NEWS

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

DEVELOPMENTS IN THE REGULATION OF ACCOUNTING AND FINANCIAL DISCLOSURE UNDER THE FEDERAL SECURITIES ACTS

Address by

John R. Evans
Commissioner

Conference on New Trends in Accounting
and Financial Reporting
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Some of you may recall that I participated in your Institute's Conference on New Trends in Accounting and Financial Reporting in 1977, 1978, and 1979. In 1980, I told Frank Holman, your Association Secretary, that surely you would like to hear from someone else for a few years. After a three year hiatus, I have again accepted the invitation to participate in this important Conference. My legal counsel suggested that this invitation either means that my remarks in the past were well received or that the Conference organizers have decided to give me another chance to do it right.

In either event, an obvious reason for my presence is that the Securities and Exchange Commission has a statutory mandate to require public companies to make timely and effective disclosures of material financial information upon the public issuance of securities and periodically thereafter. These reports are the heart of the disclosure systems established by Congress.

Our disclosure systems are not static. They are constantly evolving. The Commission, with the aid of public comment, decides what financial data must be disclosed. Thereafter, we attempt to regularly re-evaluate whether our standards are effectively serving their intended purpose without imposing undue costs on issuers. Initiatives for changes in financial reporting often come from members of the public. For example, last fall the Commission held a forum in which analysts, investment advisers and others provided us with useful insights into the effectiveness and relative importance to users of our various financial and other reporting requirements and how they can be improved.

In addition to seeking public input in establishing disclosure requirements, traditionally the Commission has relied heavily upon the accounting profession to determine the accounting principles which apply to financial disclosures. Since the formation of the Financial Accounting Standards Board ("FASB") in 1973, the Commission has recognized its pronouncements as authoritative. However, we cannot delegate our responsibility to assure the use of appropriate accounting standards by public companies, and thus we have a close working relationship with the FASB. Most of our interaction takes place at the staff level in order to preserve the FASB's independence, but Commissioners also have periodic meetings with the Board, the most recent of these meetings was about two weeks ago. Moreover, the Commission, either directly or through our staff, issues interpretive releases concerning accounting principles and, on rare occasions, establishes standards which supercede those developed by the private sector.

The views expressed herein are those of the speaker and do not necessarily reflect the views of the Commission.

With this general background, I will now discuss several recent, pending or anticipated accounting and financial reporting actions by the Commission.

In my 1979 presentation to this Conference, I referred to the SEC's ongoing effort to integrate the transaction oriented disclosure system of the Securities Act of 1933 and the periodic disclosure requirements of the Securities Exchange Act of 1934.

In 1982, the Commission virtually completed the integration of these two systems by allowing Exchange Act periodic reporting to be incorporated by reference, where appropriate, in order to satisfy disclosure requirements of Securities Act registration statements. More specifically, the Commission implemented a new three-tier system for registration of securities offerings. All three registration forms require the same basic information, but differ primarily in the extent to which information may be incorporated by reference.

Issuers with a large existing securities float who have timely filed all required periodic reports for several years are permitted maximum incorporation by reference. At the other extreme, companies which have not been public for very long and with which investors and the financial community are relatively unfamiliar, must include all required information in the prospectus itself. Thus far, it appears that integration is producing effective disclosure at a substantial cost savings to issuers while also enhancing financing flexibility and reducing Commission paperwork. Our staff has roughly estimated that annual savings to issuers resulting from integration exceeds $350 million.

One important deregulatory aspect of this integration program, Rule 415, is currently operating on a temporary basis. Following approval of the initial registration statement of an offering, and subject to future disclosure requirements, this Rule, also known as the Shelf Rule, permits an issuer to offer part or all of those securities for sale at any time during the next two years without further notice or approval. By being able to go to market quickly, issuers are able to take advantage of so-called "market windows" when offering conditions briefly become more favorable. This opportunity is particularly beneficial to issuers of debt due to the unusual volatility of interest rates in recent years.

The Commission has continued to solicit and receive written comments on Rule 415 since it was initially adopted on a temporary basis in March 1982. Last summer, during a week of hearings regarding this rule, strong arguments were presented both in its favor and in opposition. Most issuers praised it as presenting an important alternative means of raising

capital at reduced costs. Last Fall, the Commission extended the rule until the end of this year in order to have a better opportunity to assess its impact. At that time, I was willing to make this deregulatory rule permanent because it permits certain issuers to lower their capital raising costs and I found insufficient evidence that adequate due diligence and investor disclosure could not be made under the rule.

Experience thus far indicates that the Shelf Rule is very popular. Since March of 1982, 55 percent of all registration statements filed have been shelf registration statements. The reaction of those who have utilized Rule 415 has generally been very favorable, particularly as to debt offerings. For instance, a recent issue of Moody's Bond Survey had this comment:

> Our own experience with the 415-Shelf rule has been one of success during the recent period of transition in the market. This period was difficult at best for many issuers, but it was greatly facilitated by the pre-registration program. Speed of issue when interest cycle windows widen, effiency of queing during congested market schedules, and flexibility of borrowers to structure marketing strategies for particular market tactics have indeed been helpful for many borrowers over the past 15 months. Competition among borrowers, and in a broader sense among various security market sectors, has also added credibility to the 415 rule program. Early research has also suggested that, at least during a period of declining yields, the 415 shelf procedure may provide lower offering yield opportunities and a prospect of net earnings to borrowers. While time and interest-cycle experience will ultimately judge the value of a permanent 415 preregistration program for the market, evidence at this time suggest that it is a successful experiment, with good prospects for greater market efficiencies as the recovery unfolds along disinflationary guidelines.

Although some people have suggested that Rule 415 should be limited to investment grade debt offerings, I have seen no evidence that would warrant eliminating the opportunity for issuers and underwriters to use the shelf rule for equities. The Commission is scheduled later this morning to consider publishing a release asking for additional empirical evidence on the use of Rule 415 so that its future can be determined well before its current expiration date.

As work on the integrated disclosure system was winding down, the Commission began a comprehensive review of its entire system of proxy regulation in order to do away with duplicative requirements, improve effectiveness, and remove unnecessary compliance costs on registrants.

In December of last year, we adopted a new Item 404 to Regulation S-K which amended the disclosure requirements with respect to transactions between a registrant and persons connected with its management. Changes included the expansion of management family members covered by the disclosure; a narrowing of the number of company officers to be included; a $10,000 increase in the _de minimus_ exclusion from disclosure; elimination of disclosure regarding certain relationships by directors; and the raising of the threshold for disclosure resulting from equity ownership or legal and investment banking fees. This new Item 404 is effective for filings made on or after July 1, 1983. However, registrants are permitted to comply voluntarily with its requirements prior to that time.

The Commission has also issued for public comment proposed amendments to Rule 14a-8 regarding shareholder proposals. In addition to asking for comments on the whole concept of providing shareholders with the right to have certain proposals included in issuer proxy statements pursuant to federal law, the Commission has proposed three alternative approaches.

One alternative would continue the current framework of providing all shareholders access to the proxy statement subject to increased procedural and eligibility requirements and with several refinements to the categories of shareholder proposals which the issuer can choose to omit from the proxy statement. The second alternative essentially would permit issuers to adopt their own procedures governing shareholder proposals subject to such conditions as initial and subsequent periodic approval of these procedures by the shareholders themselves. The final alternative would require all shareholder proposals that are proper under state law that do not involve an election of diretors to be included in the proxy subject to a numerical maximum.

Prior to the close of of the public comment period, the Commission received almost 400 letters regarding its shareholder proposal release. As I expected, the overwhelming majority of commentators supported the continued role of the SEC in the shareholder solicitation process and either wanted no changes in existing rules or strongly endorsed the first of the three proposals which would essentially retain the current framework. Final Commission action on this issue should occur by the end of the summer so that the new rules would be in place for the forthcoming proxy solicitation season.

A third aspect of the proxy review program was our publication last December of proposals to enhance the delivery of proxy materials into the hands of shareholders whose stock is held in the name of a broker-dealer, bank or other nominee. The release was essentially based upon the twenty recommendations made by our Advisory Committee on Shareholder Communications. The Commission received approximately 325 comment letters, the overwhelming majority of which supported the proposals. Some of these proposals are expected to come to the Commission for final adoption some time this summer.

The fourth area of the proxy review program was the proposal early this year to amend Item 402 of Regulation S-K relating to top management remuneration in response to criticism that the current form is overly complex and difficult to understand. The new Item 402, if adopted, would (1) focus on remuneration actually received or vested, while excluding contingent compensation; (2) require cash paid to be set forth in table form, while permitting other compensation to be presented in a narrative or other form; (3) focus on those management persons who perform policy making functions; and (4) provide other streamlining, particularly regarding perquisites and stock options. Approximately 100 comment letters were received on this proposal. These comments presented a difference of opinion as to which management personnel should be subject to required disclosures and the minimum dollar threshold for triggering reporting. Final recommendations on these matters should be considered by the Commission some time this summer.

As the fifth element of our review program, we intend to issue proposals in the near future for revising the merger proxy which has become overly complex and somewhat ineffective in communicating relevant information to securities holders. Finally, the Commission has determined to undertake a comprehensive review of proxy contest rules and staff procedures for handling such contests.

Another area of disclosure regulation at which the Commission is taking a fresh look is that of tender offers. As a result of the increased number and size of attempted hostile tender offers and the innovative tactics being used by both acquiring and target companies, questions have arisen as to whether the current regulations adequately serve and protect the public interest. In response, the Commission has formed an Advisory Committee on Tender Offers, which is composed of financial and legal experts from the private sector, to review current practices and regulations and recommend changes. The Commission will carefully consider any recommendations contained in the Committee's report, which is expected to be submitted in July. Interestingly, based on the meetings held thus far, the Committee appears to be favoring more, rather than less, regulation.

As I previously indicated, the Commission relies heavily on the private sector to establish and improve accounting and auditing standards for the financial disclosures we mandate. However, the Commission also oversees the accounting profession's self-regulatory activities. In the May issue of the Journal of Accountancy, a member of the public oversight board of the SEC Practice Section of the AICPA characterized the Commission's interplay with the accounting profession as follows:

> To date, there has been no action on the part of the SEC that can be construed as a serious threat to the "self" designation of the section's regulatory process. At the same time, I must report no lack of interest or failure of diligence in the performance of the SEC's oversight function.

Currently, there are several significant self-regulatory projects which the Commission's Office of the Chief Accountant is closely monitoring. For instance, our staff is monitoring FASB projects which are analyzing or have recently resulted in standards regarding research and development financing, acquisitions of troubled financial institutions, and "quasi-defeasance" or "in-substance defeasance" arrangements, including whether such transactions can be accounted for as an "extinguishment of debt." In connection with this latter project, the Commission recently issued a release supporting a tentative decision by the FASB regarding the accounting treatment for transactions intended to have the same substantive effect as a legal extinguishment of debt, even though the debtor's obligations are not in fact discharged as a legal matter. To ensure consistent accounting treatment, the Commission believes that all registrants should follow the FASB's tentative decision pending issuance of a final standard which is expected to be issued shortly.

The Commission's staff is also closely monitoring several projects of the Auditing Standards Board ("ASB"). These projects include the development of guidelines for situations where an auditor discovers, subsequent to the issuance of an audit report, that he has failed to perform a material audit procedure. The Commission recently authorized the issuance of a letter to the ASB which comments on the exposure draft issued on this subject. Our letter opposes a proposed provision which states that an auditor should "consult his attorney concerning his responsibility to notify his client" and others when he becomes aware of an omitted procedure. The letter expresses our view that auditors should always notify the appropriate parties in these rare circumstances.

In addition, our staff recently has completed its initial year of having "access" to certain working papers of

the AICPA's SEC Practice Section prepared in connection with the profession's peer review program. Based on our work to date, it appears that the program is improving audit quality and performing an important oversight function.

Despite our heavy reliance on the private sector, the Commission and its staff have taken several accounting initiatives to ensure adequate disclosure regarding financial information. One area receiving attention recently is disclosures by bank holding companies, with particular emphasis on loans to foreign countries which are experiencing liquidity problems. Last October, the staff issued Staff Accounting Bulletin No. 49 which generally calls for bank holding companies to disclose exposures in foreign countries in which the current political or economic conditions may cause borrowers to have difficulty in obtaining the necessary currency to make timely interest or principal payments. Subsequently, in January, the staff issued SAB 49A which requires disclosure that foreign countries are negotiating with or have entered into agreements with U.S. lenders, foreign banks, international lending agencies or others to restructure existing sovereign debt or to obtain additional new borrowings, and the impact of these negotiations on the maturities of existing debt principal and on unpaid interest, commitments of the registrant to extend additional borrowings, and other arrangements such as agreements to maintain deposits with government banks. SAB 49A also indicates that there are complex considerations involved in evaluating whether such loans should be classified as nonperforming. The staff emphasized that it is the registrant's responsibility to make these difficult determinations based on a careful analysis of the facts and circumstances.

In April, the Commission authorized a proposal to amend portions of its Industry Guides for Statistical Disclosures by Bank Holding Companies. The proposed changes would revise the current guidelines regarding nonperforming loans to focus more broadly on elements of the loan portfolio which may indicate unusual lending risks, such as (1) disclosure of the aggregate amount of current foreign loans where there are serious doubts about the ability to make timely payments in accordance with existing loan terms; (2) information about significant industry loan concentrations; and (3) certain additional data needed to facilitate shareholder assessment of the impact of international lending activities on the registrant's operations.

In March, the Commission adopted new rules intended to simplify and improve financial statement reporting for all bank holding companies. Key changes include the adoption of a one-step income statement, revised requirements for related party disclosures, and a requirement to present condensed parent company financial information in annual reports to shareholders. Under the one-step income statement requirement,

banks will no longer report gains or losses on investment securities transactions outside of normal operating income. Revisions to the related party disclosure requirements were designed to conform to earlier Commission actions in which the term "relative" was redefined.

In another recent accounting development, the Commission proposed to prohibit the capitalization of internal costs of developing computer software for sale or lease to others by registrants that had not previously disclosed the adoption of such a practice. While most companies engaged in these activities expense all of their internal software development costs as incurred, a growing number of companies have begun to capitalize them. A moratorium is being proposed to prevent a further divergence in accounting practices. Registrants that have previously disclosed the adoption of a capitalization practice would be required to disclose the effect on net income of not expensing all such costs as incurred. The Commission will reconsider any rules ultimately adopted at such time as the authoritative accounting literature provides better guidance in this area.

The Commission has also taken the following recent accounting actions:

(1) Codified the Commission's current financial reporting policies. This indexed document includes relevant material from over 200 accounting series releases issued since 1937.

(2) Reduced the requirements for financial statements which supplement consolidated financial statements by placing more reliance on summarized and condensed information.

(3) Adopted amendments which simplify and improve the financial statement requirements for investment companies and insurance companies.

(4) Adopted uniform instructions for pro forma financial information which reflect the staff's previously unpublished policies.

(5) Consolidated and reduced the requirements for reporting historical financial statements of businesses acquired or to be acquired.

(6) Changed the requirements for certain supplemental financial disclosures for oil and gas producing activities to conform to those in a FASB standard which was issued

in December 1982 to consolidate, simplify and improve financial reporting requirements.

(7) Proposed amendments to its rules for application of the full cost method of accounting by oil and gas producers, primarily to clarify the criteria for determining which capitalized costs may be excluded from immediate amortization and thereby narrow the diversity of practice in this area.

(8) Endorsed the view of an AcSEC position paper that in certain situations changes in the percentage ownership of a subsidiary by a parent company caused by the issuances of the subsidiary's stock should be recognized in consolidation as gains or losses.

The Commission's responsibilities regarding financial disclosures are really three-fold. Not only must we establish disclosure requirements and oversee the development of accounting principles, but we must also have an effective enforcement presence to ensure compliance by issuers and accountants. Within the last year, the Commission has initiated several enforcement proceedings involving allegations that high level management had intentionally altered financial statements in order to inflate earnings or conceal their deteriorating financial condition. For instance, just last month, one corporation consented to an injunction and ancillary relief after the Commission charged it with illegally inflating its financial results by at least $23 million in order to hide its precarious condition so that it could raise desperately needed funds in a public offering. The problems which this company attemped to conceal ultimately led it to file for bankrupcy. In my opinion, the Commission has no more important mission than the prevention of this type of conduct.

There are many other instances where the Commission has taken steps to correct financial reporting deficiencies. For instance, earlier this year, after Commission intervention, a major insurance company stopped using an accounting practice that had sharply raised its operating earnings. This company had been booking future tax credits generated by current losses in its property casualty insurance operations against current consolidated earnings. Recognition of these tax credits accounted for over $200 million dollars of the insurer's reported net income for 1982 of $427 million. Existing accounting standards require that before recognizing these credits, the reporting company must establish beyond any reasonable doubt that it will generate within 15 years enough taxable income to use the credits. The Commission was not satisfied that this very strict test had been met.

Even more recently, our staff raised questions regarding the practice by a company of accounting for sales of foreclosed properties and delinquent loans on the installment method and its failure to take greater discounts on certain loans. The company made revisions in its financial reporting which caused a reduction of over 25 percent in its 1982 net income.

Also within recent months, the Commission has authorized disciplinary and injunctive actions against individual accountants and several accounting firms, including some of the nation's largest. The Commission took these actions only after being convinced that there had been an intentional or reckless failure to comply with generally accepted auditing principles, and that these failures led or contributed to serious financial reporting errors.

While on the topic of Commission enforcement activities, I would note that the Commission currently has pending before Congress proposed legislation to increase the sanctions which the Commission may seek in insider trading cases. "Insider trading" is the term used to describe the act of purchasing or selling securities while in possession of material non-public information about an issuer or the trading market for an issuer's securities. Such conduct undermines the expectations of fairness and honesty that are the foundation of public confidence in our nation's securities markets. The term "insider" includes corporate officers and directors and any other person who has a fiduciary or similar relationship of trust or confidence to the corporation or its shareholders as well as persons who, through some act or course of conduct, misappropriate material nonpublic information. The term "inside information" includes information concerning the corporation, its activities or performance, or events related to the market for the corporation's securities, such as a proposed tender offer.

People who trade using inside information stand to make huge profits based on a relatively small investment. For instance, one inside trader parlayed a $3,000 options investment into a $424,000 profit in 48 hours. Our current enforcement tools of having violators ordered not to engage in similar misconduct in the future and disgorge their ill-gotten profits are often inadequate deterrents. Thus, our proposed legislation would authorize the courts to impose a penalty upon violators of up to three times the profit gained or loss avoided as a result of their misconduct.

Another legislative initiative impacting on the SEC and on accounting requirements is the continuing effort to amend the Foreign Corrupt Practices Act ("FCPA"). Proposed amendments to the FCPA are directed at two areas of the existing law.

Currently, the accounting provisions of the FCPA require issuers (1) to make and keep records which accurately and fairly reflect transactions and dispositions of assets and (2) to implement internal accounting controls sufficient to reasonably assure that these objectives are met. Failure to do either could subject the company to criminal liability. There has been criticism from some people that the requirement of accurate books and records is difficult to comply with and unfairly subjects issuers to criminal sanctions. The proposed amendments supported by the Commission would make the books and records requirement part of the internal controls system under which their accuracy would have to be sufficient "to provide reasonable assurances" that internal controls are being complied with. In addition, while a failure to adequately maintain such internal controls or records would no longer be a criminal violation, an attempt to "knowingly circumvent" such a system would be. In short, the amendments essentially would retain the same accounting requirements, but make it clear that issuers need not incur unreasonable costs in attempting in good faith to comply with these requirements.

I would like to emphasize that these accounting requirements are not limited to foreign payments. Indeed, the Commission has used this provision as an enforcement tool not only with regard to questionable or illegal payments, but also where there has been an exaggeration of company sales or assets, misappropriation or diversion of corporate assets not involving questionable or illegal payments, and unauthorized management perquisites.

A second major aspect of the amendments would eliminate the Commission's responsibility for civil enforcement of the anti-bribery provisions of the Act because this prohibition is based on a national policy unrelated to the objectives of the securities laws.

Legislation to enact these amendments was passed in the Senate last year, but died in the House. Two weeks ago, the Senate Banking Committee reported out the amendments once again. However, two House Subcommittees are currently considering different versious of amendments. Thus, it remains to be seen whether, and if so in what form, the House will take final action.

I have tried to cover most of the subjects suggested by Frank Holman in his letter of invitation. I hope my comments have helped you to be more aware of our recent and prospective activities. In summary, the Commission attempts to adjust financial disclosure requirements to provide an appropriate level of information to the public without imposing an undue burden on reporting companies. In doing so, we work closely with the private sector self-regulatory accounting organizations. But when the need arises, we must not refrain

from taking appropriate action, be it regulatory or enforcement in nature, to carry out our statutory mandate of investor protection.

I would be happy to try to respond to any questions that you may have.