consider them inconsistent with the stated assumptions, they should qualify their report accordingly.

Reporting accountants' reservations caused by substantial restrictions of time

16. It has been noted (paragraph 7 (a) above) that before accepting instructions to report on the accounting bases and calculations for profit forecasts, reporting accountants should be satisfied that the time within which their report is required should not be so severely restricted that it would be plainly impossible for them to obtain the information they require to enable them properly to exercise their professional judgement for the purpose of reporting.

17. If for any reason, including unduly restrictive time limits, the reporting accountants have not obtained all the information they consider necessary, they should qualify their report accordingly. If they consider they have insufficient information to enable them properly to exercise their professional judgement for the purpose of giving a meaningful report, they should say so.

Specimen report

18. An accountants' report on the accounting bases and calculations for profit forecasts might, in appropriate circumstances, where there are no grounds for qualifications, read as follows:

To the directors of X, Ltd.

We have reviewed the accounting bases and calculations for the profit forecasts of X, Ltd. (for which the directors are solely responsible) for the periods . . . set out on pages . . . of this circular. The forecasts include results shown by unaudited interim accounts for the period . . . . In our opinion the forecasts, so far as the accounting bases and calculations are concerned, have been properly compiled on the footing of the assumptions made by the Board set out on page . . . of this circular [and separately reported on by Messrs . . . on page . . .] and are presented on a basis consistent with the accounting practices normally adopted by the company.

Letter of consent

19. Rule 15 of the Code requires that accountants' reports on the accounting bases and calculations for profit forecasts contained in circulars must be accompanied by a statement that the accountants have given and not withdrawn their consent to publication.

20. Before giving their consent (which should be in writing) to publication of their report, the reporting accountants should require to see the whole text of the circular and should be satisfied that it is appropriate, and not misleading, for their report on the accounting bases and calculations for profit forecasts to appear in the form and context in which it is included.

EXHIBIT I-A

Prospectus of Secondary Offering of Bost Kalis Westminster Dredging Group N.V. (A Dutch Company)

June 4, 1971

Finance and dividend policy

Although the dividend policy will be changed, retained earnings should continue to be one of the most important sources of finance. Besides, limited use will be made of loan capital in future.

An ample measure of liquidity will be necessary to enable the Company to pursue an active policy and to prefinance contracts.

Assuming that results of the current year would equal those of fiscal 1970, it is the intended to distribute approx. 35% of the net profit to shareholders.

Progress and outlook

The volume of contracts awarded guarantees a satisfactory level of activity for the remainder of this current fiscal year. A number of important projects that are due to commence include sandwinning near Reeuwijk, enclosure of

the East Schelde and improvement of ports and harbours at Boulogne, Tarragona, Leixoes, Dublin, Aalborg and Milford Haven.

In 1971 the Company also plans to undertake activities on a modest scale, in the fields of the disposal of industrial effluents. A chemical tanker M.I. Transporter No. 1 has been purchased and is being converted for this purpose.

Expansion of activities resulting from the acquisition of Grant, Lyon, the Oosterwijk and Verstoep groups and more recently of Rock Fall afford more scope for diversification. This will broaden and strengthen the Group's base.

Special attention will be paid to further internationalisation. More and more opportunities for carrying out large-scale projects are likely to occur through the infrastructural improvements particularly in the developing countries. The Group today offers a full comprehensive range of services, supported further by the merger with Verstoep. In view of the anticipated growth of foreign business it is of vital importance that the scope of the foreign working companies is further enlarged. During 1970 subsidiaries were formed in France and the Netherlands Antilles, whereas the establishment of a Spanish subsidiary is in a preparatory stage. Presently, possibilities are being studied for an enlarged participation in Continental Shelf activities.

Results for the first months of 1971 have been satisfactory. It seems justified to expect that full year results will not differ to any important degree from those obtained in 1970. However, as profits on a given project are only accounted for after completion of the contract, it is difficult to make an accurate assessment of profits for the full year at this stage.

For additional information reference is made to the financial data included elsewhere in this prospectus.

Yours faithfully,
Bost Kalis Westminster Dredging Group N.V.

Excerpt from Oce-van der Grinten N.V.
(A Dutch Company)
Offering Prospectus
Dated April 13, 1971

Forecast

It is expected that, during the next five years — acquisitions not taken into account—increases of sales of 20% per annum may be realized, which would mean that in said five-year period the sales of the present Oce companies would be trebled. Every effort is being made to step up operating profits. For 1971 a 15% rise of net profits is anticipated. Developments in the first quarter of the current financial year confirm these expectations. There is no certainty yet as to whether the equity deriving from the present issue which is destined for the financing of new acquisitions will contribute to profits in the current financial year to the same extent, since this will depend on, among other factors, the times at which these acquisitions can be effected.

EXHIBIT I-B

Offering of M.F.I. Warehouses, Ltd.
(A U.K. Company)

Profits and Prospects

The growth in the Group's turnover and profits shown by the Accountants' Report may be attributed to four principal factors:

(1) The ability of the Group to develop, in close association with manufacturers, specially designed goods at competitive prices and to sell these goods profitably through the efficient use of advertising in the national press and magazines.

(2) The continued extension of existing lines which has increased the return from advertising.

(3) The development of retail trading which has produced a greater return from the mail order advertising.

(4) The increase in turnover which has enabled the Group to buy in greater quantities at lower prices.

The Group's turnover and profits before taxation for the year ended 31st May, 1970 amounted to £3,718,000 and £532,182 respectively, and for the nine months ended 28th February, 1971 amounted to £3,914,000 and £ 609, 584 respectively. The last six weeks of the latter period were adversely affected by the postal strike. During those weeks the turnover of the retail warehouses was approximately in line with the budget made prior to the strike but mail order turnover was severely reduced. The Directors consider that stocks at 28th February, 1971 as shown by the Accountants' Report were abnormally high because of the reduction in mail order turnover. Taking into account cost savings which were made, including a reduction in advertising expenditure which it was possible to make because the Group's advertising is finalised weekly, it is estimated that the Group earned profits before taxation of approximately £40,000 during the period of the strike.

The turnover in the three months ending 31st May, 1971 is expected to amount to approximately £ 1,900,000 (1970—£ 1,300,000) of which £ 1,150,000 will be mail order sales and £ 750,000 will be retail warehouse sales. The overall net profit margin in this period is expected to be somewhat lower than for the previous nine months because of a seasonal change in the sales mix and a reduced level of credit charges receivable caused by the loss of mail order turnover during the postal strike. The Directors expect that in the absence of unforeseen circumstances the Group's profits before taxation for the year ending 31st May, 1971 will be not less than £875,000.

The Company gave evidence to the Crowther Committee on consumer credit and would welcome the implementation of that Committee's recommendations. The Directors consider that having regard to the Group's method of trading it will continue to be fully competitive.

It is the Directors' policy to continue to develop the business of the Group by increasing the range of goods sold and by opening further retail warehouses, both in suburban London and in other growing and densely populated areas of the country. It is planned to open a total of four further retail warehouses by 31st May, 1972 including those at Welling and Luton.

The Directors are confident that, with the additional space available in

the new premises at Wembley and with the further retail warehouses which it is intended to open, the prospects for both the mail order and retail businesses of the Group are good.

Dividends and Yields

The Directors do not intend to recommend a dividend in respect of the year ending 31st May, 1971. In respect of the year ending 31st May, 1972 it is their intention to pay an interim dividend in February, 1972 and to recommend a final dividend for payment in or about October, 1972.

Had the company been a quoted company for the whole of the year ending 31st May, 1971 the Directors would have recommended, on the basis of profits before taxation of £875,000 and corporation tax at the rate of 40 per cent, dividends totalling 54 per cent of which 20 per cent would have been paid as an interim dividend and 34 per cent as a final dividend. This may be shown as follows:

	£
Profits before taxation	875,000
Less: Corporation tax at 40 per cent	350,000
Profits available for Ordinary shareholders	525,000
Less: Total dividends of 54 per cent on the Ordinary share capital of £600,000	324,000
Retained profits	£201,000
Cover for the Ordinary dividend	1.62 times

On this basis and at the Offer price of 135p per share, the Ordinary shares of the Company are being offered for sale at a price/earnings ratio of 15.4 and on a dividend yield of 4.0 per cent.

Yours faithfully,
Arthur C. Southon,
Chairman

EXHIBIT I-C

Singer & Friedlander Ltd. Offering of Kwik Save Discount Group Ltd.

November 25, 1970

Profits, prospects and dividends

As will be seen from the Accountants' Report, the growth in turnover and profits of the Group since the Group adopted its present methods of trading in 1965 has been very rapid. The rise in profits has broadly followed the increase in the number of stores opened by the Group, but it has also been assisted by an improvement in net margins.

The number of outlets operated by the Group at the end of each of the

last 6 financial years and the anticipated position at the end of the current financial year are as follows:

1965	4	conventional	supermarkets	totalling	27,000	sq.	ft.	of	floor	area
1966	9	discount	supermarkets	totalling	51,000	"	"	"	"	"
1967	13	"	"	"	86,000	"	"	"	"	"
1968	17	"	"	"	108,000	"	"	"	"	"
1969	18	"	"	"	121,000	"	"	"	"	"
1970	24	"	"	"	163,000	"	"	"	"	"
1971	29	"	"	"	250,000	"	"	"	"	"

*Includes the 4 conventional supermarkets converted during the year.

Although only one discount supermarket was opened in the year to 31st August, 1969 the warehouse was expanded by 28,000 square feet and the full benefit was felt of the four discount supermarkets opened in the previous year.

In the year of 31st August, 1967 which was the first full financial year which reflected the change in the Group's methods of trading, turnover rose by some 125% but profits only rose by some 30%. The principal cause of this relatively small increase in profits was the difficulty experienced in changing the Group's methods of trading; inevitably mistakes were made, particularly in the selection and handling of stocks. In each of the three years subsequent to 1967 the percentage increase in profits has been in excess of the percentage increase in turnover, reflecting the steady improvement in net profit margins.

Two of the six new discount supermarkets opened in the year to 29th August, 1970 were not opened until the last month of this period and made little contribution to the profits of the year. As mentioned under "Future Expansion of Premises" above at least five further stores are scheduled to open in the current financial period. In addition the Group is expanding the selling area of two existing stores. Taking into account this current development programme and the expansion of turnover being experienced in existing discount supermarkets the Directors expect that profits before corporation tax for the current financial year ending 28th August, 1971 will show a significant increase over those for the previous period and in the absence of unforeseen circumstances will be not less than £900,000.

On the basis of profits before tax for the year ending 28th August, 1971 of not less than £900,000 the Directors expect to pay an interim dividend of 20% in or about April, 1971 and to recommend a final Ordinary dividend of not less than 27½% in or about December, 1971.

The Directors believe that present trends in retailing favour the type of trading carried out by the Group and that the potential for continued growth of profits in the future is good. For this potential to be realised it will be necessary for the Group to continue to acquire and develop new sites. As indicated under "Future Expansion of Premises" above, the Group is being offered an increasing number of sites and is capable of opening a new discount supermarket very rapidly after a suitable site is acquired; new discount supermarkets are expected to become profitable immediately after opening. Taking into account recent motorway development the Group has a substantial po-

tential trading area based on the present warehouse at Prestatyn. The Directors intend at a later stage to expand the Group's operations in an adjacent area centred round a second warehouse.

In the financial year ended 29th August, 1970 the Group increased its net profit margin for the third year in succession, despite two wage increases to its employees. The average size of the stores that will be opened by the Group in the future will be larger than the average size of the existing stores; since labour costs do not rise proportionately with the size of the store this should result in increased productivity. Many of the Group's overhead expenses do not vary directly with turnover; as turnover rises the Directors therefore expect that margins will be at least maintained and possibly improved.

Taking into account all the above points the Directors are confident of the Group's ability to continue to expand its turnover and profits in the foreseeable future.

Dividend yield, price earnings ratio and cover

The appropriation of the forecast profits before taxation of £900,000 based on corporation tax at 42½% and on dividends totalling 47½% is shown below:

	£
Forecast profits before taxation	900,000
Less: corporation tax at 42½%	382,500
Profits after taxation	517,500
Dividends (gross) of 47½% on £750,000 Ordinary share capital would absorb	356,250
Leaving for retention in the business	£161,250

On this basis, at the Offer price of 21s. 6d. per share, the gross dividend yield would be 4.42%, the dividend would be covered 1.45 times, and the price earnings ratio would be 15.58.

EXHIBIT II

The Pure Oil Company
Proxy Statement
for
Special Meeting of Shareholders
July 2, 1965

General information

This statement is furnished in connection with the solicitation of proxies by the management of The Pure Oil Company, an Ohio corporation ("Pure" or "Company"), to be used at the special meeting of stockholders of Pure to be held at 10:00 o'clock A.M. (Central Daylight Saving Time) on July 2, 1965, at 620 East Broad Street, Columbus, Ohio, and at any adjournment

thereof. The special meeting has been called for the purpose of considering and taking action on a proposal to merge Pure into Union Oil Company of California, a California corporation (Union), under an Agreement of Merger (merger agreement), a copy of which (as approved and recommended by the Board of Directors of Pure) is attached hereto as Exhibit A and made a part hereof. If the accompanying form of proxy is executed and returned it may nevertheless be revoked at any time before it is voted by written notice to the Company or in open meeting.

At the close of business on May 20, 1965, Pure had outstanding 10,024,605 shares of Common Stock entitled to be voted of the par value of $5.00 each. Each share of the outstanding Common Stock is entitled to one vote on matters to be considered at the meeting. Only shareholders of record at the close of business on May 27, 1965, were entitled to notice of the meeting and will be entitled to vote at the meeting.

The proposed merger

Under the terms of the merger agreement, and as provided by the applicable laws of Ohio and California, Pure will be merged into Union, which will be the surviving corporation, and the separate existence of Pure will cease. Union will thereafter continue to be a corporation organized under California law, will succeed (without other transfer) to all the rights, properties and assets of Pure, and will be subject to and responsible for all debts and liabilities of Pure.

The merger agreement provides for the amendment of Union's Articles of Incorporation to create and authorize 10,275,397 $2.50 Cumulative Convertible Preferred Shares, without par value, each of which—

- will have share for share voting power, along with the Union Common Shares,
- will be entitled to a $2.50 annual dividend in preference to the Union Common Shares,
- will be convertible into 1.3 Union Common Shares,
- will be non-callable for five years. Thereafter, unless the holder exercises his right of conversion, the Preferred Shares will be redeemable in whole or in part at Union's option at $67 in the sixth year, $66 in the seventh year and $65 in the eighth and subsequent years, and
- will be entitled in the event of liquidation, in preference to the Union Common Shares, to $65 in case the liquidation is voluntary and $62.50 if it is involuntary.

Upon the merger becoming effective, each outstanding share of Pure Common Stock will be converted into one Union $2.50 Preferred Share. Thereafter, until exchanged for Union share certificates, outstanding Pure Common Stock certificates will represent an equivalent number of the new Union $2.50 Preferred Shares.

Authorized and outstanding Union Common Shares will not be affected by the merger.

Upon the merger becoming effective, Union Common Shares theretofore authorized (whether issued or unissued) shall remain unchanged and all such shares outstanding on such effective date (including shares held in the treas-

ury of Union) shall remain outstanding. Each certificate of Union evidencing ownership of any such shares shall continue to evidence ownership of the same number of Common Shares of Union as the surviving corporation.

The Board of Directors of Pure has approved the Merger Agreement and, under the laws of Ohio and Pure's Articles of Incorporation, the affirmative vote of at least a majority of the outstanding shares of Pure's Common Stock is required for approval of the Merger Agreement. The Board of Directors of Union has also approved the Merger Agreement and the proposed amendments to Union's Articles of Incorporation and, under the law of California, an affirmative vote of at least two-thirds of Union's outstanding common shares is required for the approval of the Merger Agreement. As the amendments to Union's Articles of Incorporation relate to and are proposed for the purpose of effecting the merger, Union's shareholders will vote upon the Merger Agreement and the amendments as one matter. Accordingly, the affirmative vote of at least two-thirds of Union's outstanding common shares will be required for the adoption and approval of the proposed amendments to Union's Articles of Incorporation.

The foregoing summary of certain terms of the Merger Agreement is qualified in its entirety by reference to that document itself, a copy of which is attached to this Proxy Statement.

Negotiation of Union Oil merger terms and basis therefor

The principal reasons for the conclusion of the Board of Directors of Pure that the proposed merger is in the best interests of shareholders have been set forth in the letter of its President accompanying this Proxy Statement. Shareholders are urged to read this letter carefully.

The terms of the merger are the result of arm's length negotiations between representatives of the constituent companies. Among other factors considered were the respective assets, earnings, operations and future prospects of the companies and the market prices for their common stocks. Under the circumstances it appeared equitable to provide for the creation of a preferred stock of Union for issuance to Pure shareholders upon the merger, such preferred stock to carry a stable dividend rate above that previously paid on Pure Common Stock and to permit holders of this preferred stock to participate in the possible future growth and development of the combined enterprises through a right to convert into Common Shares of Union. The conversion and dividend rates were fixed so as to reflect a comparison of past projected earnings and market prices at the time of negotiations, adjusted, however, to reflect the differences between a preferred security with a right of conversion and Union's Common Shares.

In working out the merger arrangements, Union consulted with Dillon, Read & Co. and Blyth & Co., Incorporated, investment banking firms. Pure has had the benefit of advice and a report from Duff, Anderson & Clark, investment analysts. Their letter of opinion is reproduced on p. 258.

Developments preceding submission of Union merger to shareholders

After careful study and analysis, Pure's Board of Directors determined on February 15, 1965, by a 12 to 1 vote (Mr. Parten dissenting), that the

Report of Independent Investment Analysts

Duff, Anderson & Clark
Industrial Investment and Financial Analysts
208 South LaSalle Street
Chicago, Illinois 60604

May 19, 1965

Board of Directors
The Pure Oil Company
Palatine, Illinois
Gentlemen:

In accordance with your request, we have reviewed the terms of the proposed merger of The Pure Oil Company into Union Oil Company of California.

We have also, at your request, reviewed two alternative proposals considered at the time you determined to proceed with negotiations of definitive details of the Union merger, one of which contemplated the sale of Pure's assets and the other a merger of Pure with another oil company; and also a recent communication from Ashland Oil & Refining Company outlining a plan for the sale of Pure's assets. The results of our review and analysis of the foregoing are set forth in detail in our Report dated April 22, 1965, and supplementary letters dated May 4, and May 17, 1965.

In our opinion the proposal for the merger of Pure into Union is fair and equitable; and your decision to proceed with the Union merger was and is, in our view, in the best interest of Pure's shareholders. We consider the Union merger arrangement to be superior and preferable, from the standpoint of a shareholder of Pure, to any of the proposals or possibilities referred to in the preceding paragraph. Our belief is that the investment quality of the Union preferred to be issued on the merger to Pure shareholders is such that, under normal market conditions, it should command a higher valuation than the market has been placing on Pure common.

Very truly yours,
Duff, Anderson & Clark

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merger of Pure into Union was clearly superior to, and more in the interests of Pure shareholders than, either of the only other definitive proposals which your Company's Board of Directors received between June 1964 and the following mid-February.

One of the proposals rejected contemplated a merger of Pure into Atlantic Refining Company (Atlantic), an active competitor of Pure in a multistate area in the Southeast. Under this proposal, Pure shareholders were to receive Atlantic preferred stock on a share for share basis. The Atlantic preferred was to be convertible into one-half share of Atlantic common (then trading at approximately $60 a share); was to be subordinate as to dividends and on dissolution to $90,000,000 authorized prior Atlantic preferred, of which $32,500,000 was stated to be outstanding; was to be entitled to a $2.95

noncumulative annual dividend and $70 in liquidation, in each case in preference to Atlantic common; was to be callable after ten years at $90 per share; and was to be entitled to one-half vote per share.

The other rejected proposal was submitted by a group consisting of Carl M. Loeb, Rhoades & Co., two other investment banking firms and a chemical corporation. It contemplated purchase by this group of Pure's production properties, subject to a $500,000,000 reserved production payment, sale of Pure's refining, transportation and marketing properties to a new company having no interest in the oil and gas properties and liquidation and dissolution of Pure. The gross consideration to be given for Pure's assets was stated to be an amount equal to $62.50 per share of Pure's common stock, plus an amount sufficient to retire Pure's funded debt, and the assumption of certain of Pure's liabilities. Title and conveyancing expense, taxes generated by the sale, and liquidation expense were to be borne by Pure.

Neither of these two proposals is now open, one of them having been expressly withdrawn and the other having expired by its terms.

On April 29, 1965, Pure's Board of Directors, by a vote of 11 to 2 (Messrs. Parten and Sandlin dissenting) approved the Merger Agreement, Union's Board of Directors having previously approved. Thereafter, in accordance with applicable law, the merger agreement was executed by Pure and Union on April 29. On May 7, 1965 Pure received a letter from Ashland Oil & Refining Company dated that day. A later communciation, dated May 15, was received from Ashland which amended the earlier letter. The last Ashland letter (copy of which is hereto annexed as Exhibit B) outlines a proposal by Ashland and its associates for negotiations for the sale by Pure of its assets upon outlined terms which, it is asserted, would produce $70 a share on Pure stock. Ashland is an active competitor of Pure in a multi-state area in the Midwest and Southeast.

At the present time the Union merger agreement constitutes a contractual commitment by Pure and Union for the merger of the two companies, subject only to the approval of shareholders of each company and to termination of the merger agreement in certain limited situations defined by the agreement itself. Ashland's proposal to negotiate is, in recognition of this fact, expressly made subordinate and subject to Pure's submission, to its shareholders of the Union merger proposal.

The Ashland submission is not an offer susceptible of acceptance or rejection in its present form, even if Pure were contractually able to entertain it, and Ashland and its associates are in no way committed at the present time. The Ashland plan is, instead, only a proposal to negotiate on a variety of details. Before any clear proposal could be developed and put in definitive form for Pure's consideration and necessary action, satisfactory resolution of a number of contingencies and extensive documentation would be required, all of which would likely take a number of months. The contingencies which would have to be resolved include the financing of a new company, not yet organized, in a very substantial aggregate amount by the public or institutional investors, at a future date and under economic and market conditions not now predictable. This financing would be necessary to enable the new company to undertake assumption of Pure Oil's liabilities, which include long-term debt in

excess of $150,000,000, and at the same time to carry on Pure Oil's present refining, transportation, and marketing operations.

There is no assurance that any alternative to the Union merger can be successfully developed. The probability is that substantial time delays would be involved in the process, in any case, before shareholders could expect to realize upon their investment under any alternative.

The Union merger proposal is the only definitive offer before the shareholders for acceptance or rejection.

Over a period of ten months, in considering various suggestions, plans or proposals for merger of Pure into another company, or the sale of its assets, a major consideration has been the impact on the transaction of federal and state antitrust laws. Ultimately, the relationship between these laws and a particular transaction is a matter for judicial determination, but in the first instance the attitude of enforcement authorities is important.

For several months, the United States Department of Justice has been studying the proposed Pure-Union merger in the light of federal antitrust laws and each of the companies has been cooperating in this study by supplying information as requested. To date, there has been no indication by the Department of Justice as to whether it will oppose the merger.

Counsel have advised Pure that a merger of Pure and Union, in its opinion, will not violate antitrust laws. Counsel have further advised that a rejected merger proposal by Atlantic, a competitive oil company, as well as the recently publicized idea of Ashland, another competitive oil company (Exhibit B), for the purchase of Pure's assets, would violate the Sherman and Clayton Acts.

EXHIBIT III

Uniform Forecast
Public Service Company of Colorado and Subsidiaries
1971–1975

Assumptions made in Forecast

(1) Present federal and state income tax laws will prevail throughout the period.

(2) No rate relief is assumed beyond that associated with the 1970 rate case.

(3) Interest rates of 7 per cent for long-term debt securities and 6 per cent for short-term notes payable were assumed throughout the period.

(4) The present dividend payout ratio in common stock will be approximately maintained.

Rate Filing

For the year ended December 31, 1970, Public Service Company of Colorado did not earn the rate of return that was authorized by The Public Utilities Commission of the State of Colorado in its January 1970 Rate of

Return Order. The combination of a high rate of price inflation, higher money costs and the reduction in electric revenues resulting from the rate restructuring in March 1970 have resulted in overall earnings that are deficient. Therefore, on February 19, 1971, the Company filed an application with The Public Utilities Commission of the State of Colorado for authority to increase its gas and electric rates. The application seeks to update the Commission's 1970 order which allowed a 7.5 per cent overall rate of return (7.7 per cent on the gas business alone). No increase will be sought in the 13 per cent allowance for return to common equity, nor will the Company raise other controversial matters such as rate base definition or calculation. Of course, the increase in rate base and in operating revenue deductions will be taken into account as well as the fact that, since $75 million of new debt securities have been sold since the 1970 order, a somewhat higher overall rate of return is being sought.

Increased cost of gas — rate adjustment

On August 14, 1970, Colorado Interstate Gas Company, which supplies over 90 per cent of Public Service Company of Colorado and its subsidiaries natural gas resale requirements, was authorized by the Federal Power Commission an annual increase of approximately $5 million effective April 18, 1970. The Company and its subsidiaries were authorized by their respective regulatory commissions to increase their rates on a consolidated basis in an amount approximating 97 per cent of the increased cost of gas effective simultaneously with Colorado Interstate Gas Company's increased rates.

On September 30, 1970, El Paso Natural Gas Company, a partial natural gas supplier of Colorado Interstate Gas Company and Western Slope Gas Company, filed an application with the Federal Power Commission for increases in its rates. Subsequently, Colorado Interstate Gas Company filed a tracking increase application. The Federal Power Commission has suspended both proposed increases until March 31, 1971 at which time the proposed increases will become effective in part, subject to refund to the level of rates ultimately determined. The Company and its subsidiaries will file with their respective regulatory commissions for authority to make coincident compensating rate increases, also subject to refund. It is estimated that the amount of the March 31, 1971 increase to the Company and its subsidiaries will be about $1.25 million.

General comments on:

Air Quality Control Program. The Company announced on April 16, 1970 a new air quality control program which involves two phases and a three year estimated cost of $11 million. The objective of the program is to reduce particulate emission levels of ten of the Company's major generating units to a point substantially lower than that required by state statutes through the use of gas conditioning equipment and wet scrubbers. The Company's overall goal is to obtain a clear stack status by mid-1973.

Fort St. Vrain. Construction of Fort St. Vrain Nuclear Generating Plant is approximately 85 per cent complete as of year-end 1970. Commercial op-

eration is scheduled for not later than March 31, 1972. The total estimated construction cost to the Company is approximately $63 million, which includes the cost of the site and site preparation. Local reaction to the plant has been favorable as evidenced by over 15,000 visitors during the first six months.

Uniform Forecast Form
Public Service Company of Colorado and Subsidiaries
(Revised February 1971)

	Actual	*Estimated*				
	1970	1971	1972	1973	1974	1975
(1) *Sales and Load Data*						
Electric sales (millions of kwh)	7,259	7,883	8,522	9,213	10,721	11,558
Gas sales (millions of mcf)	185	192	209	210	226	233
Electric max. net firm demand (MW)	1,377	1,558	1,685	1,823	2,075	2,259
Electric net capability (MW)						
Peaking generation	362	362	362	362	362	362
Base load generation	1,485	1,485	1,815	1,815	2,165	2,165
Firm purchases and Colo. power pool	52	56	58	60	63	66
Total	1,899	1,903	2,235	2,237	2,590	2,593
(2) *Capital Requirements**						
Construction expenditures:						
Electric	$73.7	$75.6	$70.4	$64.9	$65.9	$75.3
Gas	14.5	17.0	14.1	13.8	14.7	15.8
Other	4.9	6.4	5.5	4.7	4.2	5.1
Subtotal	$93.1	$99.0	$90.0	$83.4	$84.8	$96.2
Bond maturities	—	—	—	0.3	—	—
Bond sinking funds	0.5	0.5	0.5	0.5	0.5	0.5
Total capital requirements	$93.6	$99.5	$90.5	$84.2	$85.3	$96.7
(3) *Sources of Capital**						
Internal cash:						
Depreciation accruals	$22.7	$23.8	$26.3	$28.9	$31.1	$33.4
Other internal sources	17.1	18.8	4.3	15.5	13.5	15.7
Subtotal	$39.8	$42.6	$30.6	$44.4	$44.6	$49.1
Outside financing required	53.8	56.9	59.9	39.8	40.7	47.6
Total sources of capital	$93.6	$99.5	$90.5	$84.2	$85.3	$96.7

	Actual	Estimated				
	1970	1971	1972	1973	1974	1975
Tentative financing program*						
Bonds	$35.0	$40.0	$ —	$ —	$ —	$ —
Preferred stock	—	30.0	—	—	—	—
Common stock	19.5	—	—	—	—	—
Short-term loans	(0.7)	(13.1)	(5.1)	(0.2)	5.7	(2.4)
Type not determined (a)	—	—	65.0	40.0	35.0	50.0
Total	$53.8	$56.9	$59.9	$39.8	$40.7	$47.6
(4) *Significant Income Items**						
Tax reductions from liberalized depreciation and guidelines (flow-through)	$ 5.2	$ 5.4	$ 6.0	$ 6.4	$ 6.7	$ 7.0
Interest charged to construction (Rate — 7-1/2 per cent)	2.8	5.4	3.9	4.6	1.6	3.7

*Millions of dollars

(a) Permanent financing — type dependent on market and other conditions at the time.

Weather Comparison
Denver Airport Temperatures

Month Ending the 7th	*Degree Days Actual* 1970	*Degree Days Normal*	*% Colder or Warmer ( ) Than Normal*	*Degree Days Actual* 1969	*% Colder or Warmer ( ) Than* 1969
January	1,139	1,088	4.7	1,065	6.9
February	910	1,076	(15.4)	956	(4.8)
March	690	983	(29.8)	887	(22.2)
April	974	748	30.2	819	18.9
May	532	433	22.9	367	45.0
June	175	200	(12.5)	157	11.5
July	30	55	(45.5)	122	(75.4)
August	—	3	(—)	—	—
September	1	26	(96.2)	—	—
October	268	173	54.9	187	43.3
November	702	509	37.9	845	(16.9)
December	741	803	(7.7)	816	(9.2)
Total to Date	6,162	6,097	1.1	6,221	(0.9)

Definition: Degree days for any day is the difference of the mean temperature (average maximum and minimum) below 65°F. *Example*: Assume maximum of 60° and minimum of 20°, the mean temperature would be 40°, which subtracted from 65° equals 25 degree days.

EXHIBIT IV

Industrial Nucleonics Corporation®/AccuRay®
650 Ackerman Road, Columbus, Ohio 43202 (614) 267-6351

OFFICE OF THE PRESIDENT

September 29, 1971

Dear Stockholder:

We are pleased to present the following progress report covering the year to date together with our current projection for the full year ended December 31, 1971. Our report is based on our detailed midyear review completed in late August of order projections, equipment shipments, rental and service revenues, and operating budgets for all departments for the remainder of 1971.

	1969 (*per audit*)	*1970* (*per audit*)	*1971* (*projected*)
Operating revenues	$20,002,000	$27,600,000	$38,000,000 41,000,000
Profit before taxes	3,366,000	4,429,000	5,000,000 5,500,000
Profit after taxes	1,916,000	2,402,000	2,600,000 2,850,000
Earnings per share	$0.60	$0.74	$0.80-0.86

The market for our process automation systems is a combination of diverse individual markets in each of the various industries we serve. As described in earlier quarterly reports, we have been engaged during all of 1971 in shipping a series of initial system configurations with the objective of rapidly expanding our potential for repeat orders for each new application. These systems have many existing new features such as "automatic grade change control," "speed optimization control," and "dynamic target optimization control" which are being offered to our customers for the first time.

Many of these large sophisticated systems, in retrospect, have taken longer to install and bring fully operational than anticipated. In a number of instances, we have also encountered delay in customer programs because of external conditions beyond our immediate control. The composite effect of these factors was that the level of new equipment orders which we received during the summer months was lower than expected. On the positive side, we have received outstanding initial application results from systems shipped earlier in 1971. With these excellent customer testimonials, we foresee a higher level of order activity during the remainder of 1971.

The lower level of orders received during the summer months has affected adversely our quarterly profit planning for the year. During each of our current quarterly periods, we have planned to balance the mix of initial systems designs having higher manufacturing costs with more standard shipments produced at lower manufacturing costs and higher profit. The delay in receipt of orders has moved several shipments into the fourth quarter which we had planned to complete in the prior quarter. The third quarter will,

therefore, be lower in volume and profit, and the fourth quarter will be correspondingly higher in volume and profit than we had anticipated earlier. The following is a summary of current quarterly projections:

	1st Quarter Ended Mar. 31 (per interim report)	*2nd Quarter Ended June 30* (per interim report)	*3rd Quarter Ended Sept. 30* (projected)	*4th Quarter Ended Dec. 31* (projected)
Operating revenues	$7,728,000	$9,954,000	$10,000,000	$10,000,000 13,000,000
Profit before taxes	1,020,000	2,037,000	500,000	1,500,000 2,000,000
Profit after taxes	530,000	1,058,000	250,000	800,000 1,000,000
Earnings per share	$0.16	$0.32	$0.08	$0.24-0.30

Our final performance for 1971 will be leveraged by our ability to capitalize on the success of each initial system installation and to produce repeat business in that industry segment. Included among these new systems recently shipped were:

- An AccuRay® Process Management 800 system with target optimization control which is now installed on a tire fabric calender in the rubber industry.
- An AccuRay Process Management 800 system with target optimization control designed for multi-line impregnation processes in the industrial laminating field.
- An AccuRay Process Management 800 system for the galvanizing industry designed with a new X-ray fluorescence system to measure zinc coatings on steel and provide for automatic control of coating weight on galvanizing lines.
- An AccuRay Process Management 832 system with target optimization control for both basis weight and moisture which is now installed on an on-machine coating process producing over 300 tons per day of coated papers.
- An AccuRay Process Management 811 system with complete automatic grade change and automatic speed change capabilities which is now installed on one of the fastest machines in the United States manufacturing publication grades of paper.
- An AccuRay Process Management 821 system with speed optimization control for both basis weight and moisture which is now installed on a high production machine producing corrugating medium.
- An AccuRay Process Management 821 system with automatic grade change, speed optimization control, and target optimization control which is presently being installed on a machine producing over 1,000 tons per day of liner-board product.

• An AccuRay Process Management 811 system with target optimization control for both basis weight and moisture which is now installed on a machine in the newsprint industry.

• An AccuRay Production Process Diagnostic System 800 designed for use with the basic AccuRay Process Management system being supplied to the tobacco industry to provide a practical link from the data base generated at the process level to higher level management information systems.

We have active marketing programs under way to contact every potential user of these systems and encourage visits to present installations in order to demonstrate the results being achieved. To better communicate the success of these systems, we are also accelerating our advertising program. The attached advertising reprint appears in the September issue of *Pulp and Paper* magazine and other trade periodicals.

In our 1970 Annual Report to stockholders, we advised that in order to aid the introduction of our computer-based AccuRay Process Management systems, we had adopted the cost accounting technique of associating the learning costs on initial system applications with anticipated orders for similar future applications. We also noted that this method would aid in the expansion of this basic system development to new applications in 1971. We have followed this program during the year and expect to include in our inventory valuation approximately $1,000,000 and defer this cost into 1972. Our experience continues to show that subsequent shipments of these systems are produced at much lower costs. During the past 18 months, we have substantially increased both our professional staff and our physical plant and facilities to accommodate the higher level of manufacturing operations. We have made significant headway in our manufacturing standardization programs, and our new personnel are being efficiently utilized. The result is that we can now offer routine shipment of all major new product lines, and we are realizing improved profitability on subsequent shipments of new designs. This will enable us to achieve improved margins in the balance of 1971 and 1972.

In summary, we report major progress in the transition of the Company to a broader systems supplier of process automation and management information systems. We believe that the strength of the Company is in our diversification by industry, by product line, and by geographical market. We remain most optimistic for continued success in the period ahead.

Sincerely,
David L. Nelson
President

Attachment

3

Ethical Problems in Context

A Montage of Financial Reporting Problems

By Robert L. Grinaker, *Professor of Accounting, University of Houston.*

Henry Parsons was trying to clear his desk of a few troublesome details before taking off with his family for a weekend at their Wisconsin shore home. Henry is an audit partner with Helman and Minert, CPAs, a regional firm with its head office in Chicago. His clean-up campaign was interrupted by a call from his good friend, Allen Petrie, vice-president and controller of R. Milby, Inc. Henry was pretty sure he knew what the call was about even before he picked up the phone, and he was right. "Friend Henry," came a too soothing voice, "I hope your calendar is clear Monday morning, because you are invited to a 10:00 AM meeting at our shop. Tom and Bill Milby want to discuss our accounting and financing problems." Henry did have another engagement, but thought to himself that he could (or perhaps more accurately, he had damn well better) break it to attend the Milby meeting. However, Henry replied that his calendar was clear and that 10:00 AM would be fine. Allen then informed him that Herb Conners and Arnold Kendall would also be there. With that, Allen wished him a nice weekend, adding the comment that he would miss Henry's money at the Saturday morning golf game.

Henry decided that he'd better put aside other matters and get his thoughts in order for the Milby meeting. He called for the Milby files and proceeded to browse through them. Among other things, the following matters were noted in the course of this review.

General Background

R. Milby, Inc., is an operator of feed and hardware stores throughout the midwestern United States. Until the middle 1950's, the company served a primarily rural market. During the fifties, as the suburban movement blos-

somed, a substantial new market developed, largely attributable to a growing number of suburban horse-owners. It became Milby's policy to exploit this expanding suburban market while maintaining those rural markets which could be served from common facilities.

The company is managed by Tom and Bill Milby, sons of Robert Milby, the founder. Tom and Bill grew up in the business. Each had served stints as stockboys, clerks, and store managers. Both had some farming experience and were graduates of agricultural colleges. Bill is president and chief operating officer of the company. Tom is board chairman and chief financial officer.

Finance

The company operated in Illinois until 1960, at which time it undertook an expansion program under the direction of Tom Milby. Expansion was financed by "going public," and Milby's shares are currently traded over-the-counter. Milby's stock issues have been handled by the brokerage firm of Kendall Bros. Since the initial issue in 1960, Milby has had one additional public issue (1962-1963) and, on two occasions (1966-1967 and 1968-1969), has exchanged stock for established feed and hardware companies. These exchanges were for long-established businesses, ideally located with respect to suburban and rural markets. Furthermore, these companies had substantial amounts of fully depreciated fixed assets. Although the condition of these facilities made a modernization program imminent, each exchange provided Milby with immediate earnings in excess of normal. Both acquisitions were accounted for as poolings, thus reflecting these excess earnings in the financial statements. Milby's earnings since fiscal 1961-1962 are summarized in Exhibit I, p. 271. Exhibit II, p. 272, contains comparative balance sheets as of June 30, 1969 and 1970.

All real estate used by R. Milby, Inc., except that obtained in the 1968-1969 acquisition, is under lease—about half from an affiliated company, Milby Investments, Inc. The investment company is owned by the Milby family. With respect to the 1966-1967 acquisition, the real estate was distributed by the former company to its shareholders. In turn, Milby Investments purchased the real estate from these shareholders for cash.

Milby has enjoyed excellent banking relations with Chicago First Fidelity. Principal contact has been with Herb Conners, assistant senior loan officer. Milby moves in and out of the bank, reflecting the seasonal aspects of the feed business. Bank loans outstanding generally are either liquidated or minimal on June 30, Milby's fiscal year end. Interim demands for cash are indicated by schedules of monthly balances in certain working capital accounts shown for the years 1969-70 and 1970-71 in Exhibit III, p. 273. Both Herb Connors and Arnold Kendall served as directors on Milby's board.

EXHIBIT 1

R. Milby, Inc.
Summary of Consolidated Earnings (1)

	Year	*Sales*	*Cost of Goods Sold*	*Selling, Administrative, and Financial Expenses*	*Income Taxes*	*Net Income*	*Earnings Per Share*
			(*Millions of Dollars*)				(*Dollars*)
(2)	1961-62	$ 45.0	$ 26.9	$ 16.3	$ .9	$ .9	$ .90
(3)	1962-63	47.5	28.6	17.1	.9	.9	.70
	1963-64	50.5	30.1	18.0	1.2	1.2	.92
	1964-65	60.0	35.8	21.2	1.5	1.5	1.15
(4)	1965-66	52.5	32.5	17.4	1.3	1.3	1.00
(5)	1966-67	80.2	48.0	28.5	1.8	1.9	1.06
	1967-68	90.0	54.6	31.4	2.0	2.0	1.10
(6)	1968-69	105.1	62.9	37.4	2.4	2.4	1.20
	1969-70	111.2	66.7	39.2	2.7	2.6	1.30

NOTES:
(1) In the above summary, earnings for years prior to years of pooled acquisitions are stated as originally reported, although appropriate adjustments were made in the comparative statements for the year of acquisition.
(2) Issued and outstanding — 1,000,000 shares.
(3) Issued 300,000 shares for cash.
(4) Changed from sum-of-years digits to straight-line depreciation.
(5) Issued 500,000 shares for an acquisition treated as a pooling of interests.
(6) Issued 200,000 shares for an acquisition treated as a pooling of interests.

Auditing and Accounting

Prior to 1960, Milby, Inc. had been audited primarily to support banking relations. The auditing work had been done by Helman & Minert. H & M did all the accounting work necessary for the initial public issue and has continued in the capacity of independent auditor. In addition, H & M provides Milby with tax counsel and management services. The accounting firm also handles the personal tax work of the Milby brothers. Henry Parsons has been the partner in charge of the Milby engagement since the public offering in 1960.

Milby's accounting is under the direction of Allen Petrie, vice-president and controller. Over the years, Allen Petrie and Henry Parsons have developed a close personal friendship. Petrie is an excellent accountant. Furthermore, he has guided a carefully controlled program of computer utilization. Developments in computer utilization have included payrolls, purchases, and billings. Most recently an innovative system of inventory control has been established. In these latter developments, considerable counsel has been received from Helman and Minert.

EXHIBIT II

R. Milby, Inc.
Comparative Consolidated Balance Sheets
(Millions of Dollars)

Assets	*June 30* *1970*	*1969*
Current Assets:		
Cash and certificates of deposit	$ 5.2	$ 4.9
Marketable securities, at lower of cost or market (cost, 1970-$6.5, market, 1969-$6.0)	6.3	5.8
Accounts receivable, less allowances for doubtful accounts — $.1 each year	3.2	3.1
Merchandise inventory, at lower of first-in, first-out cost or market	9.4	9.2
Prepaid expenses and supplies	.9	.8
Total Current Assets	$25.0	$23.8
Other Assets	$ 1.5	$ 1.4
Property, Plant, and Equipment, at Cost		
Leasehold improvements	$ 4.3	$ 3.9
Land, buildings, and equipment	2.0	2.0
Fixtures and equipment	29.4	28.4
	$35.7	$34.3
Less: accumulated depreciation	20.3	17.9
	$15.4	$16.4
	$41.9	$41.6

Liabilities and Stockholders' Equity	*June 30* *1970*	*1969*
Current Liabilities:		
Account	$ 7.4	$ 7.7
Accrued liabilities	1.5	1.9
Federal, state, and local taxes	.5	.4
	$ 9.4	$10.0
Other Liabilities:		
Minority interests in subsidiaries	.6	.5
Deferred taxes	.9	.8
	$ 1.5	$ 1.3
Stockholders' Equity:		
Common stock, 5,000,000 shares authorized; par value, $5; issued and outstanding, 2,000,000 shares	$10.0	$10.0
Additional paid-in capital	8.4	8.4
Retained earnings	12.6	11.9
	$31.0	$30.3
	$41.9	$41.6

Note A: *Long-term leases*. The major portion of the Company's business is conducted on leased premises. Minimum annual rentals under leases in effect at June 30, 1970 total $3.6 million of which $1.6 million is payable to affiliates. These leases expire at various times over the next 20 years.

Note B: *Certain accounting policies*. Costs of plant and equipment are depreciated on a straight-line basis over estimated useful lives; leasehold improvements are amortized over the terms of the leases or the useful lives of the assets, whichever is shorter. Deferred federal income taxes are provided for timing differences between depreciation for financial statement presentation and tax purposes.

EXHIBIT III

R. Milby, Inc.
Current Asset Accounts and Bank Loans
Summary of Monthly Balances

Fiscal Year	*Cash and Certificates of Deposit*	*Marketable Securities at Cost (Note)*	*Accounts Receivable*	*Inventory*	*Bank Loans*
1969-70					
July 1	$ 4.9	$ 5.8	$ 3.2	$ 9.2	$ —
July 31	4.8	5.8	3.4	9.8	—
August 31	1.6	5.8	3.6	12.6	—
September 30	1.4	.9	3.7	19.5	1.5
October 31	1.3	.8	3.8	22.4	4.5
November 30	1.3	.8	4.5	20.8	4.8
December 31	1.2	.8	6.9	19.5	4.8
January 31	1.4	.8	9.2	15.1	2.5
February 28	3.2	.8	9.7	10.9	.6
March 31	4.1	.8	8.9	9.6	—
April 30	4.5	5.4	4.8	9.5	—
May 31	4.8	6.3	3.7	9.3	—
June 30	5.2	6.5	3.3	9.4	—
1970-71					
July 1	5.2	6.5	3.3	9.4	—
July 31	4.9	6.5	3.5	10.0	—
August 31	1.7	6.5	3.6	13.1	—
September 30	1.4	3.7	3.8	20.2	4.3
October 31	1.4	3.7	3.9	23.6	7.3
November 30	1.3	3.7	5.8	21.2	7.3
December 31	1.5	3.7	7.9	19.8	7.3
January 31	1.5	3.7	9.7	15.3	5.4
February 28	3.3	3.7	10.1	11.2	3.3
March 31	4.0	3.7	8.9	9.1	2.6
April 30	4.6	6.1	4.9	8.9	1.5
May 31 (estimated)	5.1	6.6	3.9	9.0	—
June 30 (estimated)	5.4	6.6	3.9	9.0	—

NOTE: Marketable securities comprised a portfolio of dividend-paying common stocks and Treasury Bills. In 1970-71, common stocks in the portfolio were held to avoid realizing a market loss attributable to a generally depressed market coupled with rising interest rates and dividend cut-backs.

Current Activities

During fiscal year 1970-1971, R. Milby, Inc., undertook a campaign to increase sales volume in its present outlets. The decision to undertake the sales campaign was made in consideration of two factors: a sorely needed

modernization program for a number of outlets, coupled with an unfavorable financing environment attributable to a depressed stock market. After careful review of operating conditions, and in the hope of obtaining better financing, Bill Milby was convinced that the modernization program could be deferred for a year. Tom Milby then argued the view that a good year, in spite of a general economic downturn, would improve the company's chances of obtaining favorable financing. Thus, an ambitious sales goal was set, and marketing policies were adopted for the purpose of attaining the desired increase in sales.

In December it became apparent that the increased sales goal would be realized. Several press releases were issued during the next couple of months indicating that sales for the year would top $130 million and that income was expected to exceed $3 million, or $1.50 per share.

In consideration of the anticipated new financing, analysts at Kendall Bros. kept a fairly close watch on Milby's operations. They were impressed with the fact that sales dollars for the year were substantially in the till and became convinced that the earnings goal also would be realized. Excerpts from Kendall's published review of prospects for R. Milby, Inc., issued in mid-February showed the following:

	Per Share
Recent price	$ 19½
Price range	$ 17-25
Estimated earnings per share for fiscal year 1970-1971	$1.50
Reported earnings per share for fiscal year 1969-1970	$1.30
Price-earnings ratio (based on 1969-1970 earnings)	15X
Shares outstanding	2MM

Recommended for purchase because:
(1) Growth pattern — consistent.
(2) Accounting policies — moderate.
(3) Sales — especially strong.
(4) Industry group — attractive.

Some second thoughts arise. Allen Petrie was informed of the goal to increase sales and of the related modifications in marketing policies after they had been adopted. The modified marketing policies involved adjustments of commission rates, extensive promotions, and media advertising. Petrie was convinced that these increased selling costs could well wipe out any profit potential in the increased sales. As the anticipated sales volume began to be realized, he tried his best to tone down the optimism of the brothers Milby. Petrie became angry with Tom Milby, and let him know it, when he realized that income estimates released by Milby to the press were based on cost-profit-volume relationships developed prior to the changed marketing policies.

By the end of February, the impact of the increased selling costs became apparent. A number of special promotional commitments came to light. During February, a number of advertising bills totaling a substantial amount were released by local agencies. These advertising bills reflected special

authority granted to local management to place advertising. The impact on income of increased selling costs was compounded by concurrent skyrocketing of warehousing, delivery, and interest costs.

By the middle of March, Petrie was able to get figures together and come up with a revised estimate of 1970-71 earnings:

Sales	$130.3 MM
Cost of goods sold	78.2 MM
	$ 52.1 MM
Selling, administrative, and financing expenses	47.6 MM
	$ 4.5 MM
Income taxes	2.2 MM
Net income	$ 2.3 MM
Earnings per share	$ 1.15

When these figures were presented to the Milby brothers, they were finally forced to recognize that they had been suffering from financial myopia. While they were somewhat angry with Petrie for failing to develop such precise facts and figures several months earlier, they were forced to admit that the change in marketing policies had been instituted and administered somewhat informally. Hence, any earlier forecast would have been difficult, if not impossible. The conclusion to their discussion was to seek ways to "tighten the corporate belt" and salvage a few additional dollars of income.

An additional dark cloud appears. In early May, Ron Hunt, H & M senior accountant in charge of the Milby audit, had undertaken interim work. Through discussions with Petrie, Henry Parsons was aware of Milby's earnings problems. He was particularly concerned that solutions might be sought in "accounting" or in "extraordinary transactions." He thus instructed Hunt to include in his work a review of the current status of financial projections.

In the course of his review, Hunt was convinced that Petrie's income projection seemed fairly well on target, except for marketable securities. Milby's current accounting policy called for marketable securities to be valued at the lower of cost or market. This policy was not taken into account in Petrie's income projection, which ignored a possible market loss of some $1 million. Recognizing the market loss, the projected income for fiscal 1970-1971 might well be $1.3 million, or $.65 per share, as compared to 1969-1970 earnings of $2.6 million, or $1.30 per share. Proforma, the marketable securities section of the balance sheet would appear as follows:

	June 30 1971	June 30 1970
Marketable securities, at lower of cost or market (cost, $6.6 million and $6.5 million, respectively)	$5.6MM	$6.3MM

Hunt called this matter to the attention of Allen Petrie and Henry Parsons on Friday afternoon, May 21. Petrie, in turn, screwed up his courage and laid the matter on the line to Tom and Bill Milby. As was to be expected, the Milby brothers called a meeting to discuss the financing and accounting problems facing the company. The meeting (to include the Milby brothers, Petrie, Henry Parsons, Herb Conners, and Arnold Kendall) was set for the following Monday morning. Allen Petrie was instructed to call Henry Parsons.

Several hours had now passed since Henry had received the call from Allen. After his extensive review of the Milby files, he felt up-to-date and ready for the Monday meeting. He decided he could take his leave for the weekend.

A Meeting Was Held

Bill Milby opened the meeting by laying out details of the planned modernization program. He attempted to demonstrate that the program was essential to the survival of a number of the more recently acquired outlets. Tom Milby then made the point that new financing in the next fiscal year was imperative to carry out the modernization program. Next, Allen Petrie was called upon to present the earnings forecast.

Tom then posed the following question to Arnold Kendall: "If we report earnings of $.65, what will happen to the price of our stock?" Kendall replied that the price could well drop 5 to 10 points, depending on the extent to which the market discounted the special securities loss. He further pointed out that a fall-off of earnings coupled with a generally weak market tends to reinforce a pessimistic attitude toward the stock of any company.

Tom then queried Herb Conners concerning the possibility of financing the modernization program with a bank loan. Herb indicated that a 60-month loan was indeed a possibility. He was quick to point out, however, that the interest rate would be fairly high. He also noted that the bank would probably require more details with respect to accounting and auditing.

It was Tom Milby's view that the financing picture looked bleak under either alternative. A stock issue in an unfavorable market would result in a considerable dilution of equity; on the other hand, a long-term bank loan with fixed interest payments and maturities hampered flexibility of action to a considerable extent.

Then came the inevitable turn in the conversation. Tom Milby put it to Henry Parsons this way: "Is $.65 a share really a fair picture of R. Milby's earnings?" Tom pursued his point, "This securities loss is only a possibility at this time and, in fact, may never be realized. Is it right for $1 million of possible securities losses to tip the per-share price of two million shares $10 or even $5? Regardless of how we try to explain it away—showing the loss as a special item and giving an explanation in the president's letter—there's a good

chance that we will fail to communicate to the investing public the fact that the securities loss is totally unrelated to regular operations." Arnold Kendall nodded his agreement with Tom's last point. Tom pressed on, "There must be some provision in your accounting rules to avoid this kind of lick."

Before Parsons could answer, Allen Petrie suggested that accounting for securities transactions be switched this year from lower of cost or market to cost. Parsons recognized the possibility, but pointed out that the financial statements would require a footnote to explain the change and that the auditor's report would require a consistency qualification.

Clearly, Allen Petrie and the Milby brothers had given the matter some prior thought. Parsons was asked to give his immediate blessing to the proposed accounting change, subject to appropriate disclosures. He demurred, however, requesting time to research the accounting rules involved and to discuss the auditing and accounting implications with his partners. He hastened to assure the group that he was not being negative, but merely cautious.

With that point covered, Tom Milby (at no surprise to Henry Parsons) was still not satisfied. He suggested that, although the increased selling costs were real enough, a substantial portion of these costs—some $1.8 million—was more in the nature of development costs which would benefit at least two, and probably more, future years. Allen Petrie presented a schedule of "special development costs" which listed the following items:

Contributions to 20 selected communities to support annual horse shows. Under the terms of the contribution, R. Milby, Inc., is to be listed as a major sponsor for a five-year period	$ 900,000
Contributions to ten agricultural schools for establishment of R. Milby, Inc., Scholarships in Agriculture. The contributions have been set up in permanent endowment funds, with the income to be used for scholarships	700,000
Development and publication of educational pamphlets for distribution to the agricultural and equestrian community . .	200,000
	$1,800,000

In the course of explaining the nature of these costs, Petrie pointed out that Milby, Inc., had never before incurred such costs as part of its marketing program, at least in any significant amounts. He then suggested that these special costs be set up in the balance sheet as "Deferred development costs" with an appropriate explanation. "I also suggest," he said, "that the costs be amortized over a conservative three-year period, including the current period. The proposed accounting for marketable securities and special development costs will reveal an income of $2.9 million, or $1.45 per share, a figure which reflects more fairly Milby's actual operations for the year."

Henry Parson's initial reaction was an unexpressed thought, "Thanks a

lot, friend Allen." Aloud, however, he recognized the accounting possibilities but asked for time to research the accounting rules and to discuss the issues involved with his partners.

Parsons promised an answer on the accounting matters within a week. The meeting broke up, and the visitors went their separate ways.

Some Not So Amusing Musings

A banker. Herb Conners puzzled over his customer's accounting and financing problems, but without too great concern over the bank's interests. He was confident that the bank could continue to finance Milby's seasonal working capital requirements against inventories and receivables. He was also convinced that a modernization loan would be sound, although he felt certain that Milby would exhaust all other financing possibilities before going into the banks. However, he had other matters pressing for his immediate attention, and he could cross the Milby bridge if and when he came to it.

Despite a rather tension-filled meeting, Herb felt a sense of relief, primarily because he could put the Milby matter aside for awhile. He noted that he just had time to make his luncheon date with Larry Hopkins, his counterpart in the bank's trust department. Over lunch Herb was quite relaxed, told some jokes, and even allowed himself a rare lunchtime martini.

However, the Milby matter was destined to be a continued annoyance due to Larry Hopkin's parting remark, "Incidentally, Herb, you might be pleased at how well R. Milby, Inc., is thought of in our shop. We've put 100 shares each in a number of portfolios that could stand some growth possibilities. Milby's recent market performance hasn't disappointed us a bit." Herb forced a smile and took his leave.

An underwriter. After the meeting, Arnold Kendall was in a disturbed state of mind. He knew he should eat lunch, but he didn't. He knew he shouldn't have a drink, but he did. He was glad that he hadn't been asked for a direct opinion on the accounting questions. He simply wasn't sure how he felt. Kendall Bros. had pushed Milby's shares pretty hard since issuing their "tout sheet" last February. In fact, the market had been anticipating increased earnings, and the stock price was pushing $22.

Kendall was particularly concerned over what immediate position his firm should take toward promoting Milby, Inc.: continue pushing, go neutral, or go negative. He also was concerned about the longer run. If earnings held up, or accounting for earnings were corrected, Milby would want to go to the market with 300,000 shares as soon as possible, and Kendall Bros. would be expected to handle the underwriting. A question kept coming to Arnold Kendall's mind, "Is R. Milby, Inc., a $.65 company, a $1.45 company, or something in between?" He wished he knew, or he wished the auditors could tell him for sure.

A CPA. Henry Parsons wished he knew the answer to Arnold Kendall's question. He was never more concerned with the phrase "present fairly," and just what it meant. Surely, if there were a possible swing in per-share income of between \$.65 and \$1.45, *some* amount had to be more nearly "fair" than any other. It was Parson's general belief that fair presentation meant conformity with generally accepted accounting principles, insofar as these could be determined. Then he recalled a comment from the 1968 Seaview symposium on communication and innovation in financial reporting: "I would like to think that the certificate means that the auditor, in reviewing the financial statements, has exercised his professional influence to have these presented in the best way he can—not that he has searched through accounting literature to find a means of supporting the way management may have elected to present something that he doesn't completely agree with himself."

In any event, he promised Milby an answer to the accounting questions within a week. Furthermore, even if he agreed with the quotation, he was quite certain that a literature search was essential. Some pertinent thoughts developed from this search are summarized as follows:

Accounting matters involving marketable securities

APB Opinion No. 20, "Accounting Changes":

> The Board concludes that in the preparation of financial statements there is a presumption that an accounting principle, once adopted, should not be changed in accounting for events and transactions of a similar type. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data.
>
> The presumption that an entity should not change an accounting principle may be overcome only if the enterprise justifies the use of an alternative accounting principle on the basis that it is preferable.[1]

ARB No. 43:

> However, practice varies with respect to the carrying basis for current assets such as marketable securities and inventories. In the case of marketable securities where market value is less than cost by a substantial amount and it is evident that the decline in market value is not due to a mere temporary condition, the amount to include as a current asset should not exceed the market value.[2]

Hendriksen, *Accounting Theory*:

> Temporary investments in common stocks of other corporations are usually treated similarly to monetary current investments. Bal-

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[1] AICPA, Accounting Principles Board Opinion No. 20, "Accounting Changes" (New York: AICPA, 1971), pars. 15 and 16.

[2] AICPA, Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins* (New York: AICPA, 1953), Chapter 3, sec. A, par. 9.

ance sheet valuations are conventionally expressed in terms of either cost or the lower of cost or market. Since a final sales price is not known, they cannot be treated as receivables, and thus other valuation methods must be used. Cost is generally considered the most verifiable but the lower of cost or market is generally accepted because of the desire to record anticipated losses.[3]

Grady, *Accounting Research Study No. 7*:

If the cost of the investment apparently cannot be recovered if sold in the current market, a part of its usefulness to the enterprise has been impaired. Under these conditions it is customary to revalue the cost to only that portion that could be recovered. Evidence of a permanent market decline should be present, since temporary fluctuations are common for many securities.[4]

Accounting questions involving intangibles

APB Opinion No. 17:

The Board concludes that a company should record as assets the costs of intangible assets acquired from other enterprises or individuals. Costs of developing, maintaining, or restoring intangible assets which are not specifically identifiable, have indeterminate lives, or are inherent in a continuing business and related to an enterprise as a whole—such as goodwill—should be deducted from income when incurred.[5]

AICPA accounting interpretation of APB Opinion No. 17:

Question—APB Opinion No. 17 requires that intangible assets acquired after October 31, 1970 be amortized over a period not exceeding 40 years. Does this Opinion encourage the capitalization of identifiable internally developed intangible assets which have been generally charged to expense in the past?

Interpretation—APB Opinion No. 17 does not change present accounting practice for intangible assets in any way except to require that intangible assets acquired after October 31, 1970 be amortized. Paragraph 6 notes that the costs of some identifiable intangible assets are now capitalized as deferred assets by some companies while other companies record the costs as expenses when incurred. This paragraph also specifies that the question of whether the costs of identifiable internally developed intangible assets are to be capitalized or charged to expense is not covered by the Opinion. Therefore, the Opinion does not encourage capitalizing the costs of a large initial

[3] E. Hendrikson, *Accounting Theory* (Homewood, Ill.: Richard D. Irwin, Inc,. 1970), p. 303.

[4] Paul Grady, Accounting Research Study No. 7, *Inventory of Generally Accepted Accounting Principles for Business Enterprises* (New York: AICPA, 1965), par. 239.

[5] AICPA, Accounting Principles Board Opinion No. 17, "Intangible Assets" (New York: AICPA, 1970), par. 24.

advertising campaign for a new product or capitalizing the costs of training new employees.[6]

Hendriksen, *Accounting Theory*

In a few cases, costs that can be associated with future revenue cannot be assigned directly to the product of the enterprise because they do not represent value added to any specific products. In most cases, these are selling and administrative costs that can be associated clearly with future revenues. A common example is the carrying forward of organization costs that cannot be associated with a product, usually because there is no product at the time they are incurred. However, since they can be associated with the revenues of some future periods, they are usually capitalized and carried as intangible assets on the basis that they represent the value of the organization to the firm in its future operations.

Accountants are generally reluctant to carry forward other selling and administrative costs because of the uncertainty regarding their association with future revenues. But a case can be made for delaying expense recognition in a few instances. If an extensive market research program is carried out before placing a new product on the market, these costs may be associated directly with the revenues expected to be obtained from the new product.

One note of caution should be made at this point. Selling and administrative costs should not be carried forward to be matched with future revenue unless there is a reasonable assurance of future revenue with which it may be associated. The lack of current revenue or the possibility of recording an operating loss in the current period is not adequate reason for deferral. If no associated revenue is foreseeable, or if such revenue is highly uncertain, the expenses should be recognized in the current period even if they result in an operating loss.[7]

Nearly a week later Henry Parsons continued to mull over the Milby case. While he was uncomfortable with the accounting problems involved, he reminded himself that Milby was not a fly-by-night "swinger." Rather, Milby was a company with a long history of successful operations and was well managed by men who had learned the business from the ground up. Nevertheless, he also had to remind himself—as his partner, Randy Minert, had a number of times—that the growth pattern in Milby's earnings had twice been preserved by poolings and once by an accounting change. Now accounting again was proposed to elude a threat to a favorable earnings pattern.

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[6] AICPA, Unofficial Accounting Interpretations, Accounting Principles Board Opinion No. 17, "Intangible Assets," Accounting and Auditing Problems, *The Journal of Accountancy,* April 1971, p. 74.

[7] Hendrikson, *Accounting Theory,* p. 186.

Despite misgivings created by the foregoing thoughts, Parsons resolved that only objective consideration of the current fact situation should influence his firm's decision on the accounting matters at issue. In appraising the current fact situation, Henry was much concerned about Milby's future income prospects. Would the 1970-1971 sales volume be economically sustainable? After all, a very costly promotional effort had been mounted to attain the current volume. Furthermore, a continuing commitment has now been made to a commission rate increase of one and one-half per cent of sales. Also, what if the securities loss were realized in the following year? With these thoughts in mind, Parsons considered a range of possibilities for 1971-72 income:

	#1	#2	#3	#4
		(Millions of Dollars)		
Sales	$130.0	$125.0	$120.0	$115.0
Cost of goods sold	78.0	75.0	72.0	69.0
	$ 52.0	$ 50.0	$ 48.0	$ 46.0
Selling, administrative, and financing expenses:				
1969-1970 actual	$ 39.2	$ 39.2	$ 39.2	$ 39.2
Adjustments to reflect current conditions-				
Amortization of deferred development costs (1/3 x $1.8MM)	.6	.6	.6	.6
Increased commissions (1½% of sales)	2.0	1.9	1.8	1.7
General cost increases . .	1.0	1.0	1.0	1.0
Depreciation increase (1/15 of $6MM modernization program) . .	.4	.4	.4	.4
	$ 43.2	$ 43.1	$ 43.0	$ 42.9
Net income, before taxes	$ 8.8	$ 6.9	$ 5.0	$ 3.1
Income taxes	4.4	3.4	2.5	1.5
Net income before possible securities loss	$ 4.4	$ 3.5	$ 2.5	$ 1.6
Possible securities loss (assuming no tax benefit)	1.0	1.0	1.0	1.0
Net income after possible securities loss	$ 3.4	$ 2.5	$ 1.5	$ .6

While Henry was puzzling over the significance of the foregoing figures in relationship to the accounting proposals, he began perusal of APB Opinion No. 20, "Accounting Changes." He wished that the Opinion had been issued a year earlier. If so, he might have avoided the difficult reporting problem brewing with Lofton Foods.

The case of Lofton Foods. Lofton Foods maintains a research and development department whose principal activity is product development. Most of the actual work is done on a contract basis with universities and private research laboratories. In 1970, Lofton was caught in a cash squeeze and cut back substantially on its contract research. As a result, R & D for 1970 was a relatively insignificant amount. The company, nevertheless, changed its accounting for R & D costs from expensing such costs as incurred, to deferring the costs and amortizing them over sixty months. H & M made no mention of the accounting change in its report and approved the following footnote to the December 31, 1970 financial statements: "It has been the consistent practice of the company to charge product development costs to expense as incurred. Commencing with the current year, the company will defer such charges recognizing that the principal benefits are to future periods. The costs so deferred will be amortized over sixty months. This change has no material effect on the current financial statements."

It was now apparent that the product development program was back in full swing. In order to get a feel for the impact of the R & D policy and the related accounting change on income, an income summary was prepared by the in-charge auditor for the years 1969, 1970, and 1971 (estimated):

Year	*Gross Profit*	*Selling & Administrative Costs*	*Research & Development Costs*	*Income Taxes*	*Net Income*
		(Millions of Dollars)			
1969	$88.7	$57.2	$15.6	$ 7.9	$ 8.0
1970	74.2	55.3	.3 (1)	9.3	9.3
1971	80.5	57.1	3.3 (2)	10.0	10.1

Notes:

(1) Represents amortization of $1.5 million of incurred research and development costs.

(2) Represents amortization of $16.3 million of research and development costs incurred to date ($1.5 million incurred in 1969 and $14.8 million estimated to be incurred in 1970).

As much as he would have liked to have thought through the Milby and Lofton matters, Henry simply had to take some time out to plow through the morning mail. He was moving through the stack with considerable dispatch when he came upon a draft copy of Aptco Shipbuilding Company's third quarter financial statements, dated April 30, 1971.

The case of Aptco Shipbuilding. Aptco had run into some difficulties on a major construction job, and Henry Parsons was concerned as to how the matter would be reflected in the interim statements. The difficulties were encountered on a contract for the construction of two huge ocean-going tugboats at a "turnkey" price of $6.5 million and an estimated total cost of $5 million.

Just prior to April 30, Henry had visited Aptco to review the progress of interim audit work. At that time, informal talks with engineers indicated that the work on these vessels was some 60 to 70 per cent complete. At the same time some $4 million of costs were in. Henry's impression at the time was that Aptco's management seemed somewhat "up-tight" about the final outcome.

Aptco's policy is to detail new construction income by contract in its financial statements. On the April 30 interim financial statements, the tugboat contract appeared as follows:

Contract description	*Per cent complete*	*Revenue earned*	*Costs incurred*	*Gross income*
To construct two ocean-going tugboats at a "turnkey" price of $6,500,000	80	$5,200,000	$4,000,000	$1,200,000

In view of his understanding of the facts, Henry Parsons immediately called Aptco's controller to question the reported income on this contract. He was told that the job was carefully reviewed by top management and the project engineers. The conclusion reached was that construction was further along than was originally thought.

R. Milby, Inc. As if the Lofton question weren't enough for the day, the next item in the mail was a letter from Tom Milby which read as follows:

Mr. Henry A. Parsons
Helman & Minert, CPAs
3510 Milo Building
Chicago, Illinois
Dear Henry:

I would be obliged if you would attend a meeting to be held in the board room of R. Milby, Inc., on June 11, 1971. Attending the meeting will be the same group that met earlier in May — Allen Petrie, Herb Conners, Arnold Kendall, my brother, Bill, and me.

My brother and I would like each of you, including Allen, to be prepared to discuss and give recommendations concerning the various accounting and financing alternatives available to R. Milby, Inc.

Allen Petrie has given some thought to presentation of the proposed accounting change for marketable securities. So that you can consider his suggestion prior to the meeting, he has prepared the following summary:

	June 30	
Balance sheet:	1971	1970
Marketable securities, at cost (quoted market 1971—$5.6MM, 1970—$6.3MM)	$6.6MM	$6.3MM

Balance sheet footnote:

In prior years the Company has consistently used the lower of cost or quoted mar-

ket in valuing marketable securities on hand for financial reporting purposes. Effective July 1, 1970, the company elected to change to the cost method of valuing common stocks.

Auditor's report:

. . . in conformity with generally accepted accounting principles which, except for the change (as of July 1, 1970) to an acceptable alternative method of valuing marketable securities, as described in Note —— to the financial statements, have been applied on a basis consistent with that of the preceding year.

Incidentally, we are considering entering into a sale and leaseback agreement either with Milby Investments or an insurance company for the land and buildings acquired in the 1968–1969 acquisition. We believe a fair price is $4 million. The investor would issue a six per cent note to R. Milby, Inc., together with a lease for an annual rental of $400,000. The note would be repaid by forgiveness of rentals and an annual payment of $200,000 cash from the investor to R. Milby, Inc. When the note is cleared, annual rental payments from R. Milby, Inc., would commence.

Will be looking forward to seeing you at Friday's meeting.

Sincerely,

Thomas R. Milby
Chairman

Questions for Discussion

1. Taking the role of Allen Petrie, Herb Conners, Arnold Kendall, or Henry Parsons (whichever is appropriate), be prepared to participate in the June 11, 1971 meeting at R. Milby, Inc., considering such issues as the following:
   a. Your reactions and recommendations with respect to the accounting proposals.
   b. Your reactions and recommendations with respect to financing alternatives—a bank loan vis-à-vis a new stock issue. Are these the only available alternatives?
   c. Your reactions and recommendations concerning special auditing and reporting for the benefit of the bank, assuming a bank loan is obtained.
   d. Your reactions and recommendations with respect to the proposed sale and leaseback of real estate.
   e. Your reactions to press releases which include forecasts of 1970-1971 sales and income.

2. Herb Conners wonders whether the bank officer in charge of the Milby account should be changed. Or should he stop eating lunch with Larry Hopkins? To what extent should Arnold Kendall alert his brokerage staff to Milby's earnings prospects?

3. Give your reactions and recommendations to Henry Parsons concerning the Lofton Foods problem.
   a. Was H & M's action with respect to Lofton's 1970 statements appropriate?
   b. Will the APB Opinion on accounting changes preclude comparable future problems?
   c. What action, if any, should H & M take with regard to the Lofton statements for 1971?

4. Give your reactions and recommendations to Henry Parsons concerning the Aptco Shipbuilding problem.
   a. What authority and responsibility does Aptco's controller have for the data in its interim financial statements?
   b. What is H & M's authority with respect to the data in Aptco's interim financial statements?
   c. What specific action, if any, should H & M take with respect to the data in Aptco's interim financial statements?
   d. If the tugboat contract is still incomplete at July 31, 1971 (Aptco's fiscal year end), what special auditing problems are posed for H & M?

Discussion of the R. Milby Case

This case provoked spirited discussion led by the case writer who played the role of Tom Milby. Mr. Milby emphasized the fact that he really believed that the $1.45 per share which would result from accounting for marketable securities at cost and deferring the "special development costs" was the most realistic view of the operating picture of his company. He was particularly concerned about the possibility of writing down marketable securities to market, pointing out that writing down securities $1 million by a charge to income might well reduce the market value of R. Milby, Inc., by $5 to $10 million, and emphasizing that this was not an operating loss or one that necessarily would ever be realized.

The group was largely unsympathetic to Mr. Milby's position. They pointed to past poolings and the prior change in depreciation accounting as evidence that the reported growth was not entirely realistic, and there was general agreement among auditors, analysts, financial executives, and bankers that Mr. Milby's proposed accounting should not be encouraged. Other sources of financing were suggested to Milby as preferable to the equity issue which he was considering as a means of raising new capital for his modernization program, and which was the primary reason for his concern over 1971 earnings per share.

On the specific issue of accounting for marketable securities, there was some discussion of whether the loss, if recorded, was extraordinary in nature since the company had regularly been making this kind of investment for several years and reporting profits on sales as ordinary income.

The problems of all interested parties in a case of this sort were recognized and discussed. Most of the discussants felt that the investment banker and the auditor should take a strong position against the proposed accounting. The dangers of a possible violation of SEC Rule 10b-5 were pointed out, particularly if 1972 earnings did not support Milby's assertion that his was really a "$1.45 company."

It was also observed that the commercial lending officer was in all probability barred from giving information about Milby to his bank's trust department, although some questions were raised as to whether enough information could be given to stop additional trust department accumulation of the stock as long as sales were not commenced. Even this amount of information would presumably make the trust officer an insider, but an insider has no responsibility to keep buying the stock of a company about which he has adverse information. Sale of such stock could subject him to liability, however.

At the end of the discussion, the auditors present were asked whether they would accept the accounting proposed as "generally accepted" (with appropriate disclosure of accounting changes) if they could not persuade Milby to change it. The large majority said that they would not, although a small number agreed with the observation that the accountants present were being more righteous in the case dicussion than they would be in actual practice, and said that they would give an opinion that the accounting did fall within generally accepted accounting principles.

In discussing this case, the group concentrated on the Milby problems and did not consider the Lofton Foods and Aptco Shipbuilding problems also presented in the written case.

Peter Hampden, CPA

By David F. Hawkins, *Professor of Business Administration, Harvard University*

Peter Hampden, a third-year member of his firm's audit staff, was debating whether he should continue working as a public accountant. During his college years, he had considered himself to be somewhat of an idealist with a strong sense of public responsibility. Over the last few years, he had increasingly found himself questioning some of the decisions of his superiors on matters which he considered involved ethical issues—the responsibility of the profession to the client and statement users, and "fair" reporting. Hampden realized these issues were difficult to resolve—especially those involving concepts of right and wrong as applied to auditor behavior. He also recognized that his ethical standards were changing as he grew older and that he "did not have all the answers." Therefore, before he reached his career decision he sought the opinion of a second person.

Hampden spoke to the firm's senior partner about his problem. The partner said that Hampden's seniors had rated him "excellent and definite partner material if he continued to develop in the future as he had in the past." The senior partner was also sympathetic to Hampden's concern and suggested they spend some time together during the following week discussing it.

To facilitate their planned discussion, the senior partner suggested Hampden prepare for him thumbnail descriptions of some of the situations involving financial reporting that had troubled him over the last few years. The senior partner also suggested that Hampden outline the "ethically correct" action he would have taken if he had been the partner in charge. The following is a copy of the material Hampden submitted to his senior partner.

Disclosure of Anticipated Accounting Change

A client company had invited the partner in charge of their audit to discuss with their president some decisions made at a board of directors meeting at which the preliminary third quarter results and the accounting principles

policies to be followed in the annual report were discussed. The publication of the third quarter results was to follow this meeting with the president. The audit partner had brought me to this meeting to expand my knowledge of how to maintain effective top management-auditor relations.

At its meeting the Board had decided "if it is feasible," to change the depreciation accounting policy followed in their annual report to stockholders. It was anticipated that this change, if made, would permit the company to show improved earnings per share over the previous year's results. If the old depreciation policy were followed, the company would most likely show a decline in earnings.

The Board had asked the president to request their auditor to review the company's accounting department's proposed adjustments to the asset accounts. Also, the president indicated that before the annual report was submitted to stockholders other accounting principle changes might be necessary "in order to put the company's accounting on a more realistic basis." If these changes were made, the president planned to discuss them with the company's auditors.

In my opinion, the auditor should have insisted that the company indicate in its third quarter report to stockholders that they were contemplating a change in accounting practices. None of the directors apparently thought this was necessary and neither did the audit partner.

Disclosure of Tax Status of Lease Transaction

Our company had been requested to help a client draw up some sale and leaseback agreements that would qualify for tax and financial reporting purposes as leases and not as conditional sales. Subsequently, at the insistence of the Internal Revenue Service, the agreements were treated for tax purposes as conditional sales. The client was very disturbed by this ruling, but on the advice of the company counsel decided not to challenge it. This lawyer, who had replaced the company counsel involved in the original transaction, described the sale and lease agreement as "a classic example of the type of lease agreement involving nominal purchase options used to teach law students how not to try and fool the tax authorities."

After making his tax decision, the client discussed the financial reporting implications of the decision with the partner in charge of the audit. In the process of this discussion, the client indicated that he was very upset at the "poor advice" given by his auditors and that he preferred to continue treating the sale and leaseback as a lease for financial reporting purposes. If the lease were capitalized, the company's long-term liabilities would have increased about 17 per cent.

The partner in charge of the audit later agreed with the client's treatment of the transaction as a lease. In his opinion, since the agreement had been drawn up prior to Opinion No. 5, the provisions of the Opinion did not

apply. No mention of the agreement's tax status was indicated in the footnotes to the annual statements.

Comment. In my opinion, at least the lease's tax status should have been disclosed; preferably, the lease should have been capitalized. Not taking either of these actions leaves the auditor open to the criticism of (1) trying to cover up his earlier poor advice and (2) being biased in his opinion of what constitutes a full and fair presentation of financial data.

The economic substance of the lease transaction was equivalent to a conditional sale under Opinion No. 5. The legal and tax authorities used the same criteria as stated in Opinion No. 5 to make their decision. These criteria are similar to those presented in tax guides to distinguish between genuine leases and conditional sales disguised as leases.

Responsibility for Disclosing Control and Reporting Deficiencies

The founder-president of a client company raised $20 million through a public stock sale for his new company to develop, manufacture, market, and lease on a cancelable basis at an unusually low monthly rental price a revolutionary photo-copying system. To date, no major company had been able to develop the technology and production capability needed to make this kind of equipment at the low rental levels proposed by the client company. At the time of the public offering, the client company also had not developed the needed technology or production capability.

Soon after the public issue the stock's price soared to four times its offering price of $12.50. This upward movement was accompanied by optimistic articles in the financial and trade press on the company's prospects for success.

Shortly after these funds were raised, I attended a public seminar during which the client company's president discussed his technique for raising venture capital. He said:

> Raising money is very much like running for office. You have to put a campaign together. . . . The business plan you prepare must be a lie, . . . but it must be a detailed and precise lie rather than a vague and general lie. . . . If you promise enough risk, loss, and catastrophe, the financier will begin to wonder whether you're hiding something from him. . . . Go public as fast as you can.

Subsequently, the company went into bankruptcy, losing some $18 million on sales of $700,000. The principal causes for failure were poor control over production costs and a decision to sell rather than lease its equipment. This decision led to the cancellation of a number of letters of intent to purchase.

Comment. In cases such as these is it acceptable, by the public's standards, for the auditor to simply comment on the fairness of the financial statements and their adherence to generally accepted accounting principles? Whose standards of conduct should prevail? Those of the AICPA or some other? Who is responsible for telling the public about the poor control over production costs and the cancellation of the letters of intent? Indeed, should the public be told at all?

I have no answer to this kind of problem beyond saying that it is management's responsibility to disclose unfavorable information. If they will not, the auditor should use all of his power to see that they do. Yet, is this his function?

Responsibility of the Financial Press

In order to reflect better a change in their business, a client company changed from accelerated to straight-line depreciation and started capitalizing certain product development expenses. We agreed with the client that these changes were desirable.

Subsequently, a prominent financial writer used this accounting change as a perfect example of how companies change their accounting methods to boost earnings. The writer failed to mention any of the reasons presented by management in their annual report for the change in accounting.

Comment. As an individual auditor, I suspect that I cannot do much to impose more responsible standards on the press; yet, this kind of reporting disturbs me. What can be done about it? Can I as an individual auditor do anything?

Responsibilities of Financial Analysts

Incidentally, while I am raising questions about the way financial reporters discuss our client's financial reports, I would like to discuss the implications for me as an auditor of this kind of reporting of our client's situation:

> The ten per cent stock dividend recently announced by_______ makes_______ an attractive investment at current prices.
>
> If you have not got_______ in your portfolio, now would be an appropriate time to make a purchase at the current depressed levels.
>
> At present, the company is making huge capital investments, and one can expect a return within the next two or three years. Investors should not worry about the auditors qualifying _______'s recent record profits by $1.4 million. It is only an accountant's wrangle.
>
> In any case, look at provisions in the income statement for de-

> preciation which is up from $10.0 million to $12.5 million this year. Such a provision is no more than a way of creating reserves out of profits.

This company's earnings for the current year were about the same as the prior year. We disagreed with the company's deferred tax accounting practices. They refused to apply comprehensive tax allocation to some mining expenditures that they capitalized for book purposes, but wrote off on their tax return as incurred. The stock is traded over-the-counter.

Comment. Why should auditors struggle to determine what are "fair" reporting practices while this kind of reporting persists?

Questions for Discussion

1. If you were the senior partner, how would you respond to the cases presented to you by Hampden? Do these involve ethical issues? Accounting principle issues? Audit judgment issues?

2. Is it desirable that the auditor behave in the manner suggested by Hampden?

Discussion of the Peter Hampden Case

Several different aspects of this case were developed in the discussion. First the management problem of how to deal with Hampden in this situation was considered; then the role of the auditor implied in his view of his firm's responsibility was explored; and finally, some of the specific auditing, accounting, and disclosure issues in the case were discussed.

There was general agreement that the partner in this case had to respond in an understanding fashion to Hampden's initiative, even though some participants questioned Hampden's judgment in going to the senior partner rather than a partner on the specific engagement. It was also noted that the senior partner had a sensitive management problem in dealing with the partners whom Hampden had bypassed. One partner in a large firm did observe that his firm had recently established an institutional means for such expressions of concern on the part of relatively junior employees. The obvious potential which Hampden possessed was noted frequently, and the need to keep such young men in the profession and not disillusioned was emphasized.

At the same time, however, the group was not terribly sympathetic to Hampden's concern in the specific cases which he had brought forward. To a

large extent, it was felt that the responsibilities he urged upon the firm in these situations were beyond those which auditors could be expected to take in the future and certainly beyond currently perceived responsibilities. The thought was expressed that, as he gained experience, he would understand the difficulties inherent in his suggested courses of action.

The first three specific factual situations were reviewed. In the case of the depreciation accounting change being considered, most of the participants felt that the mere consideration of accounting changes did not require disclosure in a quarterly report where no actual changes had been reflected. At the point where a change was actually decided upon, there was some feeling that it should be reported to the public immediately, although a few participants believed that disclosure in the first subsequent quarterly report was sufficient.

The problem of lease capitalization was discussed from various viewpoints. It was pointed out that the lease in question predated APB Opinion No. 5; hence, capitalization was not required. In addition, the differing book and tax treatments of the lease were felt to be reflected in the deferred tax account; more detailed disclosure of these differences was not seen as necessary. On the other hand, there was dispute as to whether it was ethical not to capitalize the lease even in the absence of an effective opinion at the time the lease was drawn. There seemed to be considerable support for capitalization on the basis of the economic substance of the transaction.

Finally, the case of the company which raised capital on the basis of hope for a technological breakthrough and finally went bankrupt when the technology was not forthcoming on an economical basis was considered. It was generally agreed that the auditor could not be expected to appraise either the technology or the marketing and cost control problems of the company in such a way as to predict failure before the fact. The company's behavior, as articulated by the president, was found unethical, and there was some feeling that additional investigation by the investment banker was called for before making the new issue public. Nevertheless, the magnitude of the loss was largely attributed to speculative fervor on the part of buyers of the stock.

Despite the feeling that auditors should not be held responsible in such cases as these, there was uncertainty expressed as to whether this answer would be acceptable to people like Hampden. The case writer observed at the end of the discussion that young people were no longer accepting "reasonable explanations" such as those offered above and are demanding more of the accounting profession both in terms of responsibilities assumed and social significance. If these expectations are not fulfilled, the likelihood of outstanding young talent remaining in the profession is sharply reduced.