

ADDRESS

by

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The relationship among the Commission, financial analysts, and accountants has not always been one of complete mutual understanding. There have been times during our thirty years that the accountants and the analysts have been somewhat critical of each other and, of course, of us. Analysts have felt that the accountants have not worked hard enough to produce detailed reports in the form desired for analysis. The accountants have charged the analysts with a failure to understand some of the limitations of accounting and auditing. And we have been accused of not exercising our statutory jurisdiction to the fullest extent to achieve the best possible methods of financial reporting. I suspect there was a certain amount of justification for all these criticisms. There have, however, been occasions when forces have been successfully joined and differences reconciled; a particularly happy example is the issuance of warnings about the improper use of "cash earnings" and similar terms and to endorse instead a greater use of the source and application of funds statement. Continued collaboration is essential if we are to make progress in financial reporting and sound interpretation.

I will speak to you tonight about three subjects related to this joint effort by analysts, accountants, and the Commission. First, I would like to discuss the drive toward eliminating unjustified differences in financial statements of similar companies, so that comparability of statements is enhanced. Second, I will speak about the need for financial reporting to take account of changing circumstances here and abroad, particularly with respect to the growth of the large complex corporation engaged in a number of distinct lines of business. Third, I will speculate about what the Commission can do, consistent with its resources, to improve the quality of the financial information filed with the Commission, and to make the information available in the most accessible and meaningful way.

I. COMPARABILITY OF FINANCIAL STATEMENTS

The importance of comparability of financial statements is apparent. Not only are statements used to compare the same company at different time periods; they are used to compare similar companies with each other. And these comparisons can be of great significance. Investors and creditors use them to evaluate the worth of the company, to determine whether to purchase or sell its stock or to extend credit. Company officials, charged with the stewardship of their companies, need standards by which they and investors can measure their performance against others in the industry, and the best measuring rod thus far devised is expressed in terms of financial statements. How can growth be compared, or relative profitability assessed? How can a financial analyst, selecting prospective investments from an industry, really do his work without comparative figures?

One of the principal obstacles to comparability of financial statements has been the application of alternative accounting principles to similar sets of facts. Although the Commission has the authority under the securities laws to impose uniform systems of accounts on issuers registering securities under the 1933 or 1934 Acts, we have not done so. Instead, the statutory authority has been used in general to require only that financial statements be accompanied by the opinion of an independent accountant stating that they have been presented in accordance with generally accepted accounting

principles, and we have looked primarily to the accounting profession for formulation of those principles.

The Commission has not taken this approach under all the acts it administers. Under the Public Utility Holding Company Act of 1935, a detailed uniform system of accounts has been adopted to which all registered companies must conform. This contrasts sharply with 1933 and 1934 Act registrants where, as I have indicated, the Commission has tolerated considerable diversity in accounting. Regulation S-X states the form and content of all financial statements filed under those Acts, but it does so in rather general terms, leaving room for variations among reporting companies. The Commission has also adopted a number of Accounting Series Releases setting forth "opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions" but, particularly since about 1945, issuance of these opinions has been infrequent.

Occasional adjudicatory proceedings have also involved matters of accounting presentation, but these are more often concerned, at least in recent years, with failure to meet established standards than they are a regular source of learning on what constitutes sound accounting principles. These cases, and many of the recent Accounting Series Releases, tend to deal with auditing requirements, disciplinary matters, independence of accountants, and similar matters.

The Commission has been a strong influence in the development of accounting standards generally -- the day-to-day informal activity of our staff accountants in dealing with registrants is of great importance, and our Chief Accountant, Andrew Barr, has been active and effective in liaison with the principal accounting organizations and their working committees. For the most part, however, it must be said that our recent activity has centered on particular cases rather than on the development of overall principles of general applicability.

It is in this context that the current debate rages over the relative merits of flexibility, on the one hand, and uniformity, on the other, as a guide to the preparation of financial statements. There are those who argue, sometimes extravagantly, that comparability is such a desirable goal that a uniform system of accounts is a practical necessity. And there are others who insist that the need for judgment in the preparation of financial statements precludes the establishment of hard and fast lines of the kind contemplated by the advocates of uniformity. It is unfortunate that the debate is so often expressed in those terms, which tend to polarize positions around somewhat unrealistic extremes.

Clearly, if asked whether comparability is a desirable goal, I would answer yes -- but so would those who argue against the imposition of a detailed uniform system of accounts. Similarly, many of the arguments of those who advocate flexibility have considerable merit: It is not at all certain that even in the best of all possible accounting worlds we could develop a system of absolute comparability of financial statements. I believe

that the arguments would be less heated, and more productive, if both sides would emphasize the common goal of eliminating unjustified variances in financial reporting, and thereby achieve a maximum degree of comparability of financial statements of similar companies.

The accounting profession has not resisted the freedom, and concomitant responsibility, given to it by the Commission to develop accounting principles. There are many who believe, however, that the accountants have not fulfilled that responsibility. Without minimizing the difficulties of the task, and with no intention to criticize, it is fair to say that the accounting profession has, in the past, been unable to achieve uniformity in many significant areas of financial reporting -- that is, accountants have been unable to reduce significantly, if not eliminate, the variety of accounting principles deemed permissible in the reporting of similar financial conditions and results.

There has been no shortage of commentators on the subject. Those who produce the financial statements, the auditors who express their opinions about them, and the users -- financial analysts, credit grantors, and investors -- all feel free to express themselves, as do an articulate financial press and a critical group of educators in accounting, economics, and finance. Despite all this help the problems have not been solved. The plain fact is that the critics do not agree among themselves and some often change their minds on what should be done.

The result has, of course, been questionable diversity in accounting treatment of similar matters. It is possible to have two companies, whose financial condition and experience are substantially identical, presenting their balance sheets and income statements in very different ways. It may be argued that each form of presentation, standing alone, is permissible, in that the form of presentation is logical, internally consistent, and appropriate to an understanding of the financial condition of the company once the premises of the particular accounting system are fully explained. But direct comparison between the financial statements of the two companies is impossible, certainly without the most sophisticated analyses based upon assumptions which may or may not be justified. As long as different accounting principles are permitted to be applied to substantially the same facts, however logical those principles may be, true comparability is impaired, and an important purpose of financial reporting is thwarted.

What is being done about moving more quickly toward the goal of uniformity? Stronger leadership by the Commission is one avenue being followed. An example of this is Accounting Release No. 102 issued a few months ago, dealing with the proper method of reporting deferred income taxes arising from installment sales. At the time the release was issued, no fewer than four different reporting methods were used by companies for which the item was of considerable importance. Some treated it as a current liability. Others classified it as a long-term liability. In some cases, it appeared in a separate category neither current nor long term, above or below the equity portion of the balance sheet. Significantly, each method carried the opinion of an independent public accountant reporting that the financial statements had been prepared in accordance with generally accepted accounting principles.

The American Institute of Certified Public Accountants had not ignored the problem, but had up to then been unable to resolve it. Without going into detail, I can say that the problem was studied and restudied; suggested opinions were sent to committee and resubmitted to committee. Another year-end was approaching, and the diversity of treatment seemed bound to continue. There were two additional reasons for Commission action. One was a formal "Petition" by a leading accounting firm, which recited the several ways in which the deferred tax item was being reported and requested that the Commission issue a release requiring consistency in treatment. The other was a belief that some companies, put at a disadvantage when compared with other companies reporting deferred taxes differently, were about to change their reporting methods, and the Commission wanted to ensure that change, if any, would be for the better.

A formal expression of opinion by the Commission seemed called for, and we obliged. The Commission determined that the most appropriate treatment is to require classification of the deferred taxes consistent with that of the related installment receivables. The release was issued in December and has been generally followed since, although not without some complaint over the contents of the opinion and the manner in which it was issued.

The evolution of Accounting Release 102 is of interest primarily as an illustration of one of the principal hindrances to achievement of uniformity: the inability of the financial world -- including the analysts -- to agree on the most appropriate method of presentation, even though there is general agreement on the desirability of a uniform method. Quite obviously, the ability to agree on the appropriate accounting presentation is a prerequisite to the achievement of uniformity. Unless there develops a willingness to concede that the goal of uniformity can be more important than any particular accounting treatment, progress toward uniformity will continue to be painfully slow.

I do not mean, of course, that -- as an accounting witness testified at the hearings on the 1934 Act -- "uniformity means a uniformly low standard." Indeed, uniformity should encourage better accounting standards. Without firm authoritative guidance, management may prevail in a desire to produce the result which will make it look best in all circumstances, and will urge an interpretation of generally accepted accounting principles to attain this purpose. Those who are concerned with maintaining high standards in financial reporting must admit that there is some substance to this charge, and that it provides an additional argument in favor of uniformity.

To be wholly fair, I do have to point out that in Accounting Release No. 102 we were dealing with a subject especially appropriate for uniform treatment. The essential operative facts were all agreed upon; all that was lacking was the determination of the most appropriate method of accounting presentation. There are other areas, however, where judgment plays a much greater role, and these are more difficult. For example, two similar companies may purchase an identical piece of new equipment but, because it is so novel that there has been no experience with it, or because the industry is undergoing technological changes, they may disagree on the appropriate

depreciation rate or the likelihood of premature obsolescence. In that case, the answer may well lie more in disclosure than in uniformity.

The elimination wherever possible of unjustified differences in financial statements of similar companies has to be, and should be accepted as, a desideratum of the highest rank. If we think of financial reporting as a kind of language -- a method of expressing ideas and communicating information -- the need to agree on the meaning of particular forms of presentation becomes apparent. Ambiguity in the meaning of words obviously operates as a barrier to communication and understanding. The same is true of methods of financial reporting. If they are ambiguous, they may be misunderstood.

Although Accounting Series Release No. 102 was used to resolve one problem of uniformity, I do not believe it will be necessary for us to use that device with great frequency -- although the option is always open to us. The extent to which action on our part is required will depend in large measure on the vigor and determination of the Accounting Principles Board of the American Institute of Certified Public Accountants, which has the principal responsibility of defining accounting principles to be used in financial reporting. I am greatly encouraged by the current activity and progress being made by the Board. Areas have been selected in which differences in accounting treatment of similar items may not be justified, and the Board has identified those which, because of a combination of importance and diversity of treatment, deserve the highest priority. Pensions, Income Taxes, and Income and Retained Earnings head the list, and I am hopeful that before the end of the next calendar year the Board will adopt definitive opinions on these difficult subjects.

The Board is, I know, working with a liaison committee of the Financial Analysts Federation, and with representatives of other interested groups. The President of the New York Stock Exchange has said that the Exchange believes that comparability, at least on an individual industry basis, may be feasible. Important support may therefore be expected from that institution. We look to the Accounting Principles Board to coordinate the suggestions and views of these groups and to move forward effectively toward the development of a single set of accounting principles to govern comparable circumstances.

II. ACCOUNTING FOR THE CONGLOMERATE COMPANY

Let me turn now to a different subject, the need to adjust methods of financial reporting to take account of changing corporate conditions. The early utilization in this country of the public corporation, and the spectacular success of American business, sometimes induce us to believe that we have a monopoly on all innovations in the business area. It is easy to forget the enormous debt we have to other countries which have contributed to our development. In the case of securities regulation, the precedent of the English Companies Act is an easy reminder of how much we have borrowed from abroad. The time may be approaching when we will want to borrow again in the field of financial reporting.

The revolution which has occurred abroad since the last war -- the breakup of family corporations and the increasing public ownership of stock -- has forced many foreign governments and stock exchanges to re-examine traditional concepts of corporate disclosure. This re-examination coincides with a rapidly changing concept of a corporation, and has produced disclosure which, in certain areas, exceeds our own requirements and customs. To be sure, our disclosure is still the most comprehensive, but in some areas it is not the most imaginative or the most useful.

Take, for example, our reporting requirements for conglomerate corporations. I use the awkward term "conglomerate" to mean the large corporation which engages in a number of distinct lines of business under the same corporate roof. We have all watched the evolution of this kind of enterprise from what was once considered an unusual vehicle to what is now a commonplace. Yet there has been little in the way of significant change in financial reporting requirements to provide the kind of information needed to evaluate the experience and prospects of conglomerate companies.

The Commission's forms have for many years required the disclosure of the relative importance of each product or service or class of similar products or services which contributed 15% or more of the total gross volume of business. If income is derived from both gross sales and operating revenues, our accounting regulation requires separate reporting of each if either of them exceeds 10% of gross sales and operating revenues combined. Even in these limited areas, the rules require a breakdown only of income, and it is only occasionally that an issuer has on its own initiative or at our request indicated the relative contribution of particular classes of business to the overall net profit figure. Even then it has been done only in the most general way.

The Annual Report -- called by a critic "one of the flossiest and least informative art forms of our time" -- has at times gone beyond our requirements. There have been several examples in which issuers have included in their annual reports earnings figures for company divisions. Martin Marietta Corporation's 1965 annual report, for example, shows sales and net earnings separately for its Martin Company division, its cement and lime division, its chemical division and its rock products division. The ability to separate sales and earnings arising out of space and missile activities, from the more mundane activities of the rock products division, must be of considerable help to you who must evaluate the company's worth and prospects. Kaiser Industries, a highly diversified company, gives a summary of consolidated earnings showing operating profit or loss, before interest expense, in four broad categories of operations. The Glidden Company has for several years reported separate sales and profit figures for its several operating groups, and there are others I have not mentioned.

These disclosures are, however, usually made on a voluntary basis. But we can look once again to the United Kingdom for an example of progressive requirements in this area. A new Companies Bill, which implemented

many of the recommendations of a committee which studied the English capital markets, received two readings in Parliament prior to its adjournment before the recent election and is fairly certain of reintroduction and early passage. The Bill would require that, where a company has two or more classes of business which differ substantially, the directors' report (similar to our annual report) show the sales turnover for each class. The report must also show (and I need hardly stress its significance) the extent, or approximate extent, to which each class contributed to or restricted the pre-tax profit or loss of the company. If group, or as we call it, consolidated accounts are prepared, similar information must be given in respect of the group. Also, where the company or its subsidiaries are in the business of supplying goods, the directors' report will be required to state the total value of goods exported by them or to state, if it is the case, that no goods have been exported by them. These requirements of course go well beyond anything we require at the present time.

The Companies bill echoes recent requirements of the London Stock Exchange, which recommended that listed companies disclose sales turnover figures and provide an analysis of trading results where a company or group carries on widely differing operations. The Exchange has made disclosure of turnover virtually mandatory for all companies, those already listed and those seeking admission to the list, and the analysis of trading results for conglomerate companies is a required disclosure for newly listed companies, unless waived because of extreme hardship.

It may be that, with the examples of voluntary reporting we already have, and the English precedent, we should be looking toward a defined operating profit and loss statement on a divisional basis as the next objective beyond the breakdown of sales for the conglomerate company. We recognize that disclosure of divisional profits for the conglomerate company introduces the risk that indirect expenses may be allocated in a way designed more to produce a desired result than to effect a fair financial presentation. But this is the kind of risk always incident to progress. Professionalism in accounting and financial analysis should suffice to keep this problem within bounds.

The United Kingdom is not the only place where important advances are being made. Other countries and institutions around the free world are also improving their disclosure requirements. There is pending in Ontario legislation which includes significant and desirable changes in their law, including that relating to disclosure. The new German corporate law for the first time attempts to regulate the widespread abuse of hidden reserves in financial statements. The Johannesburg Stock Exchange is attempting to secure a statutory amendment to require more frequent disclosure. Young nations like Israel and Ghana, joining Italy, Australia, South Africa and the Netherlands, to name a few, are studying ways to protect and encourage their investors. The International Federation of Stock Exchanges is striving to obtain greater financial disclosure. I expect that, as in the case of the English Companies Act, these efforts will develop innovations which will be of great benefit to us.

III. POSSIBILITIES OF COMMISSION ACTION

Finally, let me say a few words on what the Commission can do to assist in improving the flow of information to the financial analyst.

With respect to the comparability problem, I have already noted that the Commission can give support to the program of the Accounting Principles Board. Where irreconcilable differences exist, the Commission can help settle conflicts among competing accounting principles through issuance of additional Accounting Series Releases.

With respect to financial reporting for conglomerate companies, the Commission can work with analysts and accountants to determine proper methods of allocation, or establish a defined operating profit and loss statement on a divisional basis, so that a more complete financial picture of these complex companies can be made available.

On a more general level, however, we are reviewing and reconsidering some of the basic registration and reporting requirements under the Securities Act of 1933 and the Securities Exchange Act of 1934. Our aims are simplification of the requirements and improvement of the overall quality and accessibility of the information made available under the securities laws.

Our forms under the Securities Acts distinguish to a limited extent between seasoned companies and smaller new companies coming to market for the first time. We have a form, S-2, for securities of commercial and industrial companies in the developmental stage, and another, S-11, for securities issued by real estate investment trusts and those companies primarily in the business of purchasing and holding real estate for investment. Other forms are designed for special kinds of offerings, such as employee stock purchase plans, and one is available only for high-grade debt issues. Except for these specialized forms, however our prospectus and periodic reporting requirements are generally the same for all issuers. The form with which you are probably most familiar is S-1, used by most issuers who register securities being offered to the public. Form S-1 is used by giant enterprises which have been publicly held for years, and which have been subject to our reporting requirements since the Securities Exchange Act became effective. The same form is used by smaller companies entering the securities market for the first time and which have previously been unknown to the investment community.

Taking account of some of the obvious differences in our experience with these companies, we have at times varied the extent and scope of our examination. During periods when proxy activity reaches a peak, and active new-issue markets and other burdens tax our ability to meet the demands upon our staff, we have limited our examination in those cases where the issuer has been subject to our continuing review over a period of time, and where the risk to the investor is the smallest. At these times we concentrate our efforts on the more complex registration statements, proxy solicitations and other materials filed with the Commission.

The Commission's staff is now looking into the possibility of amending our registration and reporting forms, in part to formalize these procedures with which we have experimented for some years, and in part to take advantage of wider reporting requirements under the 1964 amendments to the Securities Acts. By taking into account the company's financial experience, the scope of the Commission's reporting requirements, and the length of time the company has been providing reports to the Commission, it is hoped that we can devise modified, more sharply defined forms which may ease the current registration requirements for some companies and at the same time make more information regularly available to the public in the most useful form. We have also invited the Investment Bankers Association to submit specific proposals to achieve the same goals. I can report that considerable progress is being made and we may be in a position to announce the results of these efforts soon.

As I understand it, the starting point of each of the approaches taken will be the periodic reports that most registrants are required to file with the Commission. At present, Form 10-K (the annual report) requires an issuer to bring up to date much of the information, including financial statements, required in a registration statement or prospectus (except, of course, for information relating to the terms of the public offering). Form 9-K requires semi-annual profit and loss and earned surplus information. Form 8-K (the current report) must be filed within ten days after the end of a month during which certain important events occur, such as the acquisition or disposition of a significant amount of assets or the commencement of material litigation involving the company. A basic objective of the staff's work is to determine whether a new registration form under the 1933 Act can be devised which will permit integration of these periodic filings with the prospectus, without unduly complicating the reporting requirements or making the prospectus unwieldy or incomplete. Appropriate modification of the forms is contemplated in a manner which would not impose significantly greater burdens on reporting companies.

This work, and I believe it can be successful, is, of course designed to reduce the amount of effort required to register new securities offerings under the Securities Act of 1933 without sacrificing the needs of investors, their advisers, and security analysts generally. At the same time, revised periodic reporting requirements would have the effect of providing, on a continuing, more comprehensive, and timely basis, information comparable to that now required in a 1933 Act prospectus.

It is our hope that a program of this kind will allow us to allocate our personnel resources in a more effective way. More time should be available for review of filings by companies requiring special attention, either because of their inexperience or undue complexity, without sacrificing the quality of information available with respect to other registrants.

Last, let me assure you again that, in this program as in our program to make prospectuses and other material filed with us more understandable, we will be careful not to eliminate material information required by financial analysts. I mention this because some concern regarding these efforts has been expressed to me. I want to make it perfectly clear that when we speak of easing burdens on issuers, or helping the unsophisticated investor by insisting upon the use of basic English, appropriate captions, or introductory or summary statements, we believe we can accomplish those purposes without hindering the work of the professional financial analyst. Better disclosure is not at all synonymous with less disclosure.