NEWS

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Financial Reporting In A Period of Economic Difficulty: A Challenge For 1982

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I am delighted to have the opportunity to address this prominent group of Women Accountants and 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 in 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 recent Wall Street Journal article 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 recent 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. The accounting profession 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 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 Division of Corporation Finance reviews and comments on as many filings as their staff level will permit. Their review of a filing focuses primarily on the financial statements, the management discussion and analysis of financial statements and other information relating to what's happening to the business. While the Division does not have the staff necessary to examine every filing, they have been attempting to improve their ability to select for review the filings that involve companies whose disclosures may be most in need of improvement.

The end product of the examination by the Division of Corporation Finance often results in a letter to the registrant requesting revision or expansion of material in the filing. Division personnel often are able to take a fresh look at what is in or not in a filing, and make constructive suggestions to a registrant so that the material ultimately sent to the public is clear and gives adequate information to investors. We think the

Division's comment process results in improved disclosure and is a valuable service to both registrants and investors. However, you should know that the Division sends letters of comments only to registrants that appear to have made a good faith effort to furnish adequate disclosure.

If the Division has reason to believe that the registrant has not made a good faith effort to furnish adequate disclosure, or believes that the financial statements are false or misleading, the filing may be refered to the Division of Enforcement with a recommendation to conduct an investigation. In this regard, one of the Enforcement Division's top priorities is the pursuit of companies making inadequate disclosure of material financial information. The Enforcement staff is currently investigating a large number of cases involving alleged financial reporting deficiencies, including coverups of financial problems by companies affected by the current recession.

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 non-recurring 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 shortly after that FASB meeting 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 take this opportunity to discuss a significant on-going effort by the Division of Corporation Finance to review the adequacy of the disclosures in the management discussion and analysis of financial statements which is required in many filings.

On September 2, 1980, the Commission adopted revised disclosure requirements for management's discussion and analysis of financial statements. Under the previous rules, the MD&A only addressed matters affecting net income. The revised rules require registrants to take a broader perspective of the matters to be discussed, including the registrant's financial condition, changes in financial condition and results of operations. It is now required that the discussion provide specific information as to liquidity, capital resources and results of operations and any other information that the registrant believes is necessary.

In the summer of 1981, the Division of Corporation Finance reviewed very carefully the MD&A disclosures in a limited number of filings. At the conclusion of that review, Securities Act

Release No. 6349 was issued (September 28, 1981) and it included a number of examples of seemingly good disclosures that the staff believed met the intent of the new requirements. The principal purpose of the release was to assist companies in complying with the major new disclosure requirements by providing illustrations of various approaches used by certain companies during this initial period. In the release, the Commission staff noted that it anticipates that the disclosures made in response to these requirements will continue to improve over the years, and that it intends to continue its review of the MD&A responses and, if necessary, will provide additional guidance in a subsequent release.

The Division of Corporation Finance has recently initiated a new intensive review of the MD&A included in a limited number of filings that were made after the issuance of Securities Act Release No. 6349. If the current review indicates that there appear to be good reasons to issue additional guidance to registrants to assist them in better compliance with the intent of the MD&A requirements, the Division will make recommendations to the

Commission. However, if the Division finds MD&A's which are inadequate, registrants will be required to amend their filings. In view of the additional guidance given to registrants in Securities Act Release No. 6349, it would be fair to conclude that the Division may now require revisions of MD&A's that they would not have commented on in 1980 or before. If the MD&A disclosure appears to be false and misleading, it is probable that the filing will be referred to the Division of Enforcement for consideration. If our review of MD&A's turns up inadequacies in generally accepted accounting principles, the Division and the Office of the Chief Accountant will pursue the issues with the FASB.

This major project is one that is very timely because the comment process and any subsequent release should highlight the Commission's concerns about any deficiencies in disclosures as this unusually difficult reporting year draws to a close, and hopefully will encourage improvements in 1982 reporting. I need not remind you that if such improvements are not forthcoming, the Commission may find it necessary to take additional regulatory action such as the adoption of new or revised disclosure requirements.

In conclusion, I would like to repeat that 1982 reporting represents a stiff 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.