NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Full and Fair Disclosure: The Need to Maintain Investor Confidence and the Role of the Independent Accountant

An Address by
Barbara S. Thomas
Commissioner
Securities and Exchange Commission

New York State Society of CPAs
1982 SEC Accounting Conference
New York City
November 15, 1982

I am delighted to have the opportunity to address this prominent group of CPA's. During my two years as a Commissioner of the Securities and Exchange Commission and prior to that time as a private lawyer representing public companies, I have taken an active interest in the accounting profession and have a great appreciation of its role in developing and maintaining financial reporting standards, as well as in helping to ensure the fairness and relevance of financial reports. Indeed, my experiences to date have confirmed my belief that the auditing and standard-setting processes are critical to the credibility of financial reporting. In view of the current economic environment, these processes will be put to a severe test as we come to the close of 1982 as corporate management faces a stiff challenge to faithfully adhere to full disclosure standards by reporting their financial results in a candid fashion to their shareholders.

Today, I would like to talk about these financial reporting challenges and the Commission's concern about these matters. But first, I would like to take this opportunity to respond to what I believe is a misguided perception by some that the current Commission is somehow less concerned than prior Commissions about the role of independent accountants with respect to the Federal securities laws.

As you are aware, the Commission has a statutory responsibilities to ensure that accountants practicing before the Commission are independent, and that full and fair disclosure is provided to investors. Throughout its 50-year history, the

Commission has adhered to a policy of placing extensive reliance on the private sector to set accounting and auditing standards. This policy does not, however, represent an outright delegation of authority. The Commission has dedicated significant staff resources to oversight of the activities of the accounting profession and of the private-sector standard-setters to ensure that this reliance is justified. Many of you may recall a Wall Street Journal article last August which characterized the Commission's recent regulatory actions as indicative that the SEC has "gone soft" on accountants. This charge was based on, among other things, the Commission's rescission of several of its rules, some of which were unpopular with accountants, and on the decline in the volume of the SEC's enforcement actions against accountants.

In response to this claim, I would like to remind such critics that the Commission's emphasis on deregulation is a drive that began in the late 1970's under Chairman Harold Williams, and it is a concept that is entirely consistent with the Commission's historical policy of reliance on the accounting profession. Accountants should be aware, however, that deregulation cannot be successful if the self-regulators on which we rely, as well as the general public, believe that the SEC has taken a less agressive stance than in the past. Today's Commission, as has been often stated, is committed to a continuing review and evaluation of its requirements to ensure that they remain necessary and cost-effective. The Commission is also seeking to increase its reliance on private-sector self-regulation wherever possible and consistent with its statutory mandate. The recent elimination of several of the Commission's rules reflects careful consideration of the utility of the required disclosures to investors and, in some cases, the existence of similar private-sector disclosure standards.

The decline in the number of enforcement cases against accountants is not a reflection of any softening of the Commission's attitude. Critics should remember that one of the most significant variables affecting the level of enforcement activities is the state of the economy and its impact on business. Much of the high level of enforcement activity in the mid-to-late seventies stems from the early 1970's recession and is related to situations where severe financial pressures tempted companies to engage in fraudulent and deceptive practices in an attempt to mask their financial difficulties. In response to the widely publicized audit failures of the mid-1970's, the accounting profession itself has taken a number of significant initiatives to improve the quality of audits -- all of which have been closely monitored and strongly encouraged by the Commission. For example, the accounting and auditing standard-setting structures have been strengthened, improved accounting and auditing standards have been issued, and quality control standards for accounting firms have been established. In addition, the effectiveness of the systems of quality control of the accounting firms that audit over 90% of SEC registrants is periodically tested as part of the profession's peer review program. Furthermore, the business community has taken a number of steps -- such as the widespread formation of audit committees and improvements in internal control systems -- which contribute to reduced instances of audit failure.

As a result of these developments, the Commission expects to see fewer audit failures. Nonetheless, the Commission is concerned by the increasing instances of publicized financial problems involving public companies. We are also concerned that the current economic pressures may tempt some companies to dilute the quality of their financial reports by filtering out unfavorable news in an attempt to sanitize the information provided to investors.

The financial statements and related disclosures are the foundation of the Commission's disclosure system. Primary investor focus is placed on financial statements and on management's discussion and analysis. No other disclosures have a greater impact on market prices or on investor decisions. In view of this importance, the Commission is increasingly concerned that the current recession may be tempting companies to cover up financial problems in violation of the Federal securities laws. Past experience tells us that in times of fiscal and economic turmoil managements of companies facing financial difficulties may engage in acts designed to create an appearance of stability or prosperity. The motives are clear -- maintenance of stock prices and the need to obtain additional capital or to avoid default conditions. The Commission's concern in this area was reflected in part in a recently published report of its investigation concerning apparent false and misleading statements made in connection with the sale of retail repurchase agreements by Fidelity Financial Corporation. The message in that release is clear. The antifraud provisions of the securities laws prohibit the dissemination of public information -- including press releases -- which report operating results as if it were "business as usual," when in fact the near-term viability of the company is questionable. The Commission stated that in times of economic hardship, corporate management should be especially sensitive to the implications of financial disclosure requirements.

I would like now to briefly outline some of our concerns about the quality of reported earnings.

There appears to be a relatively high volume of one-time elective transactions this year which have provided companies with much needed profits to offset operational losses. Some of these non-recurring profits involve sales of assets or operations, sales of tax benefits, early debt refundings, and LIFO inventory liquidations. Changes in accounting methods, such as in investment tax credit recognition and adoption of the new FASB standard on foreign currency, FAS 52, have also provided additional "hypes" to the 1982 reported earnings of many companies. While we hope and expect that these kinds of transactions are engaged in for legitimate business reasons, a heavy burden will be placed on management in 1982 to fairly and objectively disclose any impact that these transactions have on its results of operations as set forth in managements' discussion, press releases, and elsewhere in communications with investors. These discussions should fully explain the one-time nature of any of these events, if this is the case; their impact on reported profits, and the trends reflected therein; their cash flow impact; and the estimated effect on future operations, if any. In other words, if business is not "as usual," management's message to investors should not imply that it is "as usual" by sugarcoating the bad news.

With respect to accounting changes, I believe it is extremely important that the impact of any such changes on the reported trend of earnings be fully highlighed and explained. This is particularly true with respect to accounting standards such as the new standard for foreign currency translation, which can have an extremely significant impact on reported financial condition, and which does not require companies to restate prior year financial statements to conform to the new standard. Investors have a natural tendency to assume consistent application of accounting principles, and notwithstanding disclosure of any change in a footnote, the accountant's report, etc., it is hardly fair disclosure to highlight record increases in earnings when a significant portion of the earnings increase (if not all of them) are attributable to accounting changes or other nonrecurring transactions. While sophisticated analysts routinely make "quality of earnings" adjustments, others could be somewhat misled by a cursory review of the annual report.

A troubled economy also results in increased instances of innovative transactions, such as various off balance sheet financing techniques and deals which are designed to clean up the balance sheet with no significant cash flow or other economic impact. These devices present a real challenge to the standard-setting and disclosure process. The FASB's recent swift action with respect to the accounting treatment for early extinguishment of debt through the so-called "quasi-defeasance" technique was a commendable response to a significant emerging practice problem. As you may know, these "in substance" or quasi-defeasance transactions may take several forms, but they all involve arrangements whereby assets are dedicated to future servicing and repayment of currently outstanding debt. The debt is then accounted for as being extinguished although, under the terms of the debt agreement, it may not have been legally satisfied and related liens may not have been released. The FASB calendered this matter as soon as it was apparent that these transactions were becoming pervasive. In an unusual action which we hope will set a precedent for the Board's dealing with other major emerging issues, the FASB announced its tentative conclusion that such debt should not be considered as extinguished and no gain or loss recognized unless the debtor has no further legal obligation with respect to the debt. The Board instructed its staff to add a project to expose a proposed standard on this subject for comment.

As many of you may be aware on August 19, the SEC issued a release which was supportive of the FASB's tentative conclusion. In that release, the Commission stated that registrants should account for debt extinguishments in a manner consistent with the FASB's tentative conclusions. These actions by the FASB and the Commission should ensure consistent treatment of any such transactions until the Board issues a final standard in this area. Ultimately, however, the Board may need to reexamine the fundamental issues of gain recognition in accounting for debt extinguishments as there appears to be substantial differences of opinion as to whether transactions involving exchanges of stock for outstanding debt should result in immediate recognition of earnings in all cases.

Whatever the ultimate result of that debate may be, my basic message today is that managements and auditors must be extremely sensitive to the need for credible financial reporting. The Commission is concerned that current economic pressures may cause some companies to dilute the quality of their financial reporting by filtering out unfavorable news to sanitize the information that they give to investors.

I would now like to discuss some recent developments which are indicative of the kind of financial reporting challenges which companies are facing in this period of economic difficulty. As you are all aware, financial institutions have particularly severe problems in an era of high interest rates and other adverse economic conditions. Much has been said about the plight of the savings and loan industry and the problems encountered by many banking institutions. Managements of these financial entities and their auditors are now being put to the test in making such judgemental decisions as the adequacy of reserves for loan losses and classification of loans as nonperforming. In addition, the need for a candid discussion and analysis of financial position and results of operations has never been greater.

The economic conditions affecting these financial institutions, coupled with competitive pressures, the potential effects of deregulatory initiatives, and rapid technology changes, have created certain accounting problems. For example, one situation that has been widely discussed is the application of existing financial accounting standards to business combinations involving financial institutions accounted for by the purchase method. There has been serious concern about the use of the purchase method of accounting in some of these acquisitions because the purchase accounting adjustments often create dramatic increases in earnings that do not reflect the economics of the transactions. In December 1981, the Commission's staff published its views in Staff Accounting Bulletin No. 42 regarding this issue. In this SAB, the staff stated that it believed that this unrealistic result often arises from the improper allocation of the purchase price in recording the acquisition, and in the automatic selection of the maximum 40-year amortization period for goodwill. The staff stated that the use of such a 40-year amortization period in many of these situations was inappropriate, because of the economic uncertainty facing the industry, and indicated that the use of a shorter period would be more appropriate, because it would offset the otherwise significant impact of the purchase accounting adjustments in an environment of high interest rates.

The FASB has recently issued an exposure draft on accounting for certain acquisitions of "troubled" banking or thrift institutions. The objective of these intiatives is to achieve more realistic financial reporting in these circumstances. I would urge the FASB to continue to closely monitor developments in this area as the rapidly changing environment affecting financial institutions may create the need for additional initiatives to maintain and enhance the objectivity and meaningfulness of financial reports issued by these institutions.

Another recent initiative by the Commission with respect to disclosures by bank holding companies was the issuance, late last month, of Staff Accounting Bulletin No. 49. This bulletin sets forth the staff's view regarding appropriate minimum disclosures by bank holding companies about loans to public and private sector borrowers located in foreign countries that are experiencing liquidity problems.

Banks engaged in international lending activities must not only be concerned with economic conditions in the U.S. -- they must also be concerned with conditions in countries in which their borrowers are located. Periodically, certain countries experience political and economic conditions which create liquidity problems that may result in unusual risks and uncertainties.

Although these factors may be separate and apart from the normal credit risks involved in international lending activities, they potentially affect the ability of borrowers to comply with the terms of their lending agreements because it may be difficult to obtain U.S. dollars or other foreign currency necessary to service their obligations to U.S. banks on a timely basis.

The Commission's rules are clear with respect to the need to disclose material information to investors, including disclosure of any unusual risks and uncertainties. However, our rules do not specifically address this situation and although many bank holding companies were providing certain disclosures about specific country risks, the nature of these disclosures varied significantly. Further, the staff was receiving numerous questions regarding its view as to appropriate disclosure in these circumstances. Thus, the staff issued Staff Accounting Bulletin No. 49.

SAB 49 contains general guidance and provides for two disclosure alternatives. The Commission staff believes that the guidance in the SAB will result in better and more consistent disclosure about international lending activities that involve more than normal credit risks.

In the first alternative, the registrant would identify only those individual countries where the bank has significant exposure, and where, in the registrant's judgment, conditions have created liquidity problems which may have a material impact on the timely payment of obligations of borrowers in that country.

Exposure is deemed to be "significant" when the outstandings to a foreign country exceed 1% of its total outstandings. (In this context, outstandings are defined to mean loans, acceptances, interest bearing deposits with other banks and other investments.) Certain other information would also be provided including an indication of the magnitude of the bank's total exposure in those countries so identified, and an assessment of the effect that these conditions may have on the registrant.

The second alternative calls for identification of each individual country and the amount of related outstandings where the bank's outstandings to such country exceeds 1% of its total outstandings, without regard to the existence of any liquidity problems. This listing would be coupled with a general discussion of the risks and uncertainties involved in international lending activities in general. No specific discussion of liquidity problems in any individual countries in the listing would be necessary unless, in the registrant's judgment, the exposure in that country either has had, or is very likely to have, a material adverse impact on the registrant.

The objective of the second alternative is to provide disclosure of all material foreign country lendings so that the investor can make his own decisions as to the bank's potential exposure in foreign countries where there may be liquidity problems now or in the future. This disclosure has the additional benefit of providing the investor with useful information about the credit extensions of the registrant in foreign countries that is currently beyond that required by the Commission's rules.

In conclusion, I would like to repeat that 1982 reporting represents a significant challenge to management to fully, fairly and objectively report and discuss the results of their operations and financial condition. The Commission, for one, will not look favorably on any sugarcoating of bad news. It is only by being honest, unbiased and objective that we can maintain and even increase investor confidence in the financial reporting system.