

NEWS

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Washington, D. C. 20549

(202) 755-4846



FUTURE-ORIENTED AND DIFFERENTIAL DISCLOSURE

An Address By

Philip A. Loomis, Jr.
Commissioner
Securities and Exchange Commission
Washington, D. C.

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of Certified Public Accountants
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In the four years that I have been on the Commission, I appear to have had an opportunity to address an accounting audience about once or twice a year. I enjoy these opportunities and, particularly the opportunity to be with you today, even though I approach accounting with considerable diffidence, recognizing that I am not an accountant, and that my only formal education in the process was an accounting course which I took many years ago, and from which I appeared to have learned only two things -- first that a balance sheet should balance, and secondly, that my ability to add and subtract is by no means infallible.

I have two principal reasons for feeling this way. In the first place, accounting affords a welcome change of pace from the Commission's customary preoccupation with the functioning of the securities markets and the major changes which are occurring in these markets, including such matters as the elimination of fixed commission rates and the first stages in the development of a national market system, together with a process of legislative revision, which has been going on pretty continuously for about a decade. In the second place, since I have been on the Commission, I have found,

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somewhat to my surprise, that accounting seems to abound in novel, interesting and difficult questions. Contrary to the sterotype that yours is a rather staid profession engaged in reporting historical financial events strictly in accordance with immutable conventions engraved in stone, yours seems to be a fast moving and rapidly changing environment. I am sure that you recognize this fact and I would certainly understand and sympathize if you did not welcome it, but unfortunately, that seems to be the kind of world we live in these days.

While, as I just noted, the Commission has been preoccupied with changes in the securities markets, and changes on the legislative front, as well as with such exotic questions as the prevalence of bribery in certain foreign countries, an issue not without its impact on the accounting profession, it would be a mistake to suggest that the past few years have been quiet ones on the accounting and financial front. We have been making steady, if not spectacular, progress in these areas, and it is these that I would like to review with you today.

I would like to be able to share with you the Commission's master plan for financial disclosure and accounting. Such a plan, including an optimum ultimate disclosure system and the systematic schedule of steps

towards its achievement, would certainly be of interest to you. I must confess, however, that there is a minor obstacle to this endeavor. We don't have a master plan. It may be that when the seers of Stamford, Connecticut get their tablet-creating mechanism in full swing, there will be a conceptual framework for financial reporting which will serve as the basis for a master plan. Until that happy day, however, I must confess to its absence.

I would not like you to have the impression, however, that, even without a master plan, SEC actions in the disclosure field can be described as a series of unrelated random events. I think there are some evident directions which have become increasingly apparent in the last two years, and it is some observations on these directions that I would like to share with you today.

First, I think it can be said that the Commission is moving in the direction of a continuous disclosure system, which seeks to meet the differing needs of different classes of investors, and which is increasingly future-oriented. This represents quite a change from the Commission's traditional posture of past oriented disclosure aimed at "the average investor." I think this change is for the better

in making our disclosure system more responsive to the needs of investors and the market place.

Let me review some of our actions in this direction. Perhaps most significant is our recent adoption of rules which substantially expand interim reporting by all registrants. Form 10-Q filings with the Commission must now include balance sheets and fund statements, and full statements of income rather than abbreviated income statement information. We believe in order to make sound judgments about a company it is necessary to see something of its financial position at different points in its annual operation and at different points in its business cycle. There may be major differences in liquidity from quarter-to-quarter which go unnoticed with only a year-end balance sheet. There may also be significant changes in the level of receivables and inventories which require analytical attention. In addition, the funds statement should give investors a better picture of the flow of funds into the firm throughout the year.

Beyond these financial statements, we have asked management to supply an analysis of quarterly results in Form 10-Q, so that significant changes from quarter-to-quarter and from one year to the next will be explained. We have purposely left our specific guidelines somewhat flexible in this regard so that management can identify the most important

trends and communicate them effectively to shareholders. While we have not required either financial statements or this analysis in the quarterly report to shareholders, we hope that it will find its way there, in whole or in part.

In addition to quarterly data on Form 10-Q, we have required larger companies whose shares are actively traded to include certain quarterly data in their annual financial statements, so that investors can see the pattern of operations throughout the year, while considering results for the whole period.

A second major step in the direction of the future-oriented disclosure, which we have recently proposed, is the inclusion in notes to the financial statements of certain limited data based upon the replacement cost of corporate assets. Specifically, we have asked for four pieces of information, two oriented toward the income statement and two toward the balance sheet. These are cost of sales and depreciation, computed on replacement cost basis, and the current replacement cost at the end of the year of productive capacity and inventories. We believe that this information will significantly assist investors in assessing the current economics of a business enterprise which will be of great assistance in making judgments about the future. While we have not suggested that historical financial statements are

outmoded, we do believe that in a time of inflation and dramatic economic change they may lag behind reality sufficiently to be unreasonably biased if they are used uncritically. We do not have to look far to find examples of historical cost financial statements that do not reflect today's realities. Utilities and petroleum companies are two examples.

We have noted around the world a move in the direction of financial reporting based on replacement cost. In some countries, proposals have gone far beyond ours. In Australia, for example, there has been a proposal that the basic financial statements be changed to use replacement cost information. In the United Kingdom, the recent report of the Sandilands Committee made a similar recommendation. It may be that ultimately we should consider such a fundamental change, but the Commission believes that such a change should come from a careful study of all the issues, such as the conceptual framework project now being undertaken by the Financial Accounting Standards Board.

In making our proposals, we also gave consideration to the possibility of general price level adjusted financial statements as the only form of supplemental information, and we concluded that this would not be a sufficient answer, even though we did not reach a conclusion that such information was

without value. We believe that in an inflationary environment relative price changes between enterprises are very significant and that the application of a single general index representing a composite of all exchanges in the economy cannot effectively communicate to investors, or for that matter to managers, how the forces of inflation are impacting on a particular enterprise. Such an approach is still a historical approach, even though it is based upon a different unit of value, and, accordingly, it does not adequately reflect the situation of individual enterprises.

We certainly recognize that our proposals are controversial, and in making them, we have provided for a substantial comment period which ends on January 31, 1976, so that all interested parties will have an opportunity to consider them with care, in the light of their own situations and supply us with comments. We are not committed to the specific words of our proposal, and we are cognizant of the costs which it may impose upon registrants. Nevertheless, it seems to me that there is a real need for information of this sort, to assist investors in making judgments about current and future economics, although such data may have been developed primarily to assist managers in micro-economic decision-making. We have seen a number of examples of

companies that have established replacement cost systems for their own internal purposes and found them extremely useful. While a few of these companies have presented such data in external reports, the majority still use it solely for internal decision-making. In the latter connection, while we cannot believe that managements are unaware of current costs, we do think that many do not have a system which brings such costs to their attention, on a regular basis, as part of their control over operations. It seems reasonable to think that such data may be valuable.

We have also heard a great deal in recent years from the business and financial community about the inequities of our current tax structure and the fact that taxation based upon historically-computed income may, in an inflationary economy, result in taxing capital as if it was income. While I recognize the logic behind this view, I think it must be recognized that Congress is not likely to be responsive as long as corporations are telling one story to their stockholders, while at the same time urging another on the creators of the Internal Revenue Code. Management cannot have it both ways. If they wish to tell their shareholders that everything is going well, it is unlikely that they will be able to communicate a different message to the tax man.

It seems essential, therefore, that business begin to develop systematic and regular data which are part of their information system recording the impact of current costs. Data which is developed only to make a tax case is suspect, particularly in a climate such as today's where the good faith of business is often questioned. I suspect that the ultimate recognition of replacement cost on a tax basis will not be easy to achieve, but without having it part of the regular corporate information system, I am convinced that it is impossible. We hope that our proposals will constitute a first step in this direction.

In recognition of the potential cost of such a system, we have asked for comments on whether initially replacement cost data should only be required of companies above certain size levels and whether such data should be labeled as unaudited. We have observed from early comments some agreement that requirements should only be imposed upon companies above a particular size. Our Chief Accountant advises me that he has developed a mathematical expression of these views. He says that commentators generally feel the rule should be applied to companies of a size of X plus 40 million, where X is the size of the commenting company. I should say in fairness that we have not yet heard from any of the Fortune 500 in this regard.

Our moves toward a future-oriented disclosure framework also include Accounting Series Release No. 166, which urges better recognition of business uncertainties in corporate financial reporting. This release has received perhaps the greatest attention in the banking area, where it calls for specific and substantial disclosure regarding uncertainty in loan portfolios, but its implications are considerably broader. Carefully constructed disclosure of uncertainties is perhaps the best way of communicating the fact that there are many possible futures for investors in business enterprises.

Another step in the direction of future-oriented disclosure was our proposal in the area of forecasts and projections. I have to tell you that we have been humbled by the public response to our well-meaning efforts in this regard. We thought that we would help virtually everyone in the financial reporting community by developing a voluntary system of forecasting which would permit the inclusion of forecast data in Commission filings, provide certain protections for those companies that wanted to forecast through the development of a safe harbor rule, permit the association of experts with forecasts, if desired by the registrant and the expert, and prevent certain potential abuses, such as selective disclosure of forecasts to small groups. It was thought that this would provide a framework whereby forecasts could be made available to all in an orderly and systematic manner.

We put out our proposals and waited for the accolades that we were sure would follow. We have been surprised and concerned by the result. Not only did we not please everybody, it appears we did not please anybody. Lawyers, analysts, corporate executives and accountants have all joined with remarkable unanimity in informing us of the deficiencies of our proposals. For someone who is trying to help, this has been a sobering experience. We are now rethinking our proposals, and I would guess that it would be some months before they reappear.

The other element that I mentioned was the Commission's effort to develop a disclosure system aimed at different classes of investors. This is our differential disclosure approach, which recognizes that there are many different investors who use many different approaches in evaluating investment opportunities. Such investors also have widely diverse backgrounds and abilities to utilize different varieties and levels of disclosure. It has seemed to us that it is not desirable to assume a single level of sophistication in developing reporting requirements. Rather, we have felt that information must be available which will satisfy the professional analyst, who believes that he should develop an understanding in depth of corporate activities. At the same time, some information should be in a form that is understandable by the interested investor who lacks technical training.

What we have done, therefore, is to require, on the one hand, greater management analysis of financial results in textual statements, aimed primarily at the average investor who does not have the analytical background or who may not have the time to dig into the details himself. At the same time we are requiring more detail about many elements in the financial statements for the professional analyst. We have recognized the need for various levels of summarization and believe this approach is consistent with the world as we find it today. Since there is no single set of financial data which precisely meets the needs of everyone, especially when different users see their needs substantially differently, we think that differential disclosure is a practical solution to the communication problem and I would anticipate that the Commission will continue to move in this direction.

Another broad direction that can be seen in our disclosure policy is the move in the direction of increased responsibility of independent public accountants. We have moved in this direction in a number of different ways. First, we have attempted to improve the position of public accountants in dealing with their clients, through requiring increased disclosure of auditor-client relationships. In 1971, the

Commission took its initial step by requiring disclosure of disagreements between auditors and clients when changes in auditors occurred. This requirement was amended and strengthened in 1974.

In addition, the Commission has encouraged formation of audit committees, and required disclosure in proxy statements of whether or not a corporation has an audit committee. The revised proxy rules also require disclosure of who the auditors are, even where no action is being taken in regard to them, and whether or not representatives of the auditors would be present at the annual meeting of shareholders with the opportunity to make a statement. In this fashion, the Commission sought to make stockholders more aware of the identity of the auditor of record.

About a month ago, the Commission adopted rules covering interim reporting which will associate the auditor in a limited way with reported interim results. In promulgating these rules, the Commission indicated that it believed that it was important that the expertise of the independent accountant be brought to bear on interim reporting. It urged the Auditing Standards Executive Committee of the AICPA to develop procedures which would constitute sound professional review procedures for association with such unaudited interim data.

The Commission also adopted a requirement that all changes in accounting principle be approved by the auditor as representing in his opinion an improvement in financial reporting by the client. This reflects our view that the independent accountant, as a professional expert in reporting, can bring his judgment to bear on what accounting is most appropriate in the circumstances, even though there may be no specific rule which requires one accounting method or another. In cases where a change in accounting is being made, APB Opinion No. 20 requires that the new method be preferable. While the accounting profession has expressed some concern about being required to make such a value judgment, I believe that such judgments are a part of a professional's responsibility.

We hope that these various steps will encourage auditors increasingly to view their role as a continuing representative of the public in all financial reporting done by their client even when they do not report specifically on particular financial data. We believe that the auditor must be involved with the financial reporting system of his client on a continuing basis and that this will improve both the analytical content of annual audits and quality of published interim results.

One of the most controversial areas in which the question of auditor responsibility has been raised is in connection with illegal payments and corporate slush funds. This is one of the most difficult disclosure problems faced by the Commission, and I am sure you are aware that there are many strong and contrasting views regarding virtually every aspect of it. The Commission has clearly indicated that it feels that disclosure of certain payments is necessary to make filings with it not misleading. This has been done by bringing enforcement actions in major cases, and through Congressional testimony and speeches by Commissioners. We have not to date named independent public accountants in any of these cases, nor have we established guidelines covering the nature of payments which must be disclosed or the responsibility of auditors in this regard. We are working on such guidelines, but we are by no means sure that we can produce a meaningful statement with universal applicability.

I do believe, however, that I can make a few observations on the subject. It is apparent to me that where there is a deliberate and significant practice of totally removing funds from the corporation's usual accountability system, that fact is material to investors and must be disclosed. In addition, I have no problem reaching the conclusion that significant illegal payments involving a material risk to the corporation

if discovered require disclosure. On the other hand, I have difficulty with the definition of significance and with the question of just what form disclosures should take.

At the present time, the staff is working with registrants and their independent accountants to develop appropriate disclosures in particular cases, and perhaps from this effort we will be able to develop usable guidelines, notwithstanding factual variations.

It is my view that the greatest concern of independent accountants in this area is the apparent breakdown of corporate control systems. When payments are made from unaccounted-for funds, there is no way that auditors or boards of directors can be confident that they know where those payments are going. An auditor must be alert for situations where such funds may exist. This does not mean a fundamental change in audit objectives or procedures, but it clearly does mean an increased awareness of this area. When such unaccounted-for funds or undocumented expenditures are discovered, audit procedures must be extended until the auditor is satisfied that he has the whole story. If he cannot satisfy himself, it is hard to see how he can continue as auditor. At a minimum, his lack of satisfaction would have to be set forth in his report on financial statements.

If he is satisfied that he has the whole story, he must face the more difficult problem of determining what disclosure, if any, is required and what form it should take. In making this determination, it is clearly essential that the matter be considered by the board of directors, as well as top management. If the auditor concludes that disclosures are not adequate, he must of course set this forth in his report.

I am afraid that I have not been very helpful in answering hard questions in this area, but perhaps by setting forth the problem we will move closer to its solution. I should say that it has been somewhat discouraging to me in some cases to see the conclusions reached by accountants as to what their responsibilities were, where they had knowledge of illegal payments outside the accountability systems of their clients. My statement that we have not yet named public accountants in enforcement actions relating to nondisclosure of illegal payments should not be heard as an endorsement of their apparent lack of concern in some cases, nor as a forecast of all future enforcement decisions.

In addition to our attempts to increase auditor responsibility by strengthening their hand and involving them with additional reporting, we have also continued our enforcement

program by which we identify deficiencies in the work done by public accountants in particular circumstances and work out plans for improved procedures so that such deficiencies will not be repeated. Our efforts in this regard, together with the threat of legal liability which hangs over all professionals today, has led to substantial improvements in the quality controls of public accounting firms. We think this is also an important part of our program to increase auditor responsibility, and we are encouraged to see the profession move in this direction.

I should emphasize that despite enforcement actions, we have great respect for the accounting profession and substantial faith in its ability and commitment to serve its function of assuring investors complete, reliable and relevant information as a basis for investment decisions. There have been indications on occasions that our faith in the profession is not fully shared by all in Washington. From time to time over the years, Congressional committees have suggested that the Commission was unduly deferential to the accounting profession, and Senator Proxmire has, on several occasions, proposed that the Commission itself conduct audits of defense contractors. This Congressional concern emerged forcefully in connection with the energy bills now being considered by the Congress. The bill which passed the House would have required audits of oil company

financial statements by the General Accounting Office, either at its discretion or at the request of any Congressional committee or subcommittee, and would have required the Commission to establish by rule accounting principles for the petroleum industry. We, as well as the accounting profession, oppose these sections and they have been modified in Conference. The conference bills would authorize what is referred to as verification examinations by the General Accounting Office, and with respect to accounting practices for oil companies, would authorize the Commission to rely on accounting practices developed by the Financial Accounting Standards Board, subject to certain conditions, including an assurance that the practices developed by that Board will be observed by the industry. This would constitute the first statutory recognition of the function of that Board, which strikes me as highly significant.

We expect that we will be devoting continued effort to the process of communicating to the Congress and to other agencies our view that the private sector through the accounting profession can do the necessary job in the most efficient way. Instances of deficient performances by accountants will certainly make this task more difficult.

In addition to the broad efforts which I have described, any survey of Commission activities in the accounting and reporting field would not be complete without mention of our continued efforts to deal with specific problems as they arise. We have played an active role in obtaining improved disclosures, both in specific cases and in full industries. The bank holding company disclosure guidelines issued last month are a case in point. We have also identified emerging accounting problems and taken interim steps to limit them until they could be considered by the Financial Accounting Standards Board, as in the case of interest capitalization and catastrophe reserves. Finally, we attempt to prevent the erosion of accounting principles through practice, and we have taken steps in the areas of business combination and lease accounting and more recently, in the case of tax loss carry forwards.

Even without a master plan, therefore, we have been active, and we hope effective, in improving the financial and reporting environment. We see our efforts as complimenting, and in some cases, stimulating those of the private sector, and we are confident that together we can produce an environment in which informed investors can make reasoned investment decisions for the economic good of all.