

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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IMPROVING FINANCIAL DISCLOSURE  
TO INVESTORS

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

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AMERICAN INSTITUTE OF CERTIFIED  
PUBLIC ACCOUNTANTS  
Regency Hyatt House  
Atlanta, Georgia

It is a pleasure for me to address this annual meeting of the American Institute of CPA's. I gather that, in doing so, I am maintaining a tradition of close contact between the Chairman of the Commission and representatives of the accounting profession, which augments the cooperation between you and our professional staff. These traditional contacts are vital to our common goal of protecting the public interest through upgraded and increased financial disclosures of corporate operations.

The necessarily close communications that we have had over the years have assuredly not always resulted in unanimity of views. Points of view have been quite varied; debate certainly has been heated at times. But, if the result of these policy disputes is the formulation of a comprehensive program to improve financial disclosures and to clarify the responsibilities of independent auditors as well as the standards to which they must adhere, we will have served well our common constituency -- the investing public.

Events of the past few years seem to have brought into sharper focus the questions with which we both must become increasingly concerned and the ones to which I wish

to address myself today -- what functions do we want financial disclosures to serve and what functions do we want independent accountants to perform? In a way, it seems odd to raise these questions, as if they were novel formulations predicated upon recent, dramatic events. They are not. Rather, these are the same issues that were hotly debated in 1933 and 1934 by a Congress which had a keen understanding both of accountants and the documents they produce. But the changing facets of our securities markets and the participants in them compel a constant re-examination and re-evaluation of these fundamental issues.

In the past year, we saw two major accomplishments representing notable contributions to the reporting environment. The first was the report of the Trueblood Committee on the objectives of financial statements. I am well aware of the tremendous personal commitments and substantial economic resources which were devoted to this effort, and the end product is a statement of significance. The emphasis on the needs of users of financial statements will serve as the underpinning for the development of meaningful principles

of reporting. The recognition of the future orientation of statements, the identification of corporate earning power in terms of cash generating capacity, and the development of a new statement of financial activities are specific suggestions which should lead to future improvements in reporting practices. While I realize that the report was not designed to be a document which could be adopted and implemented as it stands, I do feel it points in a number of very useful directions. I am sure that both the Financial Accounting Standards Board, the technical committees of the AICPA and the staff of the Commission will find it valuable as they consider reporting changes.

Secondly, and even more significant, this year saw the establishment of the Financial Accounting Standards Board as an operating entity. I recognize that the Board's creation was not solely the result of the actions of the accounting profession -- since analysts and financial executives played a significant role -- and that the Board's

parent body, the Financial Accounting Foundation, is an independent entity with diverse membership and not part of the AICPA. Nevertheless, in a very real sense the Board is the offspring of the accounting profession and the profession has every right to be proud of it. A year ago the Board was only an idea. Today it is a reality.

The Commission understands that all organizations have growing pains and progress frequently seems slow (perhaps it is worth noting that the Accounting Principles Board took nearly three years to issue its first opinion). While we are occasionally impatient, we do see progress being made and also efforts to accelerate that progress, with appropriate regard for problems of due process. Such acceleration is necessary in a world that demands not only excellence but prompt action. Many of the problems facing the Board are of such an urgency that we cannot afford the luxury of leisurely contemplation.

We remain confident, however, that the Board is pursuing a logical course, that its members and staff have been well selected and that its institutional structure is sound.

We believe that our historical policy of reliance on the private sector for solving financial measurement problems has served investors well and we expect to continue that policy.

At the same time, it must be recognized that the Commission has the statutory responsibility as well as the statutory authority to assure that accounting principles do serve the needs of investors. It is therefore essential that we work closely with the Board, and there is every evidence that we will be able to do so. It is apparent that such a relationship is in both our interests and that conflict between us would be detrimental to our joint objective of serving the information needs of investors. We expect to publish a release in the near future articulating our policy with respect to the Board and the establishment of accounting principles.

The Commission itself has had an active year on the reporting front. We have adopted a number of rules designed

to improve the quality and quantity of information available to investors. Early in the year, we issued new requirements for detailed and timely disclosure via Form 8-K of material unusual charges and credits to income. On this disclosure, we will also require a report from the registrant's independent accountant that the reporting principles used are in conformity with generally accepted accounting principles fairly applied. In June, we issued amendments to our registration and reporting forms requiring more meaningful disclosure in prospectuses of competitive conditions, new product development and, in the case of new registrants, a description of their plan of operation. These amendments grew out of our "hot issues" hearings in 1972.

Two weeks ago, we amended Regulation S-X to call for improved disclosure of leases by lessees. We believe that this disclosure is essential in financial statements prepared in conformity with generally accepted accounting principles. In the release accompanying the amendment, we noted specifically that we were not prejudging the issue of proper measurement of the effect of leases -- which we had referred to the Financial

Accounting Standards Board -- but were acting to provide adequate information to investors while the Board was considering the matter, since we did not feel that the APB opinion provided all the guidance necessary in this regard.

In addition to rules adopted this year, there have been a number of important proposals put out for comment which we hope to be able to issue in final form in time for them to be effective for 1973 financial statements. Two of these proposals were recently revised and reissued for comment as a result of comments received on our initial proposals. One provides for substantial additional disclosure of tax expense, while the other calls for information on the impact of using alternative accounting principles. The latter proposal was substantially changed in response to comments calling for greater specificity in our requirements and includes a number of items which I recognize are controversial. I hope that we will receive a significant number of useful comments from members of the accounting profession on these matters. We are also currently reflecting upon the comments which have been received on our liquidity disclosure proposals and we expect to issue final rules shortly.



Beyond rules and proposed rules, we have issued a number of statements articulating Commission policy in accounting and reporting matters. The release in which we proposed disclosure of the impact of accounting alternatives also includes a statement setting forth our view that all disclosure should not be designed solely for the average investor, but that there is also an obligation to be certain that professional analysts who have the time and professional training to analyze detailed financial data in depth have adequate information available to them to perform this function. Such data should not necessarily be routinely sent to all investors but should be data of public record which is available to all. At the same time, we recognize a need for improved analytical summarization of results that will be understandable to the average investor. We addressed ourselves to this in our proposal that management present a textual statement in connection with the summary of earnings to assist investors in appraising the quality of earnings and in our requirements for a summary of the contents of a prospectus.

In February, we issued a statement of policy on forecasts and projections and the staff continues to work on the releases which will discuss the implementation of that policy. Policy statements were also issued on the subject of the presentation of cash flow and cash flow per share data and on our interpretations of Accounting Principles Board opinions on lease accounting and business combination accounting in cases where we felt that principles with authoritative support were being eroded through practice. Such statements were intended to make public the administrative policies being followed by the Commission.

In the light of our substantial activity in the financial reporting field this past year, questions have been raised whether such activity is consistent with our announced policy of reliance upon the accounting profession and the Financial Accounting Standards Board. We firmly believe that it is. The needs and demands of investors are such that there is more than enough for all of us to do. By working together, our cumulative expertise can be brought to bear on problems and more can be accomplished. I have observed no indication that we are working at cross purposes and

and I want to dispel any rumors that we are seeking to preempt the FASB before it can get started.

There is a tendency on the part of some accountants to view our joint progress toward fuller and more meaningful financial disclosures with trepidation. Recent judicial developments have made some accountants gun shy; so much so, in fact, they are concerned that our disclosure initiatives may increase their liability to an endless series of plaintiffs to an unwarranted extent by law or logic.

Public accountants, of course, by virtue of their title, their social function, and their commitment to professionalism, assume an important public role. Fear of liability, if exaggerated, can lead to a serious depreciation in the value of services performed by accountants. We certainly have a great stake in maintaining and improving the high standards of quality the accounting profession has achieved. Fear of liability can lead to attempts to abdicate responsibility, and such a reaction is profitable neither for the profession nor for the public. By the same token, we are concerned that undue emphasis on enforcement actions against accountants is the least likely method of upgrading professional standards. Accountants must, of course, be financially responsible for deficient professional work, but they should not be required

to serve as insurers who guarantee the panoply of deficiencies that may arise in documents stimulating investor response to new or existing securities offerings. In part, the unpleasant tightrope between these extremes that we have been forced to walk is the result of the limited tools at our disposal. Our basic tools in this context, aside from informal comment and criticism, are enforcement weapons -- suspension or disbarment from practicing before the Commission, under Rule 2(e) of our Rules of Practice, and an action for an injunction on the ground that the accountant has participated in or aided and abetted a violation of the securities laws, including Rule 10b-5. While these enforcement weapons are essential and we shall continue to use them when necessary, they do not provide an adequate vehicle for enunciating general standards of professional conduct.

Limitations on unreasonable liability must be achieved, if they are to be achieved at all, both by emphasizing the willingness of accountants to assume appropriate responsibilities in the public interest and the public need for such an expanded function while at the same time pointing

out the unfairness and the inhibiting impact of certain aspects of liability.

It cannot be gainsaid that there is a substantial need for accountants to expand their functions and responsibilities. I believe this can be accomplished without a concomitant expansion of liabilities if the profession itself is prepared to adopt reasonable standards. It is far better to meet public responsibilities through forward looking professional leadership than to have responsibilities forced upon the profession through enforcement actions in cases where the facts may make dispassionate conclusions and standards difficult, if not impossible. While it is premature to suggest or to enumerate all the areas which may be covered, a number of areas seem self-evident.

First, I think accountants must assume a measure of responsibility for the use of financial statement data in summaries, texts of annual reports, prospectuses, press releases, and similar disclosure documents. Accountants may not be performing their function effectively if financial statement figures are misused in the process of developing

textual statements and tables of financial highlights describing corporate operations and their results.

Second, accountants should be prepared to assume responsibility for interim reports. Interim reports do have a significant impact on stock prices. Auditors who are already "on record" should perform some prepublication review of interim results to satisfy themselves at least that the accounting principles used were appropriate under all the circumstances, and that compliance with the requirements of the Accounting Principles Board opinion on interim reporting have been achieved. Auditors have experience with interim period reviews in connection with registration statements and perhaps this process could be expanded.

Third, I think accountants should be willing to assume responsibility for the detection of management fraud in appropriate cases. In the past year, several major cases of substantial management fraud have come to light. In most of these cases, the fraud was one which was designed to present a misleading picture of results through transactions with related parties or through outright fictitious transactions.

If the accounting profession adopts the view that auditors should never be responsible for detecting management fraud, there is little likelihood that increased imposition of truly onerous and unfair burdens on the accounting profession can be prevented. Standards can best be promulgated by the profession and can serve to allay fears that auditors will become insurers against all forms of management fraud, however carefully concealed.

While the whole problem of professional liability, in my opinion needs reexamination and imaginative thinking, the establishment of clearer standards should provide protection as well as guidance.

There is also a demonstrated need for improved procedures for quality control over audits. While I am convinced that the quality of most auditing work is quite high, we recently have seen an increasing number of cases of substandard work. Sometimes these cases have led to formal disciplinary proceedings; in others, these have led simply to a feeling of disappointment that better auditing work had not been done even though minimum professional standards has been satisfied.

This may well be a problem which defies complete resolution, depending as it does upon hindsight judgment. But guidelines in this area seem possible, and we have attempted to foster that kind of an approach. In one recent disciplinary case, the accounting firm involved agreed, as part of the sanctions imposed, to adopt revised and improved internal quality control procedures and to permit inspections by a group of its peers to determine whether compliance with the new procedures had been achieved. I hope the AICPA will take the lead in developing this and similar approaches to resolve the pressing need for greater certainty over professional standards.

I think we can be justifiably proud of the important progress the profession and the Commission have achieved over the last year. Professionals in the markets are, of course, our first line of defense against the varied predatory practices the federal securities laws were intended to prevent. The continued improvement of required financial disclosures and the implementation of a program designed to maintain and upgrade professional standards must certainly serve to improve public confidence in our markets.