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DIFFERENTIAL DISCLOSURE: TO EACH HIS OWN

An Address By

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On October 4, 1973, the Securities and Exchange Commission issued Securities Act Release No. 5427 entitled somewhat innocuously, "Notice of Proposed Amendments to Regulation S-X Providing for Disclosure of Significant Accounting Policies." This release proposed for further comment proposed changes in Regulation S-X which would require increased disclosure concerning the consequences of an issuer opting for certain accounting principles in preference to others.

The previous exposure for comment of these proposed changes had elicited the sort of responses one might have expected. Generally, analysts endorsed the thrust of the proposed changes and issuers endorsed the objectives but expressed concern about the particulars of implementation -- and it was to be expected that the re-exposure would elicit another round of fairly technical comment and suggestions.

However, Securities Act Release No. 5427 contained a section that raised the debate from one over technicalities to one concerning fundamental disclosure philosophy. This section was entitled "An Approach to Disclosure." The first paragraph of this section said:

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> "The proposals set forth in this release are primarily designed to assist professional analysts who have the responsibility of developing an understanding in depth of corporate activity. They are not primarily intended to serve the direct needs of the 'average investor.' Such an investor does not usually have the time to study or the training necessary to fully understand the data which are called for herein. It is not appropriate, however, for such data to be unavailable to the average investor who does wish to devote the time necessary to consider it. By being included in financial statements filed with the Commission, therefore, data will become 'data of public record' and, hence, available to all. Disclosure will not be discriminatory even though usage will mostly be by professionals. Data of this kind would not be expected to be sent routinely to all shareholders, although it would be useful if its availability was mentioned in communications with shareholders and if management took steps to make it available on request."

This was the first indication, at least officially, by the Commission that financial statements might be something other than unitary -- that is, that there might be financial statements for the sophisticated investor and professional analyst and financial statements for the average investor. This reminds me, I must confess, of the famous Bill Mauldin cartoon during the Second World War which showed a brass-laden officer watching a sunset asking his orderly, "Magnificent! Is there one for the enlisted men?"

This development, reiterated in subsequent releases concerning income taxes and compensating balances, quickly became a matter of extensive comment, concern and criticism. I think it is fair to say that few, if any, voices were raised in support or praise of the Commission's innovation and, as is not uncommon, the Commission found itself somewhat alone.

I would suggest that the new direction pointed by the Commission is a step in the demytholigization, if I may call it that, of the disclosure

process; a step that in one way or another has been called for by eminent commentators such as Homer Kripke, though I hasten to add that I am not sure he and his fellow critics would particularly endorse the particular manner in which the Commission is setting about accomplishing this demytholigization. This effort recognizes and responds to such fundamentals, acknowledged by all, as the fact that American business has grown steadily more complex, that such complexity has been geometrically expanded by conglomerization and the expanding multinational character of American enterprise, that increasingly complex accounting rules have been necessitated by changes in the business scene. It recognizes the rather fundamental fact that investors come in not 57 varieties, but more accurately, fifty-seven thousand and more varieties. Some are astute as Warren Buffett of Omaha, Nebraska, whose exploits are amply described in Supermoney; others are as naive as the legendary Aunt Jane in Dubuque, Iowa. Some are assisted by professionals, but retain the final judgment, which may reflect not only the astute analyses of those they pay handsomely but other considerations as subjective and, if you will, irrational as those that often animate horse players. Some have abandoned the individual quest for investment success and have committed their resources to professionals who, hopefully, have greater capacity to comprehend this swiftly changing, ever more complex, business world and interpret it meaningfully and in a way that leads to profits.

This is the world that the Securities and Exchange Commission, Congressionally designated enforcer of broad standards of disclosure, determiner of what should be disclosed and how it should be disclosed and how it should be disseminated, confronts: a complex world in which just the footnotes of the financial statements of a conglomerate -- described by one commentator as "the most exciting part of the annual report" -- might run

a dozen or more pages, with perhaps other pages of notes following the financial statements of non-consolidated or separately reporting entities; a world in which there are asserted to be some thirty million shareholders (a declining number, incidentally), many of whom find it difficult to balance their checking accounts, some of whom are as trained and knowledgeable and astute as Mr. Buffett; a world in which annual reports compete with television, Playboy (and now Playgirl) and a multitude of other human activities and endeavors for the attention of investors.

Manny Cohen, a former Chairman of the Commission, would often say that he had difficulty explaining anything unless he went back to Genesis. I don't propose to go back quite that far, but I do think it would be helpful to go back to the genesis, small "g" if you will, of the federal disclosure system, the Securities Act of 1933.

Congress in 1933, confronted with indisputable evidence of massive financial wrongdoing in the 1920's, and convinced that much of it stemmed from the failure of promoters and entrepreneurs to fairly and candidly inform those whose resources they garnered and used in their endeavors, adopted the philosophy of the English Companies Act and mandated that those who sought money from the public through distributions of securities should, with narrow exceptions, make comprehensive disclosure in connection with the distribution. Prior to this mandate, multi-million dollar offerings of large and respected companies were made with no more disclosure than could be put on a single sheet of paper, and this disclosure often consisted of little more than an identification of the issuer, the kind of securities involved in the issue, and a few financial facts.

Congress' hope, one that many think has proven to have been unduly optimistic, was that disclosure would in time defeat the schemes of the predators and restore the integrity of the financial markets. In Schedule A to the 1933 Act it specified the information prospectuses and registration statements should contain and gave the Federal Trade Commission (supplanted in 1934 as the monitor of the disclosure system by the newly created Securities and Exchange Commission) broad powers to vary the requirements.

It was apparent from examining Schedule A that financial statements of integrity loomed large in Congress' thinking. A prospectus was required to include a balance sheet and income statement certified by independent public or certified accountants and it was specified that such statements should show:.

> "[A]ll the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the Commission shall prescribe . . . . All the liabilities of the issuer in such detail and such form as the Commission shall prescribe, including surplus of the issuer showing how and from what sources such surplus was created . . ."

> "[E]arnings and income, the nature and source thereof, and the expenses and fixed charges in such detail and such form as the Commission shall prescribe . . . [W]hat the practice of the issuer has been . . . as to the character of the charges, dividends or other distributions made against its various surplus accounts, and as to depreciation, depletion, and maintenance charges, in such detail and form as the Commission shall prescribe, and if stock dividends or avails from the sale of rights have been credited to income, they shall be shown separately with a statement of the basis upon which the credit if computed. Such statement shall also differentiate between any recurring and nonrecurring income and between any investment and operating income."

The legislative history of the 1933 Act clearly showed the determination of Congress that financial statements be honest and reliable. At one time it was proposed that federal auditors certify the financial statements of publicly-held companies and only the avowals of the accounting profession that it could supply the sought for reliability prevented this development.

In 1934 Congress adopted the Securities Exchange Act of 1934 which provided the framework for a continuous disclosure system, including periodic reports to be filed with the Commission and disclosures to shareholders through proxy statements by companies listed on exchanges. It should be noted that at this time exchanges, principally the New York Stock Exchange, had been steadily increasing their pressure for listed companies to increase the quantum of disclosure to shareholders.

In the 1934 Act, perhaps largely because of the steps which had been taken by exchanges, Congress did not specify in the detail it had in the 1933 Act, the kinds of disclosure which should be made, but rather left to its new creation, the SEC, the task of specifying such details.

This scheme of disclosure, I suggest, reflected several assumptions of varying merit. First, I think it suggested the assumption that investment decisions, not all perhaps, but certainly a sociologically significant number, were made on a rational basis. This approach was reflected in Graham and Dodd's first edition of Security Analysis published in 1934 which ushered in a new era of fundamental investment analysis. It was believed that investors would -- and could -- use the information provided, that they would thereby be impelled to make sounder decisions, thus avoiding the fraud and overreachings characteristic of the twenties.

I would suggest that perhaps underlying the Congressional commitment to the disclosure philosophy was a far more basic assumption, one having its roots deep in American history and ideology: the belief that the "common man" had an innate wisdom, a natural capacity for the absorption of knowledge, an inborn facility for sound judgment if only he had the facts. This is reflected in many of our popular sayings; for instance, "let people know and the truth shall make them free." It is reflected in our commitment to education and the assumption, now perhaps discredited, that everyone has the capacity for the fullness of a classical education. This ideology has its origins, of course, in Rousseau and many others.

With these assumptions so entrenched, it is not surprising that there is little in the legislative history of the 1933 and 1934 Acts concern- the use that people might make of the information Congress wished them to have, the manner in which investment decisions were made, the process by which judgments were reached. That the intervening four decades have done little to change this situation is indicated in the Report of the Study Group on the Objectives of Financial Statements in October 1973:

> "Users' needs for information, however, are not known with any degree of certainty. No study has been able to identify precisely the specific role financial statements play in the economic decision making process."

The natural consequence of the Congressional mandate for a disclosure system, the assumption that investors are generally rational, the conclusion that the quality of investment decisions is related to the quantity and integrity of disclosure, and the belief that the "common man" has uncommon wisdom and judgment, has been a constant pressure for increased disclosure: more information, information of higher reliability, broader dissemination.

This insistence upon more disclosure and more reliable disclosure has been particularly pronounced with respect to financial information. Through the years, to assure reliability, the Commission has steadily tightened the mandate of auditor independence. There has been steady expansion of the amount of disclosure. For instance, in 1971 the Commission required a source and application of funds statement and in 1969 the Commission first required disclosure of line of business profitability in 1933 Act prospectuses and later extended this to periodic reports. One reads the list of the Commission's Accounting Series Releases and can discern there the rising demands for more and better information.

This expansiveness has been accompanied by rather constant controversy. The business community, which is the source of the information, has repeatedly urged restraint for several reasons. It has contended that frequently the Commission was indifferent to the costs involved in producing the additional information; that the additional information was of questionable utility; that analysts always want more without knowing what to do with what they had; that additional disclosures would favor competitors at the expense of and to the hardship of the enterprise's shareholders. The Commission has often given

recognition to these contentions through what must fairly be described as minor concessions, but the expansion of disclosure has gone forward unremittingly.

While the controversies concerning the particulars of disclosure have been fought through Commission releases, comments on them, articles in the Financial Executive and Journal of Accountancy, a deeper and broader controversy, which had for so long been hidden on the shelf, has been emerging. In this controversy the issues are simple: does all this financial disclosure mean anything? Has it a utility? Has it made a difference? Is the investor better off because of all of this federally mandated disclosure?

The critics of the whole disclosure system have brought to bear on the controversy techniques of analysis that are in some instances novel, at least to the ears of the lawyers and accountants who have been the principal custodians of the disclosure grails since 1933; among these has been sophisticated mathematical analysis. In the forefront of these critics has been Professor George Benston (popularized and encouraged by Professor Henry J. Manne) who has written that the disclosure requirements of the Securities Exchange Act of 1934 have had no measurable, positive effect on the securities traded on the New York Stock Exchange, that there is little basis for the 1934 Act and no evidence that it was needed or desirable, and that "certainly there is doubt that more required disclosure is warranted." Professor Benston uses an empirical method of analysis in an attempt to prove that the disclosures mandated by the 1934 Act have not been effective in preventing fraud and manipulation. Professor Manne has echoed this thought in Barron's:

> "As we approach the 40th Anniversary of the Securities Exchange Act of 1934, honorable men everywhere would do well to reevaluate the whole field of securities regulation. Instead of constantly repeating the deadening cliches about fairness, disclosure and fraud, perhaps some brave Congressman or Senator or even Commissioner of the SEC will take note of what competent economic scholars are beginning to say about the field."

Critics of the Benston-Manne analysis have retorted that the mathematical mode of analysis is not suited to the complexities of the investment process, that within the parameters of their technique there are insufficiencies, that disclosure serves purposes beyond that of simply informing investors, that forty years of steadily stronger securities markets in this country (recent aberrations excepted) provide some evidence of the values of disclosure, that the propensity of other countries to emulate our system indicates convictions of objective observers of the value of the disclosure system.

And there are other more fundamental discussions that reach to the heart of our disclosure system. Increasing attention is paid to the so-called "random walk theory" which questions the utility of the Graham and Dodd kind of fundamental analysis (as indicated above, a premise of the disclosure system) by asserting that if an investor simply diversifies his risks he will do as well as the investor who engaged in extensive research and analysis. Without attempting extensive analysis of the pros and cons of these somewhat exotic theories, it does strike me that the random walk theory is grounded on notions of an efficient market, and an efficient market is one in which all information of consequence is evenly and fully distributed; hence I think even if one is a devotee of the random walk theory, there is the necessity for an effective information dispensing system, otherwise the fundamental of the theory, an efficient market, is impossible.

While these intriguing and potentially most significant discussions continue -- and I think they are extremely important and pose challenging and difficult problems for those responsible for securities regulation -- there have been changes in the manner in which investment decisions are made. For one thing, increasing amounts of investable funds are in the hands -- and under the control -- of institutions. In 1961 some 430 billion dollars were under the control of institutions; in 1971 this amount had grown to 839 billion, and by now the amount is surely near a trillion dollars. In 1961 investment companies had 34 billion dollars under management; in 1973, even considering heavy redemptions, the total was about 73 billion. Institutional trading currently accounts for approximately 70% of the volume of trading on the NYSE. A further indication of the nature of this change is reflected in the membership figures of the Financial Analysts Federation. At the end of 1950, there were 2,422 members; there are currently approximately 14,000 members. Increasingly various financial institutions have offered money management services. Brokerage houses and banks are actively competing for such business and frequently brokers state their preference for such activity over customary brokerage services because of its reliability and persistence as a source of revenues. There is a constant lowering of the minimum portfolio which advisors will undertake to manage. The growth of this activity was recognized in the report of the Commission's Advisory Committee on Small Business Investment Management Services which, among other things, urged the Commission to forego tight regulation of so-called "mini-accounts," provided certain specified conditions were met.

Thus, the institutionalization of the market has been accompanied by what I could call, for want of a better term, the quasi-institutionalization of the market -- the increasing reliance -- in many cases conclusive reliance --

of individual investors who retain the final decision with respect to investment decisions upon the advice of professionals.

Perhaps indicative of this increased emergence of quasi-institutionalization of the market is the concern of the financial analysts themselves for the quality of their performance and the integrity of their profession. Several years ago the Financial Analysts Federation commenced a program of study and qualification which would result in the encomium, "Certified Financial Analyst," in the belief that sufficient public repute would attach to the magic initials "C.F.A." that less reputable or competent analysts would be driven from the market. While the program has resulted in the award of this designation to about 3,000 analysts, it has not, in the minds of many, been sufficient and there have recently arisen demands for more rigorous regulation, either state or self-regulatory or federal with perhaps a measure of self-regulation.

The disclosure system has resulted in the availability of tremendous amounts of information for anyone who wishes to use it. Whenever an issuer "goes public" for the first time it must file with the Commission a registration statement containing extensive financial and non-financial information and much of that must, albeit for the most part at a somewhat insufficient time before the final investment decision is made, find its way into the hands of investors. Thereafter, until the number of its holders of equity securities falls below certain minimal levels, it must file each quarter with the Commission an abbreviated income statement, it must file annually a Form 10-K which in effect updates its registration statement under the

1933 Act, it must file with the Commission promptly reports of certain important events such as changes in debt terms that affect the rights of any registered class of securities, it must furnish to shareholders annual reports containing certified financial statements, and it must furnish proxy materials in connection with proxy solicitations (and comparable information even if it doesn't solicit proxies). And increasingly there are pressures from exchanges and courts for publicly-held companies to make prompt public disclosure of important developments, even though the legal theories relating to such disclosure are in a state of development and not yet fully articulated.

All of this information, legally mandated, is of course supplemented in many ways. There are analysts' meetings, increasingly subject to judicial mandates that important information provided at such meetings be given wide circulation; there are the interpretations published by commentators; there are the speeches of company officers. All of this adds to the fund of information, often approaching torrential proportions, available to the investor.

I think it would be naive -- and irresponsible -- if, having achieved this vast outpouring of information and its relatively efficient dissemination, we concluded that our task was done. That may have been the conviction that animated Congress in 1933 and 1934, but I say we know more about the limitations of human beings, we have somewhat more concise, albeit still quite inexact, notions of how people invest, we have less Rousseauian confidence in the competence of the common man, to reach that easy a conclusion.

All of the above has led critics of the present disclosure system like Homer Kripke to criticize what he rather pungently calls "The Myth of the Informed Layman." Professor Kripke said in his article bearing that title:

> "[T]he Commission has misconceived its market. It has never admitted any hypothesis other than that the prospectus is intended for the man in the street, the unsophisticated lay investor. My theme is that the theory that the prospectus can be and is used by the lay investor is a myth. It is largely responsible for the fact that the securities prospectus is fairly close to worthless."

In another article, Professor Kripke has said simply: "My conclusion is that the goal of financial accounting should be to provide the most useful information for serious securities investors, financial analysts and money managers who serve investors, and for economists."

His conclusion, and that of others, is that we should do away with the nonsense of trying to make prospectuses and other disclosure documents simple and understandable for the layman (it is a prerequisite under Rule 460 that a prospectus be reasonably concise and readable so as to facilitate an understanding of the information contained in the prospectus and periodically the Commission urges issuers to make their documents more readily understandable) and recognize that the only ones able today to cope with the complexities of American business and the concomitant complexities of disclosure about American business are the sophisticated, knowledgeable, informed professionals to whom the non-professionals increasingly turn for help in making their investment decisions.

This approach has much appeal. The Commission could multiply the requirements of disclosure with no concern for easy comprehensibility; it would be possible, for instance, to perhaps mandate new kinds of mathematical and economic disclosure, including sophisticated projections and other forward looking information, which would mystify the average investor but make sense to the trained analyst familiar with sophisticated research methodology. Certainly an express abandonment of the small investor would open the door for far more sophisticated disclosure techniques.

And yet there lingers the mythos and the fact: the mythos, that Americans can make up their own minds, that they have a competence to decide their own political fate and a fortiori their financial fate; the fact that, notwithstanding the increasing dependence upon professionals, there are still many investors who do make their own decisions, who do try to cope with the data provided to them, who are unwilling to surrender their judgment. And there is the fact that often we hear of such investors who regularly outperform the professionals despite their apparently limited expertise.

This "common man" concept has been expressed repeatedly in Commission rules and determinations and court decisions relating to standards of materiality. For instance, Rule 405 of the Commission defines materiality as "those matters as to which an average prudent investor is reasonably to be informed before purchasing the security registered."

Similarly, in SEC v. Texas Gulf Sulphur Co. the Court of Appeals for the Second Circuit used as one of its criteria of materiality this:

> "[W]hether a reasonable man would attach importance . . . in determining his choice of action in the transaction in question . . ."

The standard of materiality is thus that which means something to the "ordinary prudent investor" -- not the expert, but the ordinary prudent investor. This notion has been almost reduced to a statistical criterion. In Feit v. Leasco Data Processing Equipment Corp., Judge Weinstein, in speaking of materiality, said:

> "A fair summary of the rules stated in terms of probability is that a fact is proved to be material when it is more probable than not that a significant number of traders would have wanted to know it before deciding to deal in the security at the time and price in question . . ."

The varying purposes of and audiences for disclosure have not gone unrecognized. In the Commission's "Disclosure Policy Study" (the "Wheat Report") it was said:

> "By and large, the Commission has responded to the various needs for disclosure in pragmatic fashion. Thus, where an issue of securities possessed unusually speculative elements, it was felt that special efforts should be made to call these factors to the attention of the ordinary investor -- hence the development of the 'introductory statement' to the prospectus. By contrast, the detailed financial information required by the schedules to the Form 10-K report could be intended only for the skillful analyst. Indeed, it was recognized from the beginning that a fully effective disclosure policy would require the reporting of complicated business facts that would have little meaning for the average investor. Such disclosures reach average investors through a process of filtration in which intermediaries (brokers, bankers, investment advisers, publishers of investment advisory literature, and occasionally lawyers) play a vital role."

In an article recently published by the Hastings Law Journal, Alison Gray Anderson has perceptively described the efforts of the Commission to both protect the small investor and serve the needs of the professional and the sophisticated investor, and suggests that perhaps the Commission is today according less primacy to the protective role.

Given this background, it is rather surprising that the idea that there should be "differential disclosure" has met with such dismay and dissent. After a

in matters of news we are accustomed to "differential disclosure." The man who wants simply, shall I say, notification watches the eleven o'clock news; the one who wants more, say enough to handle a conversation on current events intelligently after a couple of martinis at a cocktail party, reads Time or Newsweek; the person seeking perhaps more detail and some interpretation goes

to the New York Times or the Washington Post; while the real student reads the Congressional Record, official releases of governmental agencies, and the myriad of other materials available.

There are as many capacities to understand and cope with information, and willingness and desire to do so, perhaps as there are investors; consequently, it is impossible to design a single disclosure system that perfectly matches the needs and capacities of each person. Consequently, as in most things in life, we must categorize, recognizing that the fit will be crude in most cases, but better than the kind of procrustean achievement that would dictate a single set of requirements for everyone simply on the grounds, somewhat Steinian, that an investor is an investor is an investor.

Once one concludes that a disclosure system should at least be bifurcated, if not refined more precisely, then I think the problem is much more complex than simply quantity. It is not enough to say simply, "Now that we recognize that the skilled professional can use well more sophisticated information than the amateur, we will simply give him more information." There is at the minimum a correlative necessity to process and prepare the information for use by the "average" investor (to use a wholly inadequate term) in a manner that will make it useable and useful; it is a matter of presentation, as well as quantity. There is also the problem where and how the respective disclosures are made. If that directed to the professional is so interlaced with that intended for the amateur, then it may well have the effect of causing the unsophisticated investor to back off in fear and confusion. Attention must be paid to the fact that professionals have access to information that would not be available to the

small investor; for instance, analysts frequently seek out filings with the Commission -- in many cases they receive "microfiche" copies routinely, while small investors would hardly know where to begin in seeking out this information, although the Commission's recent proposal that corporations make the Form 10-K available on request is designed to partially remedy this problem. Thus there are problems of mode of presentation and dissemination as well as those of quantity and complexity of information that must be faced.

Undoubtedly the part of the Commission's approach to differential disclosure which has troubled most, particularly those in the accounting profession, is the requirement of the Commission that this differential disclosure be accomplished through the financial statements of the enterprise. Securities Act Release No. 5427 indicated that the extensive additional information which would be required by the proposed amendment of Rule 3-08 of Regulation S-X should be a part of the financial statements filed with the Commission but would not necessarily have to be part of the financial statements furnished to investors at large. The release said, "By being included in financial statements filed with the Commission . . . data will become 'data of public record' and, hence, available to all." The same concept is embodied in Accounting Series Release No. 148. In Accounting Series Release No. 149 pertaining to income tax expense the distinction is most clearly indicated:

> "The Commission has concluded that the benefits of the disclosure are sufficient to require its presentation in financial statements filed with the Commission but it recognizes that the detailed disclosure required herein will be primarily of interest to professional analysts . . . and may not be required in financial statements designed for the average investor . . ."

Two facets of this concept trouble accountants. First, the term "financial statements" has traditionally had a unitary connotation; there is one set of numbers and notes that constitutes the financial statements of the enterprise; the notion that there should be two or more financial statements is alien. It might be noted that there is, in a different context, increasing suggestion that there may be the necessity for more than one set of financial statements to properly convey necessary financial information concerning an enterprise. In a paper prepared for the Tenth International Congress of Accountants, Robert Trueblood said,

> "Today, however, many more groups are expressing a need for enterprise financial information. And, as always, users of financial statements ask for more information, in more depth. The interests of different user groups vary somewhat, and their information needs sometimes conflict. General purpose financial statements simply cannot be expanded to cover all legitimate information requirements.
>
> "To meet the diverse information requirements of all those who have a legitimate need for enterprise information, a new reporting method must be developed. The core-statement satellite-report concept is a suggested solution.
>
> "The core statement would present financial position, net earnings, and equity status -- as those terms are understood in an economic sense. Ultimately, the core statement would be accepted as the common denominator, by all users, in all countries. The information needs of particular user groups would be served with satellite reports, tailored to their specific needs."

This is hardly a new idea. George O. May, one of the giants of the accounting profession, as long ago as 1937 suggested that a single set of statements could no more serve the diverse needs of investors than a single

utensil could satisfy the need of table silver. He expressed the notion in an article appropriately entitled, "Eating Peas with Your Knife," in which he discussed

> "the inefficiency, if not the danger, entailed in the use of accounts for purposes for which they were not designed, and for which they are not appropriate . . . [I]t should be obvious that it is not possible to get one form of account or one statement which will serve equally well the purposes of regulation, taxation, annual reporting and a security issue. Yet this does not seem to be at all generally appreciated."

The second concern of auditors derives from concern over leaving out of financial statements on which they issue an opinion information and data which at least some investors consider important. Is this inconsistent with the opinion that the statements have been prepared in accordance with generally accepted accounting principles? It is fundamental -- and so expressed in accounting literature -- that certified financial statements may not omit anything material to the fair presentation of the information. Do financial statements omitting the information which would be required in filed financial statements by the proposed revisions of Rule 3-08 and the information now required by Accounting Series Releases Nos. 147 and 148 "present fairly" in accordance with generally accepted accounting principles?

I will frankly confess these are genuine concerns expressed by the accounting profession and they are deserving of careful and close analysis. The concerns of the profession are, of course, compounded by the increasing incidence of litigation involving members of the profession and the still expanding limits of Rule 10b-5, which, among other provisions, makes it a violation of the Rule to omit anything necessary to make statements made not misleading.

Of course, differences between the financial information filed with the Commission in a Form 10-K and that furnished to shareholders is not completely without precedent. Rule 14a-3 provides that certain of the particulars contained in Form 10-K financial statements may be summarized or omitted in those contained in the annual report and it is quite common to do this. Furthermore, there is no explicit requirement that the financial statements contained in the Form 10-K be the same as those in the annual report, although Rule 14a-3 under the 1934 Act does require in the event of divergence explanation of the reason for it. Also there are required in the Form 10-K certain technical compliance notes (e.g., concerning stock options) which generally do not appear in the financial statements in reports to shareholders. And Form 10-K, as well as part II of the most used registration forms under the 1933 Act, requires the filing of schedules which are covered by the auditor's report in addition to the financial statements.

I would suggest that the concerns of the accounting profession are perhaps needlessly grave.

First, any omission of information which is identified by the Commission as necessary in filed statements but not in those circulated to the investors in general would be in reliance upon Commission rule. Section 23(a) of the 1934 Act provides: "No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission." Thus I think the liability

concern should be abated. Further than that, the Commission in Section 13(b) of the 1934 Act is given the power to prescribe:

> "[I]n regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income . . ."

That the inclusion of the additional information in filings with the Commission is pursuant to Commission rule is clear; that such information may be omitted from the financial statements in annual reports is less clear. However, the explicit permission in Rule 14a-3 to "omit such details or employ such condensation as may be deemed suitable to management", combined with the clear benediction of the Commission for the omission of such information, would seem clearly to insulate auditors from liability. If there remain, however, doubts of this, then perhaps the Commission should remove the uncertainty through the rule-making process.

While the Commission has traditionally deferred to the accounting profession with respect to the orderly development of accounting principles, nonetheless it has been fully recognized through the years that the Commission has broad power over the contents of financial statements and it has on occasions, such as accounting for the investment credit, exercised that power when it felt it necessary to do so. If the Commission has the power to determine the content of financial statements, then I would suggest that it has the power to _classify_ financial statements and determine that

financial statements used for this purpose have such and such contents, but that other financial statements intended for a different audience or use have other or additional contents. And again, the Commission having made such a determination, and an auditor having relied upon such determination by the Commission, it is difficult to see wherein the danger of liability lies.

Apart from narrow legal considerations such as those discussed above, does the mandating of additional information in financial statements filed with the Commission do a wrong to the small investor -- is he misled, is he denied information which he is entitled to have?

I would suggest he is not. At the present time the accounting process consists of summarization, judicious omission, careful selection of items which are of use to those using financial statements; certainly no one would suggest that there should be furnished to anyone outside a corporation the full financial data that is available, e.g., the amount of each receivable, each payable, the particulars concerning each category of inventory, and so on. The entire process of financial presentation is founded upon selection, summarization, condensation. Conventionally this is done according to prescribed standards which have their roots in deeper principles -- founded on assumptions -- concerning what information is useful to the users of financial statements. The profession has just engaged in a most challenging study of this entire matter in an effort to find what information is useful to users of financial statements. Until that report is fleshed out, the profession will continue to use the conventional standards embodied in generally accepted accounting principles as presently articulated.

Those standards of presentation, I submit, are founded upon assumptions with regard to the identity of users. I would suggest that those assumptions are not sacred, or embedded in stone, or engraved on bronze. All that differential disclosure is suggesting is that there be explicit recognition of the fact that implicit in the standards governing presentations are assumptions concerning users and that there be developed a further recognition that among those users are many who have need for and ability to use effectively this additional information.

A necessary correlative of expanding the detailed information available to the professional and the skilled investor is the necessity of more and better summarization of data and sounder interpretation of it by management. The interpretation of financial data is a complex business in which relatively few investors are skilled. The best source of meaningful interpretation of data is management. As a consequent the Commission has increasingly required that the documents furnished to or made available to investors contain interpretations of the data presented; financial disclosure should not be a contest between management and owners of the enterprise to see whether the investor can uncover the significance of the raw figures. For many years, for instance, the Commission has included in the instructions to the use of Form S-1 a requirement that:

> "/T/he information set forth in the prospectus should be presented in clear, concise, understandable fashion."

The Commission articulated this increased concern with understandable presentation to the small investor in Securities Act Release No. 5427 under the same heading where the needs of sophisticated investors are discussed:

> "While analysts' requirements are of great importance, the needs of individual investor must also be served. If this investor is to remain an active participant in the securities markets, he must be confident that he is receiving data in a fashion which he can understand and which does not mislead him as to the operations or position of the firm. He should not be presumed to possess a depth of accounting or analytical knowledge in order to obtain a reasonable picture of the results of an enterprise's activities. The needs of the average investor can only be met by developing a better process of analytical summarization where information shown in detail in financial statements is selectively presented in an interpretive fashion so that the most significant elements are highlighted in relatively simple form. Since those elements which are most significant vary from enterprise to enterprise and from period to period, no fixed rules can be established as to the specific elements to be included in such an analytical summarization."

In proposed Guide 22 pertaining to 1933 Act filings, which would also become Guide 1 with respect to 1934 Act filings, the Commission stated:

> "Securities Act Guide 22 and Exchange Act Guide 1, if amended and adopted as proposed herein, would require an introductory narrative explanation of the Summary of Earnings and Summary of Operations whenever clarification is needed to enable investors to appraise the quality of earnings. Investors should understand the extent to which accounting changes, as well as changes in business activity, have affected the comparability of year to year data and should be in a position to assess the source and probability of recurrence of net income (or loss). Thus, whenever there are material changes in the amount and source of revenues and expenses, including tax expenses, or changes in accounting principles or methods or their application that have a material effect on net income, or if whenever management believes that historical earnings are not indicative of present or future earnings, an appropriate analysis and explanation would be required."

As a further indication of the dynamics of the process of determining which information should be available where and to whom, the Commission has proposed to transport large segments of information heretofore previously contained only in filings with the Commission into the annual reports circulated to shareholders, including preeminently the information concerning the sales and profitability of lines of business. With the continuing diversity of American enterprise, the Commission concluded that this information is material to a larger group than simply those who have ready access and opportunity to use the filings with the Commission and hence should be available more readily in the investment market place.

Do these developing practices favor the professional investor and the analysts' clients over the average investor? The easy answer, of course, is that the information will be available for anyone who wants to extract it from the Commission's files; but that is too glib. The fact is, of course, that the professional investor and the analysts' clients have significant advantages now deriving from their skills, their access to publications interpreting data, their ability to secure quite legally background information from management through interviews and attendance at analysts' meetings; there is no way that the Commission, or Congress for that matter, can legislate or mandate equality of wisdom and skill among investors.

But even that, I would suggest, is too easy an answer. The fact is that the Commission believes that this program will not enhance the advantage of the professional, substantial as it is now, but will in the final analysis give the small investor a better shot at knowledgeable

investment than he has now. I would emphasize that fully as important a part of this approach as the increase in data filed with the Commission is the requirement for better summarization of data and management analysis. These requirements will afford the investor access to more of the kinds of information with which he can deal most effectively. It will hopefully lead him away from simplistic analyses centered on earnings or cash flow per share and into deeper awareness of the complexity of enterprise and the investment process.

If it has the collateral effect of pressing more investors into the offices of the professionals, I would suggest that is not a bad result either -- provided the Congress, the Commission and the profession combine to develop an adequate program to exclude from the ranks of professional analysts those lacking integrity or expertise. More and more Americans are realizing that the investment process is hazardous, uncertain, and, like surgery or trial advocacy, demands more than ordinary intelligence. To the extent that these advances by the Commission give better tools to the analysts in their work, I would suggest all investors are the beneficiaries.

In summary, I would suggest that "differential disclosure" is a new tool, with roots firmly in the past as well as in a greater present perceptiveness concerning the investment process and the nature of investors, by which the disclosure process can become more useful and more meaningful to investors and their advisors. It recognizes the capacity of many to deal with complexity and the inability of still others, who nonetheless are essential to the investment process, to match the formers' skills and expertise,

but who nonetheless must be the beneficiaries of the process if we are not to abort and abandon the purposes of the Congress in enacting the scheme of federal securities laws which we have. Like any experiment, we must watch carefully its workings and assess realistically its achievements and failures. I believe it will succeed.