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FINANCIAL DISCLOSURE, INVESTOR
CONFIDENCE AND CORPORATE CREDIBILITY

An Address By

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Securities and Exchange Commission

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I'd like to suggest today that we at the SEC and you, as the financial executives of America's leading corporations, have a common task and a common challenge. It is to maintain investor confidence in the values set in the American securities market, in the fairness of those markets, in the adequacy of the information made available to investors.

There are many reasons for this. The fact that the investor in the American securities markets is the most informed and the best served investor in the world attracts investment to your companies from all over America and all over the world. That's what makes it possible for your corporations to command more capital for a dollar of earnings than your competitors abroad, to plow back earnings which your competitors abroad have to distribute in order to maintain their capital values and to raise larger amounts of capital more quickly in order to apply your technology more rapidly and on a larger scale to bring your products to markets you have developed around the world. All this is vital to the economic welfare of 200 million Americans.

It seems to me that you have a further concern that strikes closer to home. Investors can have confidence in our economy and in our security markets and still lose confidence in the whole financial reporting process or that of a particular industry or of a particular company. When an industry or a company loses credibility, values go down and the cost of financing goes up. Today's investor is increasingly sophisticated.

He hears a lot of criticism of financial reporting. He is apt to be skeptical -- some have been shell-shocked by surprise writeoffs, confused by the difference between shareholder reporting and tax reporting, puzzled by footnotes, and generally discouraged by their inability to assess the prospects for a company from the information supplied. He is told that the large institutional shareholder is supplied with or has access to supplementary information which provides additional insight unavailable to the individual investor.

We at the SEC, the accounting profession, the members of FEI, the presidents and directors of your companies, all have no more important job than to make financial reporting

more useful, to overcome investor skepticism, to maintain the credibility of the issuers who use public savings. What do investors need, and what do they expect?

They want an earnings figure, and they want one which they can rely on as a consistent measure of corporate performance and progress, one not subject to manipulation. They want to know how good the company is, how solid the earnings are and how real the growth is. Now, much of this can be indicated by the financial statement.

When the figures are elusive or too complicated to grasp, investors have to base their judgment on their confidence in management. To maintain credibility with investors, management has to tell it like it is. If the true course of operating progress or growth is exaggerated or obscured by accounting methods, tax factors or new assumptions or perceptions about the future, credibility can only be maintained by spelling out the facts whether the accountants require it or not.

The market has a measure of credibility which it calls the price-earnings ratio. When the work of analysts, the work of the financial press and the great reaction of investors big and small simmers into a feeling that earning figures may be contrived or gimmicked up and apparent growth is not real, the market speaks, the price-earnings ratio erodes and values evaporate. In recent years, we saw the price-earnings ratio erode in conglomerates and many industries from two to five years before the accounting and financial reporting problems were publicly recognized and when that happens it's a long road back.

I have great respect and great hope for the accounting profession's current effort to accelerate the improvement of accounting standards. We want to encourage it in every way. But it seems clear to me that the task of maintaining corporate credibility and investor confidence is so broad, and the

variety and complexity of American business is so great, that there is a limit to the degree to which it can be simply passed on to the accountants. It may be too much to expect of a financial statement that it adequately reflect the complexity, the variety of managerial approaches and strategies, the interplay of transactions, operations and taxes, the choices and elections which are available and which prevail in the intricate economic structure we have developed in the United States. That is why I believe that the Commission, to discharge its obligations to investors, will have to be more active in calling for supplementary disclosure. That's why I believe your corporations in order to maintain their credibility and security values will have to be increasingly innovative in the methods used to convey economic reality in the business to investors.

Let me indicate some of the areas where it seems to me you have to go beyond the financial statement. In some of these areas the Commission has already acted. Others

are being studied, either by the Commission or the Accounting Principles Board. Individual corporations have shown the way in many of them.

I would hope that in the more significant areas we would be able to establish clear and definite disclosure rules that can be reflected in the annual reports filed with the Commission and sent to stockholders for the calendar year 1972.

To start off I lean towards requiring a description of all significant accounting policies which would identify and describe accounting principles and their method of application that materially affect financial position, changes in financial position or results of operations. This would describe and quantify, to the extent material and possible, choices made from acceptable alternatives, principles and methods peculiar to an industry and unusual or innovative applications of generally accepted accounting principles. The Accounting Principles Board opinion requiring disclosure of accounting policies represented a significant step forward although it did not call for disclosure of the quantitative implications of various accounting principles which we believe is necessary under some circumstances.

Going beyond accounting policies, I believe there should be disclosure of all elections and assumptions which affect reported earnings in any material way. This requirement should reach tax elections, assumptions with respect to earnings on pension funds, production estimates on long-term contracts, decisions to invest in plant and equipment which will reduce the current year's taxes but have to justify themselves over a period of years and that sort of thing.

It seems to me that changes in the classification of accounts should be brought out in the same manner. There has been a growing trend for corporations to capitalize unusual items such as engineering costs, computer software development costs, basic research and development and questionable items of general overhead. Should a company be required to disclose in its statement of accounting policies or in a footnote all expenses that are capitalized as part of the company's inventory and the method and assumptions utilized to allocate this overhead to the inventory accounts?

I believe corporate credibility will be enhanced if elections and changes of this kind are grouped,

assessed and explained in one place rather than scattered among several footnotes. I believe also that the materiality of these matters should be assessed not item by item, but in the aggregate. Significant offsetting adjustments should be disclosed even though their net effect is small. Materiality should be judged in relationship not to total earnings but in terms of the contribution to increases in earnings or to offsetting decreases in earnings.

Another disclosure we are looking at would spell out the differences between earnings reported for taxes and for financial reporting purposes. Tax deferrals resulting from legitimate differences between tax and shareholder reporting can give misleading impressions. Perhaps a tabular reconciliation of these differences would be useful, showing the reasons for the difference between taxable income and pretax income reported to shareholders. A presentation that indicates specifically the future periods in which currently deferred taxes will become payable might well alleviate confusion. The disclosure would also bring out whether changes in earning power, on which analysts and investors are so prone

to predicate values, are derived from the improvement or deterioration of operating performance, or from some decision which may have no relevance to operating performance.

Perhaps even more important to the investor watching reported net earnings is the variation from year-to-year of the reported tax rate, as opposed to the difference between taxes accrued and taxes actually paid. Clearly a reduction of the effective reported tax rate can preserve an established trend in net income while pre-tax earnings are following a different pattern.

Better supplementary disclosure of significant changes in the effective tax rate and the underlying causes is necessary. For example, consolidation or expansion of foreign operations, which requires supplementary explanation in itself, could be the cause and should be identified clearly.

Recently, the London Economist predicted that there would be \$2 billion of surprise losses among American corporations this year. That's not good for confidence or credibility. We can't eliminate loss but we may be able to mitigate surprise.

Material unusual charges often include many components of varying sorts and significance; we have recently proposed that all the components of such a charge be identified, and that the charge be allocated to other reporting periods (both historic and prospective). We also believe that assets which might be the subject of a future write-off, such as deferred development costs or plants which might be uneconomic at a low level of product demand should be identified to reduce the element of surprise.

We emphasized last June the need for prompt and accurate disclosure of performance on long term contracts. Reporting for long term contracts gives management considerable flexibility because it is very difficult for outside public accountants to contradict management's estimates of the costs to be incurred in completing the contracts.

Long term contracts also have proved to be a frequent source of write-offs. Extensive discussion of management assumptions is critical, so that the investor may make his own judgment. For example, the investor is entitled to know the units over which development costs will be amortized and the current

and assumed orders for these units. We are actively monitoring reporting for these contracts to determine compliance with our recommendations.

Pension fund and benefit costs are rarely discussed outside of the specific requirements of APB 8 and Regulation S-X. One result is that the size of unfunded liabilities and current expenses may appear more significant than is appropriate. A description of the history of the pension fund, the plan for meeting future obligations, and the investment performance, in layman's language, might clear up confusion. Furthermore, a more comprehensive description of changes in benefits and actuarial assumptions in light of the impact on reported earnings is important for complete disclosure.

Management should also consider supplementary disclosure whenever assets are recorded on the balance sheet at substantially below market value. Conservative accounting principles require the write-down of certain balance sheet items to current value; but management should not neglect to point out where certain items, particularly of a liquid nature,

are carried below reasonable market value. The courts have held that such a failure can be just as misleading as overstatements. Furthermore, substantial gains from sale of assets, even if they were purchased with the intent of sale, should be clearly disclosed.

Let me give you an example. A large diversified company, which had been built at least partly by acquisition, purchased a large block of stock and subsequently sold the stock at a substantial profit. At year-end this transaction was recorded as part of operating earnings; simultaneously, management wrote-off certain deferred charges related to a long-term contract in an amount exactly equal to the profit resulting from the sale of the block of stock. The effect, of course, was mainly to distort future earnings since costs applicable to the long-term contract were reduced, although earnings for the year in question were somewhat misrepresented as well.

We intend that our proposed guidelines for reporting write-offs and progress on long-term contracts will result in clear identification of this type of practice. However,

you can see that writing rules to cover all facets of specific situations, such as the one I described, is impossible. Corporate management must assume responsibility for carrying out the intent of our rules.

When analysts circulate inflated earnings estimates and then lower these estimates after an upward price movement, investors are hurt. Management may be charged with misleading investors when they permit this to occur. At least they will have unhappy stockholders.

We are finding that some companies are so concerned about the problem of misleading estimates that they are seriously considering establishing formal procedure to provide regular earnings estimates publicly. Some companies, which have shelf registration statements on file, are concerned that this would violate our historic rules. As you know, we are reexamining our past publicity on forecasts, with the help of the FEI and others, to determine whether we can accomodate those companies who believe all investors are entitled to know how management views the future.

I know you are concerned about forecasts. The Commission determined some months ago that it should review its policy of restricting the use of forecasts in disclosure documents. We have had very useful meetings with committees of your organization, the American Institute of CPA's, the American Bar Association, the Financial Analysts Federation and the National Investor Relations Institute. All of these committees have undertaken substantial projects such as an evaluation of the British system of forecasting; the use and value of forecasts in the United States; their reliability; and an assessment of potential liabilities. We have your paper on the legal aspects of public disclosure of corporate financial forecasts and should be receiving all of these studies soon.

I know that many of you feel that forecasting can be misleading, can create new problems and new liabilities for you. I assure you that we share this concern. But it is not a simple choice between exposure to liability and freedom from liability or forecasts and no forecasts. We have forecasts, they are in circulation, they are sometimes misleading and can always affect stock values. We already have litigation as to whether forecasts have been responsibly made or are deliberately misleading. Judge Weinfeld in a New York Federal Court, held

last year that an earnings forecast program carried out in good faith and with immediate public dissemination of changes in the forecast protected Monsanto Chemical and its directors and officers against private suits for liability. However, there is always the danger of the bad case, the bad set of facts, resulting in the judicial enunciation of standards and requirements which do create unreasonable exposure to liability. That is one argument for the Commission taking the lead in establishing reasonable and workable standards to which both issuers and the courts can look for guidance.

Let me tell you about a visit I had recently from the financial and legal officers of a very large company with a fairly diversified and complicated set of businesses. This company, after a year of careful exploration was, at least tentatively, leaning towards adopting a continuous earnings forecast program-- a year ahead, revised quarterly. The interesting thing to me was how they reached the opinion that this was the best way to maintain their credibility with the investment community and protect against liability. For a long time, they put out a simple annual report and said nothing at all to anybody. Then they improved the form and content of their annual reports in response to analyst requests. As analysts produced widely varying projections on their earnings, they decided they

should step up their communications with the investment community and they became very assiduous in guiding and correcting analysts in their forecasts. Then, they realized that in dealing with one analyst at a time they could be exposing themselves to litigation. This turned their thinking to a carefully controlled and publicly disseminated forecasting program. To me this boils down to a decision that it's better to have potential liability for a procedure you can place under careful control than for one in which you are continually responding to what someone else does.

Let me also, just for a moment, touch on some of the considerations which a Commissioner of the SEC will have to weigh in the reconsideration of our policy on forecasts. There is the obvious one of the fairness in the dissemination of forecasts as they are put out, concocted and circulated to say nothing of their unevenness in quality and reliability. Then, there is the question of whether we can really justify the prohibition of forecasts which are carefully prepared, relied on for budgeting and planning purposes, based on comprehensive data and reasonable assumptions and well articulated and regularly supplemented to reflect supervening developments and revisions in estimates. If we do prohibit forecasts which a company

makes and circulates, are we subjecting the company to statutory liability for failure to disclose a material fact? The forecast is an estimate but its existence and the articulated judgment it represents is a fact. On previous occasions, in recent years, the Commission has prohibited the use of appraisals, which are an estimate of value, in disclosure documents and the courts have found that this kind of estimate should have been a matter of disclosure. Today, the earnings estimate which we call a forecast is a much more frequent event and much more significant to stock values than the estimate of asset value which we call an appraisal.

I have spelled out these concerns of the Commission for you because we want to get as broad a cross section of your thinking as we can. All of us recognize this as a very important crossroads to be approached very carefully. If there is to be any change in our policy it should be a cautious one, perhaps even experimental in character. I've discussed this matter of forecasts quite freely to generate discussion and reaction. But, I assure you that I am suspending judgment on the final decision. Indeed, in our internal discussions, I claim to be a dove on forecasts; we do have some hawks who believe they should be permitted and even required.

Incidentally, the Commission recognizes that its reports may be burdensome and their format confusing. We want to avoid the syndrome of continually piling it on and never looking to see what can be peeled off. Accordingly, I have persuaded a group of experienced financial executives, accountants and underwriters to serve as an advisory committee to report by year-end on the forms and reports you must file with the SEC, the difficulties encountered in their preparation, their utility to users and what might be done to simplify them and ease the cost and burden they represent.

We want your ideas and suggestions in all of these matters either individually or from your organization. We are in this together. We need your help. We maintain an open-door policy.

Thank you for this chance to bring our concerns before you.