NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR RELEASE: MONDAY, APRIL 29, 1974, 4:00 P.M. (EDT)

# IMPROVED DISCLOUSRE -- OPPORTUNITY AND RESPONSIBILITY FOR FINANCIAL ANALYSTS

An Address By

Ray Garrett, Jr., Chairman

Securities and Exchange Commission

April 29, 1974

FINANCIAL ANALYSTS FEDERATION
ANNUAL CONFERENCE

Century Plaza Hotel
Los Angeles, California

It is a pleasure for me, as Chairman of an agency dedicated to full disclosure, to have the opportunity to speak to a group whose principal objective is the effective use of that disclosure.

Ever since the first analyst studied the entrails of a chicken in a Roman temple, it has been recognized that special skills are needed in the interpretation of data. While there may be those who feel that this analogy strikes too close to home in articulating the analyst's job today, I think it is apparent from the Commission's activities in the past year that we have quite a different view, and that I am only teasing in making the allusion. Dispite the intriguing and frequently entertaining efforts of the chartists, the random walkers and the dart throwers to force upon you gentlemen the gloomy prospect of technological obsolescence, we adhere to the quaint notion that there is something of value in fundamental analysis.

A significant portion of our effort has been, and will continue to be, devoted to obtaining adequate information for the investor and his financial interpreter, so that rational economic decisions can be made. The importance of an efficient capital market in conditions of capital shortage, which I think most people agree exist today, is apparent to all thinking persons. We cannot rely upon hearsay and emotion, or even chicken livers, as the basis for capital allocation decisions.

If a market is to be efficient, it must be well informed, and this information must be used intelligently. Increased information represents both an opportunity and a responsibility for the analytical community, and we are confident that it will rise to accept both.

In the year 1973, the Commission took a number of significant steps to increase the amount of financial information available to investors. Early in the year, we required the filing of timely information regarding unusual charges and credits to income.[1/] This information was designed to enable analysts and others to study with care the major charges and credits which were being made to the income account, often, previously, without full disclosure. Under the new rules, a Form 8-K must be timely filed, setting forth the details associated with the charge and including a letter from the registrant's independent public accountant indicating that the accounting principles followed are in conformity with generally accepted accounting principles. While this does not solve the fundamental accounting problem of the "big bath," it does prevent significant data from being obscured in a single figure, and it makes it possible for people to understand what is taking place.

---

1/ Accounting Series Release No. 138 (Jan. 12, 1973).

Later in the year, we took three significant steps to increase financial disclosure, all of which were effective in time for 1973 financial statements. These dealt with financing leases,[2/] income tax expense discrepancies,[3/] and short-term borrowing.[4/]

The first, concerning leases, provided that corporations disclose not only substantial additional details as to cash outflows in connection with leases, but also the present value of noncapitalized financing leases in a single figure, to enable analysts and others to appraise debt equivalencies, and to compare, in a meaningful way, companies using lease financing with those using more conventional debt techniques. In addition, this rule requires disclosure of any effect on earnings that would have resulted if nonfinancing leases had been capitalized. We recognize that the fundamental accounting issue associated with leases must still be dealt with, and we are pleased that the Financial Accounting Standards Board is working actively on the topic. In the meantime, our disclosure rules at least increase investor awareness of this type of financing and the possible noncomparability of financial statements of companies who use it extensively.

---

2/ Accounting Series Release No. 147 (Oct. 5, 1973).

3/ Accounting Series Release No. 149 (Nov. 28, 1973).

4/ Accounting Series Release No. 148 (Nov. 13, 1973).

Late in the year, the Commission also made a significant change in its requirements for the disclosure of income tax expense which we believe will be of substantial assistance to the analytical community. Corporations now must explain why their effective tax rate, as indicated by their financial statements, differs from the statutory federal income tax rate, and they must reconcile any differences between the two. By the use of these data, analysts will be able to understand variations in tax rates from one period to the next, and will be able to judge whether they constitute merely a one-time tax saving, or a tax saving which may be expected to recur and, hence, to contribute, on a continuing basis, to a firm's earning power. In addition, this rule change requires disclosure of the source of timing differences between book and tax deductions, which should further assist analysts in understanding the nature of the tax accrual and the current and prospective cash implications of taxes.

Finally, the Commission promulgated rules late in the year which provide for increased disclosure of short-term financing costs and policies. Under these rules, corporations must disclose short-term borrowing rates, lines of credit outstanding, maximum amounts of short-term borrowings incurred during the year and compensating balances maintained to support short-term financing arrangements.

In addition to these adopted requirements, a number of significant proposals are still outstanding, proposals upon which I expect action in the year ahead. First, there is the proposal for improved disclosure of the effect of accounting alternatives on reported results.[5/] We have been working with this proposal for over a year, and we have already published it twice for comment. Comments have been extensive and we recognize that the area is a difficult one. It is likely that we will put yet another proposal out for comment before adopting final rules, but, ultimately, we do hope to adopt rules applicable to 1974 financial statements.

We have also published a proposal for the amendment of Guide 22 to the preparation of registration statements, which will provide for an improved analytical summary of material changes in corporate results, supplementing the summary of earnings.[6/] We believe this to be an important step in requiring management to take some responsibility in pointing to the most important aspects of corporate results and indicating the extent to which past results may not be indicative of what can be anticipated in the future.

---

5/ Securities Act Release No. 5343 (Dec. 18, 1972) and Securities Act Release No. 5427 (Oct. 4, 1973).

6/ Securities Act Release No. 5443 (Dec. 12, 1973).

We have also proposed amendments to our proxy rules, which will require the inclusion of other significant data in the annual report to stockholders.[7/] Our proposal would require that the annual reports to shareholders include the following information: the general nature and scope of the issuer's business; the contribution of a company's various lines of business to the company's sales and earnings; a five-year summary of earnings; the nature and scope of the liquidity and working capital requirements of the issuer; at a minimum, the name and principal occupation or employment of each director and executive officer; the principal market in which the company's securities are traded as well as the high and low prices for each quarter over the most recent two years, together with information as to dividends paid and a statement of the company's dividend policy; and a statement that the company will send a copy of its Form 10-K annual report to any security holder on request. In addition, we have proposed that financial information and data or financial highlights, in the form of charts, graphs, figures and the like, should not present the results of operations or other financial information in a light more or less favorable

---

7/ Securities Exchange Act Release No. 10591 (Jan. 10, 1974).

than that presented by the actual financial statements included in the annual report to shareholders.

In our proposal, we have tried to adhere to our traditional policy of not intruding upon management's annual communication with its shareholders. We have not tried to restrict so-called free writing, or the format of the report, except to point out that charts and graphs and pictures and whatnot should not be significantly different in the financial results and conditions that they portray from what appears in the financial data included in the Form 10-K.

In addition to new and proposed disclosure requirements, the Commission, in the past year, articulated for the first time an approach to disclosure which emphasized the needs of different groups of investors. This approach, which we call "differential disclosure," recognizes the fact that the data needs of the average investor may be different from those of the professional analyst and, accordingly, it identifies the desirability of different levels of summarization in the presentation of financial results.[8/]

Under this approach, we recognize that certain detailed data may be of interest primarily to the professional analyst

---

8/ Securities Act Release No. 5427 (Oct. 4, 1973) who has the responsibility for developing an understanding in depth of corporate activity. Such an analyst would expect to devote substantial time to the study of corporate information and would have the professional training and skills to understand and use it. It is our view that if analysts do use this information effectively, the results will be reflected in the market place and improve the capital allocation mechanism.

While the emphasis on disclosure aimed at analysts has received the most publicity, I believe that an equally important part of the differential disclosure concept is that part which identifies the responsibility of the corporation to present meaningful analytical summaries in terms that the average investor can understand. It is apparent that many investors do not have the time or the training to analyze carefully a set of financial statements and footnotes to extract those elements which are most important in appraising results. Management, on the other hand, is in an excellent position to do this, and it seems to us an important part of their responsibility that they do so. Guide 22, which I mentioned earlier, is therefore a vital part of our differential disclosure approach.

We realize that the concept of differential disclosure has not been met with universal joy. In addition to the complaints of those who routinely whine at any increase in required disclosures, there are the serious and legitimate concerns of those who fear undue advantage to the professionally advised institutional investor over the ordinary little fellow, as well as those who fear additional exposure to legal liability. Without attempting to explore the subjects with any thoroughness, we think there are adequate responses to these fears.

For one thing, the fundamental idea involved in the concept of differential disclosure is as old as our federal securities laws, if you assume, as I do, that the purpose for requiring the filing of exhibits was to make them available to the diligent professional, certainly not to the ordinary investor. The schedules required by Regulation S-X have long been of this nature, as indeed is all of the information in Part II of a Form S-1, or its equivalent. There seems to have been no undue alarm over the years that the document delivered to the ordinary investor, the prospectus, does not contain everything in the '33 Act registration statement plus exhibits.

Why should there be such alarm at present suggestions to expand the instances of this sort of discrepancy? Is it, perhaps, because of our more specific, if not more frank, rationale? We are expressly basing the differential on the presumed usefulness of data to broad categories of persons without reference to bulk, expense or what not. And we have now given it a name.

We are aware of the facile truism that information is either material or it is not. If it is material, then every investor and offeree should get it. If it is not, then no one need get it. We believe that the federal disclosure system has always recognized, or tacitly assumed, that this disposition of the problem is overly-simplistic and stands in the path of making disclosure more meaningful because it is better tailored to the user. At least, since the Wheat Report, the Commission has been consciously seeking this latter objective.

Naturally, we would be most disappointed if the further development of differential disclosure were to further alienate ordinary investors from our equity markets because of the superior information provided professional analysts who, presumably, work for institutional and very large investors. We do not expect this to occur. First of all, nothing is or ever will be furnished to professional analysts pursuant to our rules that will not be available to any investor. Second, the whole philosophy of the '33 Act has relied heavily on the proposition that ordinary investors benefit from the information available to brokers and brokers' analysts. We think this is still true.

Happily, the Commission has by no means been alone in improving the quality of information available to investors. The past year has seen the creation of the Financial Accounting Standards Board as a going concern. The publication of its first statement of an Accounting Standard, and the development of several Discussion Memoranda, have shown that that body is well on the way to making significant improvements in the standards of measurement used by accountants. Our staff has developed a close working relationship with the FASB, and we are confident that it will be a great success in improving financial reporting. In addition, the various committees of the AICPA have continued to work in the accounting and auditing areas, and we believe that they too have made progress in the past year.

It is particularly encouraging to note that the New York Stock Exchange has added its weight in a significant way to the movement toward improved financial disclosure. Its white paper -- <u>Recommendations and Comments on Financial Reporting to Shareholders and Related Matters</u> -- made a number of important suggested improvements, and we have seen evidence that this has had an effect on the annual reports of many public corporations.

These various approaches to improved disclosure and reporting and, particularly, development of the concept of differential disclosure, present analysts both with greater opportunity and greater responsibility in performing their tasks. The opportunity arises from the additional data available to increase the analysts' understanding of corporate activity. This means that supposition and guess can be replaced, in many cases, by analyzable data, and the result should be sounder analysis based on facts, rather than on "concepts" or emotions.

Additional data also means more responsibility, however. Analysts have an increasing obligation to develop improved skills and understanding in using data and disseminating that data to the investment market place. If the analyst doesn't use the information developed, he is not doing his job. Related to this, it seems desirable that the analytical profession move in the direction of defining improved professional standards for analysis. We know that the Financial Analysts Federation is attempting to move in this direction, and we encourage such efforts.

I am sure that it is interesting to hear about what the Commission has done, but if you follow the pattern of analysts everywhere, I am sure that you are likely to be more interested in forecasts than in historical presentations. As you know, we have indicated that we will adopt standards governing the filing of forecasts with the Commission, 9/ but since these standards have not yet been promulgated, I should not be violating them by making some observations about the future, and indicating the sorts of things we are thinking about doing in the months ahead.

In the disclosure area, we have a number of plans. First, the statements promised in that very release on projections issued in February, 1973, are overdue, and we hope to get them out in the Fall. I believe that the guidelines set forth in our statement of February, 1973, still represent a sound approach for the Commission to take on the subject of forecasts and projections, and I expect us to move forward in this area, along those lines.

The present Commissioners have not addressed themselves to this topic in a collective way so, adhering to the policy of our earlier statement, any forecast or projection made here by me with respect to future actions of the Commission on the subject of forecasts and projections is subject to the possibility that a majority of the Commission may have, at the time of action,

---

9/ Securities Act Release No. 5362 (Feb. 2, 1973) a contrary view, and, indeed, that I may be persuaded by the staff or other Commissioners to join in a contrary view.

With this careful hedging, I expect the Commission to do what it said it wanted to in February, 1973. We were a little discouraged by the recent federal district court decision concerning Douglas Aircraft Corp.[10/] The court, in that case, seems to have applied a standard of accuracy to a forecast that supports the worst expectations of those that argue that forecasts are too dangerous legally. On the other hand, we were encouraged by the earlier court decision in the Monsanto case,[11/] which seemed to apply reasonable tests, as we were by the recent exposure draft of the AICPA Management Services committee, which indicates increasing interest in the ideas.

On the whole, I am about where the Commission was in February, 1973. Most investing is based on estimates of future earnings. We should, at least, experiment on a voluntary basis with permitting the investor to get this information from management in a formal and regulated way, rather than only, and always, from salesmen, based on God knows what. We might

---

10/ Beecher v. Able, [Current] CCH Fed. Sec. L. Rep. ¶94,450 (S.D. N.Y., 1974).

11/ Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y., 1971).

as well, so to speak, experiment with providing sex education in the schools.

As to liability, we hope that we can include statements that will give courage to counsel for registrants who want to engage in the bold experiment, by making clear our view of the law, namely, that a projection or forecast is not actionable merely because it turns out to be wrong, provided only that it was based on a reasonable and good faith effort on the basis of information available at the time.

Another area which will be receiving attention is that of interim reporting. Historically, interim reporting has been on a highly summarized basis -- somewhat of a step-child to accountants and registrants alike. However, there is plenty of reason to believe that interim reports have a very substantial effect upon market behavior, and we believe that it is desirable to give this matter a new look.

We certainly do not contemplate a requirement for the publication of full audited financial statements for interim periods, but we think that summary figures now made available may be too summary and may not be the most useful figures to most investors. We would welcome your thoughts on this subject. We will also be working with the AICPA in determining the responsibility of independent public accountants in the interim reporting field.

A third area which should receive attention in the year ahead is improved liquidity disclosure. The proxy rule proposals, which I described earlier, include the requirement for a textual statement which will analyze the working capital position of the firm. Perhaps we have to go further. A number of cases have indicated to us that corporate reporting on liquidity and short-term financial expectations has not been what it should be, and we think this has to be considered further. It may be, in this connection, that we must take another look at definitions of working capital and fund statement presentations, both in general and in certain industries.

An additional area to which we have recently had to give some attention, as a result of the request of a particular registrant, is the disclosure of fair value data as supplemental information included in supplemental financial statements or footnotes. We may have to look at this area further, if additional registrants indicate an interest in presenting data of this sort to their stockholders. Basically, we believe that it is desirable for us to encourage experimentation in various forms of financial reporting, as long as these presentations are not made in such a way as to be confusing to investors who might think they are something which they are not. We do not propose any rapid or general movement in the fair value field, and it is clear that any data of this sort must be subject to constraints to assure that investors are not misled. Nevertheless, we are pleased to see that there is some interest on the part of registrants in presenting information of this sort, and we encourage continued experimentation within the framework of reasonable constraints.

Related to the fair value issue are the problems of coping with inflation in financial statements. In January, we called attention in a release to the possible existence of "inventory profits" as an undisclosed part of income during periods of rapidly rising prices, and we urged registrants to make adequate disclosure of such an effect.[12/] Thus far, it is not apparent that registrants have found means of conveying the effect of inflation in financial statements, and we may have to consider this and other inflation-related accounting problems in cooperation with the FASB in the year ahead.

Finally, and perhaps with a longer time horizon, the staff is working on the development of techniques for the improved disclosure of uncertainties. This does not mean simply a prolongation of a boiler plate list of "risk factors," but rather the presentation of data in a fashion that will assist

---

12/ Accounting Series Release No. 151 (Jan. 3, 1974).

analysts and investors in the appraisal of uncertainties facing a corporation and their implications. We noted, for example, the disclosure in one report this year of the extent to which costs included in an inventory could not be recovered in the absence of additional firm orders. This is one type of disclosure which might be developed further. In addition, questions as to the desirability of presenting data in range format must also be considered, as well as other techniques for reflecting uncertainty adequately. I would not anticipate any general statement on this subject in 1974 from the Commission, but it is an important area which requires attention.

I think that it is healthy and desirable to see that not only the Commission, but numerous bodies in the private sector as well, are actively working today to improve financial reporting and disclosure. We look forward to working with these groups and to playing a significant part in the progress of making information available to investors which will improve their ability to make investment decisions and which will make our capital markets both more efficient and more prosperous.