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PONDERING FINANCIAL REPORTING: REMARKS BEFORE THE 2018 LEET BUSINESS LAW SYMPOSIUM

Commissioner Hester M. Peirce†

Thank you for the opportunity to be here today. I will begin with my standard disclaimer. The views I express today are my own and do not necessarily represent the views of the Commission or my fellow Commissioners.

It is a real honor to be back at Case Western Reserve University a quarter of a century after graduating. As a wide-eyed freshman, I lived just down the street in the North Side dorms. I took the LSAT right here in the law school. On nice days, I used to study out in front of the art museum, where I could gaze at the statue of Rodin’s The Thinker for inspiration in my own thinking. This statue is one of the approximately ten large versions created during the master’s lifetime under his watch. The museum acquired the statue in 1917, coincidentally the year Rodin died.†

As you may know, the Cleveland version of The Thinker is not fully intact. The Thinker arrived whole and enjoyed more than fifty years of uninterrupted thought. Then, in the middle of a March night in 1970, someone placed a bomb underneath the statue’s base. The Thinker has continued to ponder for another almost fifty years, but the bombing literally knocked the legs out from under him and surely affected his thinking in some form or fashion.

Today, I want to talk to you about an attempt to knock the legs out from under many years of thinking regarding financial reporting and securities disclosure by public companies. Specifically, I want to talk with you about the role that financial reporting plays in giving investors a window into the companies they own. Recently, some people have suggested that financial reporting should perform other functions too. I contend that we need to be very careful in making changes to something that is so central to the functioning of our economy.

† Commissioner of the U.S. Securities and Exchange Commission.
2. Id.
3. Id.
4. Id.
5. See, e.g., Alana L. Griffin et al., Institutional Investors Petition the SEC to Require ESG Disclosures, BUS. L. TODAY (Jan. 11, 2019), https://
To understand its importance, it may be helpful to start with a quick outline of the financial reporting process itself. It is probably worth throwing in some history as well.

Financial reporting is not new. For as long as investors have been investing in enterprises, one imagines they wanted insight into how their money was being used. Double-entry bookkeeping, or debits and credits, began over five hundred years ago. Later, during the Industrial Revolution, railroad companies found they needed a coherent system for presenting their operations to prospective investors, which paved the way for the development of financial reporting. Other companies then began to follow suit. Soon the need for a reliable financial accounting and reporting framework became evident. The framework would have to pull together existing practices and provide a uniform set of standards for companies so that investors could readily understand the financial statements of various companies.

Generally Accepted Accounting Principles (GAAP), which were built on time-tested standards, brought that much-needed uniformity to financial accounting and reporting. By using GAAP, companies can produce financial reports that are consistent, which allows investors to compare and analyze different companies. The Financial Accounting Standards Board (FASB), which was created in 1973, maintains the standards under authority given to it by the SEC. GAAP are not static, so the FASB’s work is ongoing as it adjusts standards to allow for better, more comparable financial reporting.

Having skimmed the surface of a bit of the history, we can now dive into the process of financial reporting itself. The primary actor is the company. As the SEC’s Chief Accountant, Wes Bricker, has noted, “high-quality financial reporting starts with companies.” As a first
step before reporting begins, the company creates the reporting environment through the development of appropriate internal controls. These company policies dictate how the company will make its decisions, who has the authority to act on behalf of the company, how these decisions and transactions are documented, and what checks ensure that the company adheres to its own policies. A company that maintains insufficient controls will have difficulty presenting its financial condition accurately to investors. Equally troubling, the company’s managers will have difficulty understanding its own financial condition, which makes management tough. Additionally, the company will be at the mercy of wrongdoers within its ranks if it lacks the proper controls to flag questionable activity. Federal securities laws now require these controls, but even without such a statutory mandate, only a foolhardy company would operate without controls.\(^12\)

Having controls in place is just a start. The company must document the controls and all authorized transactions in its books and records.\(^13\) This documentation forms the backbone of the actual financial reporting process. For companies subject to the U.S. federal securities laws, the responsibility for maintaining books and records in reasonable detail is assigned to the companies themselves.\(^14\) Again, even without a statutory mandate, this arrangement makes sense; companies are in the best position to maintain their own books and records. These books and records are the building blocks of financial statements that are “comparable, verifiable, timely, and understandable by investors and others.”\(^15\)

Although financial reporting starts with companies, a number of outside parties also have a role in the process. People reading the financial reports might not be inclined to trust them simply because companies say they have implemented internal controls and complied with GAAP. An independent third party—the independent auditors—must review the company’s financial statements and issue an opinion.\(^16\) Auditors add credibility to financial reports by performing procedures to determine whether the financial reports are presented fairly in accordance with GAAP. For an audit to be effective it must be objective and performed by auditors who are “ethical, independent, skeptical, and who apply the diligence necessary to meet professional

\(^{13}\) Id.
\(^{14}\) See id.
\(^{15}\) See Bricker, supra note 11.
\(^{16}\) Id.
and regulatory standards.”17 These auditors are overseen by the Public Company Accounting Oversight Board (PCAOB), which was established to develop standards to ensure these objectives are met in public-company audits.18 Even before the establishment of the PCAOB after the Enron and WorldCom debacles, auditors were subject to professional standards, which helped investors to trust the auditors’ work.19

Because of their position as the last check on a company’s financials, auditors often serve as attractive scapegoats when a company runs off the rails.20 When a company has been poorly run and subsequently collapses, however, we should look first to management, not the auditors. While the auditors perform a vital function, their role is limited to ensuring that the financial statements are free of material misstatements. They do not assess whether a company is well-run, nor is it their job to ferret out every instance of negligence or malfeasance.

A recent example from the United Kingdom serves to illustrate the point. In January 2018, Carillion, a British facilities management and construction services firm, was forced to liquidate with £29 million in cash and £1.3 billion in debt.21 The liquidation came shortly after the company announced an £845 million write-down on unprofitable, long-term construction projects, the value of which declined at the same time that the company’s debt increased significantly.22 Carillion’s collapse left many wondering how a failure of this magnitude could go unnoticed for so long. In response to public outcry, politicians turned their sights on the auditors, some of whom are calling for a forced break-up of the Big Four.23 I cannot offer any opinion on the quality of audit work done

17. Id.


22. Id. at 1.

for Carillion. Rather, this example shows how quickly and completely the public’s attention often turns to auditors and therefore away from management.

Firms that assume the role of outside auditor take on a heavy burden, and so they should. They are an integral part of our reporting system and, in return for their position of trust (and the comfortable fees that accompany that position), they assume certain obligations. We must be careful, however, to lay on them only the burden they are designed to bear. The financial reporting process begins with the company. The company is responsible for designing and implementing internal controls, keeping its books and records, and ensuring that management is held properly accountable. Blaming the auditors for the company’s failures not only overstates the role of auditors, it also lets the company off the hook and reduces the incentive for other companies to keep their own houses in order.

Along with companies and auditors, the SEC also has a role in the financial reporting process. The SEC’s Division of Corporation Finance selectively reviews filings to monitor compliance with financial accounting and disclosure requirements. Our Office of the Chief Accountant answers questions from accountants and auditors and works with FASB, PCAOB, and international standard-setters.

This entire process, from developing and maintaining internal controls to auditing financial statements to reviewing and establishing accounting standards, is not a source of revenue; to the contrary, the process is a consumer of resources. Companies must devote staff hours, information technology, and management time to the process, and they hire outside experts to complete the work. They pay for auditors and they fund the PCAOB and FASB. The costs incurred by the SEC in its oversight role are also part of the price for the financial reporting process.

Why bother? Why focus so much energy on and why pour so many resources into company financial statements? Investors need this information to make good choices about how to invest their money. Financial reporting is essential for effective capital allocation, which, in turn, is critical to our economy. As Wes Bricker said when he spoke to the Institute of Chartered Accountants in England and Wales in June,

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EY charged millions of pounds for auditing companies even though they did not warn about the financial dangers facing companies like Carillion).


“[A]n efficient [capital] allocation process would not be possible without financial disclosures, because adequate and high-quality information helps investors to judge the opportunities and risks of investment choices accurately.”

There is not enough capital to fund every idea. Funds are limited. An accurate financial picture of a company—a picture that is comparable with the pictures of other companies and a picture that is a credible representation of reality—is a key input in an investment decision. These capital investments encourage economic growth by channeling funds to productive investments. Productive investments, in turn, are a boon to society. They produce life-saving drugs, new ways of processing data, and new ways of getting around. So in a way, the railroads, by setting us on the road to uniform financial reporting, helped pave the way for their competition—the automobile and the commercial jet—to get funded.

Public companies, pursuant to our securities laws, make disclosures in addition to accounting disclosures. These disclosures provide context for the financial statements. Again, the purpose of these disclosures is to help investors make an assessment about the long-term value of the companies’ shares of which they are considering buying or to which they are considering lending money. Remembering why we engage in financial reporting and disclosures under the securities laws helps us to understand its limits and resist efforts to rethink its purposes.

If information about a company is so important to investors and, by extension, to the rest of society, wouldn’t it make more sense simply to require companies to disclose everything? If information is good, more is always better, right? Not necessarily. In fact, almost certainly not. First, as I mentioned earlier, disclosure entails cost. There is, of course, the cost of gathering the information itself, but that is just one line item on the bill. Reviewing the information, ensuring its accuracy, and presenting it in a way that is consistent with the law is costly too. Such review and presentation require the assistance of experts—very expensive experts such as lawyers and accountants. And, of course, there is the cost of incurring legal risk. Every disclosure an issuer makes can give rise to a lawsuit by the government or investors if it is

27. Bricker, supra note 11.
inaccurate,31 incomplete,32 or simply improperly disclosed. The potential for legal action means lots of costly expert attention to detail and, if legal action occurs, many more expensive expert hours and burdensome management distraction. Lucrative for lawyers and accountants, but quite the opposite for the companies and—ultimately investors—footing the bill.

So, more is not always better even from the investors’ viewpoint. The more a company must pay to make a disclosure, the less money is left for shareholders to receive in the form of dividends or increased company value. A company’s shareholders may also worry that the disclosure of too much information could make it vulnerable to competitors.33 There is also investor cost in terms of the time she spends wading through disclosures. Reliable, relevant information helps an investor evaluate whether a company’s stock is a good buy, and the investor is helped by having access to information that will help her make that decision, but she does not want pages of disclosures that are irrelevant to her question: is this company a good bet?

How do we decide, then, what a company should or must disclose? Our federal securities laws have rested on the foundational principle that issuers should disclose that information that is material to investors.34 A fact is material if “disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”35 This “total mix” has been traditionally understood to mean information about whether the company is likely to provide a return on investment to the investor. In other words, investors need—and our securities laws strive to provide them with—information about the long-term financial value of the company.

Materiality is a cornerstone of our regulations. In most cases, if a company omits or misstates a fact, the company faces liability only if

32. Id.
the fact is material. For example, if a company miscalculates a number by a penny, it is unlikely that that misstatement is material. The reasonable investor is unlikely to reach a different conclusion about her investment in the company because a number was off by one cent. If a company miscalculates by a much larger number, the likelihood that the misstatement is material increases.

It will come as no surprise to a room full of lawyers that what constitutes materiality has been defined, in part, through litigation. If a company is facing litigation over an allegedly material misstatement or omission, one way the court will determine whether the misstatement was indeed material is to look at the company’s stock price. If the correction of the misinformation or omission had a sizable impact on the company’s stock price, that is evidence in support of materiality. In other words, a decreased stock price can indicate that investors do indeed find that the information has significantly altered the total mix of information available. As you can imagine, however, conducting these types of event studies is difficult.

The difficulty of putting limits around materiality has long bedeviled the SEC. In a speech forty years ago, then-Commissioner Roberta Karmel noted that “the Commission is being accused of substituting moral for economic or legal materiality.” She further noted, people outside the SEC were pushing the SEC in that direction by requiring “disclosure of matters which are not necessarily economically material,” specifically environmental disclosure. She hoped that trend would not continue, but in recent years it has gained steam. People whose primary interests are not in the long-term value of companies have realized the power of our mandatory reporting regime and have grabbed hold of it for their own purposes.

In recent years, there has been a call from some commenters to realign the boundaries of what must be disclosed by public companies, and therefore what we deem “material.” If materiality is determined

37. Id.
38. See id. at 251, 253.
40. Id. at 11–12.
41. See Alana L. Griffin et al., supra note 5.
42. See id.
43. Id.
by asking what the investor would want to know, the argument goes, why should the inquiry be limited to asking what the investor would want to know about a return on investment? If an investor is interested in knowing about a company’s labor practices—and if that information would “significantly alter the ‘total mix’ of information made available” to the investor about labor practices—should micro-level wage and salary data be deemed material? Or, if an investor cares a lot about the company’s use of green energy, isn’t all information about the mix of solar, wind, coal, and natural gas being used at each of the company’s offices material? Or, what about an investor who owns a trash hauling company with a big contract with the company and has a real interest in having the company not engage in waste reduction and recycling, so wants detailed information about refuse? Isn’t detailed information on the firm’s recycling program material? The answer to all these questions is no.

First, there is a reason that we talk about materiality in terms of the “reasonable” investor. That modifier is intended to limit the language to ensure that a company is required to disclose information that is broadly useful to investors, not information that responds to idiosyncratic interests unrelated to the investment’s profitability. The term “material” would come to be meaningless if it meant information important to any investor. While one investor may care deeply about labor practices, another may care about whether the offices all have recycling bins, and yet another may worry about whether the company is increasing investment in certain geographic regions of the United States. “Materiality” has a stable meaning because it is not feasible to require the company to respond to the interests of individual investors, or even groups of investors.

Second, even if a large number of investors wanted information about the same issue—the company’s environmental footprint, for example—the process for reporting or auditing this information is simply not reliable and auditable in the way that financial reporting is. As I mentioned earlier, financial reporting is a process that has developed over centuries, with methods that worked becoming codified and methods that did not work being discarded. Not only are the accounting methods themselves time-tested, but the process from

44. See id.
46. See id. at 448–49.
48. See supra notes 6–9 and accompanying text.
developing internal controls to documenting the implementation of those controls to entering transactions into the company’s books to presenting those records for audit have been developed and refined over time.  

Additionally, for many issues that may matter to certain investors, the data are not settled. Audited reporting suggests that there are clear standards that can be uniformly applied across companies, or even across industries. Soft issues like environmental footprints are simply not susceptible to this type of reporting or auditing. Nor is it easy for a regulator to assess the quality of disclosure on many of these soft issues.

Indeed, the Commission has struggled to implement requirements for the disclosure of non-material information that are driven by concern for constituencies other than investors. It is hard to know how to measure the effectiveness of such requirements. For example, eight years ago Congress directed us to require companies to make disclosures about the degree to which they use minerals from conflict zones. The hope was that the disclosure would discourage companies from sourcing minerals from areas of conflict, but the information is really hard to come by and is not necessarily material. Congress also directed us to disclose mine safety violations, which are already disclosed to one

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53. See Griffin, supra note 5 (noting that such requirements often fail because they do not fit SEC’s “long-standing principles-based” materiality framework).


55. See id. § 78m-2(a).
regulator and many of which are not material.56 Contrast these requirements with the disclosure requirements we issued just this week with respect to mining companies.57 We are updating the requirements governing how these companies disclose the extent of their mineral reserves, any obstacles to mining, and their plans for marketing the minerals they extract.58 These disclosure requirements were driven solely by investor need,59 so they are much more straightforward—I will not go so far as to say easy—to implement.

Accounting itself is not black and white; it depends on the art and judgment of the accountant. Given the variability present in what seems like such a straightforward presentation—the amount of money a company has and how it is spending it—reporting less straightforward information raises considerable challenges. Consider, for example, a question such as “what are the company’s overseas labor practices?” What factors do we care about in answering this question? Perhaps that is not even the starting question. The starting question may be better phrased “what factors should we care about?” What is the purpose in asking the question? Often it is to determine whether workers are well-treated.60 But what does “well-treated” mean? How will we define this? What data will we use? How do we determine which data are relevant? These questions may be answered in five different ways by five different investors. Whether certain practices indeed benefit workers may vary wildly by industry and location.61 They may even vary by the idiosyncratic preferences of different workers themselves.62

Of course, treating its workers well is one way a company can help build towards its long-term financial value. The company may choose

58. See id. at 66, 346–47.
59. See id. at 66, 344–45.
to publicize detailed information about how it treats its workers. Doing so might, among other things, be a good way to appeal to customers. Companies often choose to make disclosures they are not required to make about any number of issues, from hiring practices to recycling efforts to environmental practices.

The yearning for soft information is creeping into the core of financial reporting. Given the importance of reliable financial statements, even small steps away from the established parameters of financial reporting can raise red flags. For example, the International Accounting Standards Board (IASB) has recently released a conceptual framework that placed a new emphasis on stewardship. Whether this change alone will result in a change in accounting standards is difficult to say, but the use of this word gives me pause. It is not an easy word to define. At the time the framework was released, the IASB noted that the term “stewardship” had presented difficulties for the international body given the challenge of appropriately translating such a meaning-rich word into the various members’ native languages.

Even in English it can be hard to say definitively what “stewardship” might mean in the financial reporting context. As one scholar has noted, it can mean “management’s honesty in husbanding the enterprise resources,” or “management’s efficiency in utilizing them,” or even “providing the shareholders with a suitable return on management’s employment of the resources.” To the extent that “stewardship” means simply that the company has implemented adequate internal controls and is deploying its capital to economically productive ends, financial reporting can indeed assist investors and

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63. O’Connor, supra note 5, at 534–35 (providing an overview of voluntary disclosures concerning human capital).


67. Id.


69. Id.

70. Id.

creditors in assessing management’s stewardship.\footnote{Id. at 9.} The quality of “stewardship” in this context is audited under existing standards. But to the extent the term means something broader—maybe it encompasses, for example, an inquiry into whether management is doing a “good” job—things get murkier.

Financial reporting has always been about financials. These financials provide insight into how a company operates, but they do not tell us directly about people. The uncertainty that a word like “stewardship” presents is the uncertainty of trying to apply the same concepts that can provide a reasonably accurate picture of a company’s financial situation to a much softer set of variables such as its management situation. Additionally, once we have opened the door to applying financial reporting to one set of non-financial variables, it is too easy to try to apply them to others, such as the so-called sustainability factors I discussed earlier.\footnote{Id.; see also supra notes 50–52 and accompanying text.}

Thus far, the IASB has not taken any concrete steps away from its core purpose: setting accounting standards. Indeed, the Chairman of the IASB has remarked that the IASB is not well-equipped to address sustainability reporting and that “the world of sustainability reporting does not provide the same kind of global comparability that exists in the world of financial reporting.”\footnote{Hans Hoogervorst, Chair, Int’l Accounting Standards Bd., Speech at the Accountancy Europe Event in Brussels: The Times They are A-Changin’ (Sept. 18, 2017), https://www.ifrs.org/news-and-events/2017/09/iasb-chairmans-speech-the-times-the-are-achangin/ [https://perma.cc/JXS9-4NT4].}

I very much agree. Financial reporting loses its value when it is applied too broadly to circumstances not amenable to its standards or processes.

Conclusion

Our financial reporting and corporate disclosure system is essential to well-functioning markets, which are, in turn, essential to the ongoing provision of the goods and services that make modern lives so safe and comfortable. This system has served investors well for many years. When we seek to bend this system out of its proper shape, we risk undermining the value it provides. Whether we do that by trying to account for and audit things that are essentially unauditable, by expanding the scope of financial reporting to information that would never have been deemed material in the past, or by making auditors


72. Id. at 9.
73. Id.; see also supra notes 50–52 and accompanying text.

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the guarantors of management to an extent never intended, we do violence to a system that has historically served our markets well. Financial reporting deserves more respect from us than that. So too, when we attempt to pack our securities disclosures with items that are not directly relevant to a company’s long-term financial value, we diminish the value of these documents to the investors for whom they are intended.

Thank you all for your time today. I have enjoyed the opportunity to be back at CWRU. The topics we are discussing today are important ones, so I look forward to hearing your comments and questions. I suspect that we all will be contemplating these issues for the next half-century, although perhaps not as intently as The Thinker.