CHANGING FINANCIAL REPORTING--

YESTERDAY, TODAY AND TOMORROW

TODAY

As Seen From the Standpoint of the Investor

Comments by

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In your invitation to me to address this Accounting Educators' Conference, it was suggested that I discuss the changing requirements and problems of financial reporting today from the standpoint of the investor, in conformity with the general theme of the conference.*/ Since the SEC administers the Securities Acts, which require disclosure of financial and other information essential to informed investment analysis, it provides a vantage point for such a discussion. I am pleased to have this opportunity to participate in this program.

The SEC for many years has published a small pamphlet describing the work of the Commission. On the inside of the back cover is a brief summary of that work:

> "'Truth in Securities Laws' Administered by the Securities and Exchange Commission Seek to protect the investing public by providing for:
>
> (1) Disclosures of material financial and other facts about securities offered for public sale so that investors may make informed investment decisions.
>
> (2) Current reporting of similar data about securities of many companies, including securities traded on stock exchanges, so that investors may make an informed analysis and evaluation thereof.
>
> (3) Disclosure of information about corporate matters on which stockholders are asked to vote, so they may vote intelligently.
>
> (4) Current reporting by management officials of stock holdings in their company, and recovery of their short-term trading profits.
>
> (5) Penalties against fraudulent practices in the purchase and sale of securities and against market manipulations, and investor recovery rights if defrauded."

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In conjunction with this summary a paragraph from the foreword warrants attention:

> "It should be understood that the securities laws were designed to facilitate informed investment analyses and prudent and discriminating investment decisions by the investing public. It is the investor, not the Commission who must make the ultimate judgment of the worth of securities offered for sale. The Commission is powerless to pass upon the merits of securities; and assuming proper disclosure of the financial and other information essential to informed investment analysis, the Commission cannot bar the sale of securities which such analysis may show to be of questionable value."

The Securities Act of 1933 and the Securities Exchange Act of 1934, which are often referred to as "full disclosure" laws, contain detailed provisions regarding the accounting and other data to be filed with the Commission by companies subject to the Acts. Most of the other four laws administered by the Commission also require affected companies to file considerable accounting data. Since the various laws provide the Commission with general authority over the financial reporting of companies under its jurisdiction, a continuing problem for the SEC is the determination of what information the investor wants and needs in relation to what it is practicable for the companies to provide. We are now, in fact, engaged in a special study under the over-all supervision of Commissioner Francis M. Wheat for the purpose of reappraising our disclosure requirements in the light of present day conditions. All segments of industry and the legal and accounting profession have been invited to offer suggestions.

What should be called for by way of financial statements in implementing the Acts is not left entirely to our imagination. Section 19(a) of the Securities Act authorizes the Commission "to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to

be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; . . ."

From this general authorization we must turn to Schedule A where we find in paragraphs (25), (26) and (27) the specifications for balance sheets and profit and loss statements to be included in the registration statement and prospectus pursuant to Sections 7 and 10(a). Congress recognized the need of the investor for reasonably current financial information by a requirement for a balance sheet within ninety days of the date of filing and, if this was not certified, another balance sheet not more than one year prior to filing which was certified by an independent public or certified accountant. The need for current financial information, incidentally, is the cause of much of the trouble that grows out of misleading interim statements.

The balance sheet (paragraph 25) is required to show "all of the assets of the issuer, the nature and cost thereof, whenever determinable, in such detail and in such form as the Commission shall prescribe (with intangible items segregated), including any loan in excess of $20,000 to any officer, director, stockholder or person directly or indirectly controlling or controlled by the issuer, or person under direct or indirect common control with the issuer. All the liabilities of the issuer in such detail and such form as the Commission shall prescribe, including surplus of the

issuer showing how and from what sources such surplus was created. . ." These, I am sure you will agree, are rather interesting requirements in light of some of the contentions from various quarters that some of this information is unnecessary--such as the point often made in academic as well as in business circles that the distinction between earned and capital surplus is more misleading than helpful. Our regulations implement the Act and do not support the dissenters.

The profit and loss statement (paragraph 26) [and may I point out to the sticklers for definitions that Section 19(a) refers to an earning statement and in the corresponding Section (13(a)) of the Securities Exchange Act the term "income account" is used at one point to mean the same thing] must show the nature and source of the earnings and income and the expenses and fixed charges in such detail and form as the Commission shall prescribe. These statements are required for three years, year by year, or for the life of the issuer if less. The requirement for interim period income statements is not clearly integrated with the balance sheet requirement but this is covered by the instructions in the forms. The lawmakers said that the statement shall "show what the practice of the issuer has been during the three years or lesser period as to the character of the charges, dividends or other distributions made against its various surplus accounts, and as to depreciation, depletion, and maintenance charges, in such detail and form as the Commission shall prescribe. . . Such statement shall also differentiate between any recurring and nonrecurring income and between any investment and operating income." And the statement is required to be certified as in the case of the balance sheet. Here we find requirements which are met in some cases by footnote disclosure which some of our critics

impatiently refer to as compliance notes. Recent Accounting Principles Board opinions require better disclosures of this type in reports to stockholders than have been the general practice in the past.

Paragraph (27) is of particular interest because of the many mergers and acquisitions today. This paragraph requires that, when the proceeds, or any part of the proceeds, of the security to be issued is to be applied directly or indirectly to the purchase of any business, financial statements for such business meeting the requirements I have mentioned shall be furnished. Should this idea be adopted more widely in reports to stockholders?

The 1934 Act prescribes financial statements substantially similar to those under the 1933 Act except that certification is authorized for prescription by rule rather than mandatory in the Act. One other significant difference between the laws is the authority given to the Commission to prescribe, in addition to the basic statements we have been discussing, "any further financial statements which the Commission may deem necessary or appropriate for the protection of investors."

It has been suggested that the Commission should require a statement of source and disposition of funds. The provision just cited would appear to give us ample authority. It is well known, I think, that we supported the Accounting Principles Board in its Opinion No. 3 on this subject. Perhaps we should go further. Prescribing a form by rule would, I am sure, open up a considerable debate over the form of the statement.

The 1934 Act authorizes the Commission to prescribe quarterly reports. Our present requirement is for a simple mid-year income and surplus statement. Most listed companies publish quarterly reports under agreements

with the exchanges. As all accountants know, short period reports create problems. I understand that the APB is studying the subject.

The Commission from its inception has followed a policy of encouraging and cooperating with the accounting profession in the improvement of accounting practices rather than attempting to prescribe accounting and reporting methods in detail, a policy it continues to follow with some few exceptions. It also maintains contacts with other professional organizations representing financial analysts, financial executives, and others in its efforts to insure that adequate disclosure of financial information is provided to investors. We are also conscious of the contributions, criticisms and suggestions made in the financial press, speeches and papers by authoritative writers and, of course, the financial reports issued by registrants.

One recent annual report of a registrant contained the results of a survey it had made among its shareholders to determine their reaction to various features of the report and to learn what other investment data they used. These stockholders voted for more facts and financial details and less color pictures; they indicated that they got more help from the financial pages of the newspapers and financial magazines and from their brokers than they did from consulting lawyers or accountants. These stockholders seem to support the current theme of a well-known critic of corporate reporting.

A recent report of a natural gas company included the results of a survey made to determine what factors security analysts interested in such companies considered most important for analysis. They listed the following ten factors: growth of service territory; estimate of future

earnings; stock price in relation to current earnings; relations with regulatory agencies; competence of management; diversification into non-regulated areas; factors affecting the industry as a whole; company's capitalization, financial resources; outlook for interest rates; and stock price in relation to current dividend. None of these factors got into the specifics of current financial reporting problems. The corporation's president, in commenting on capitalization and financial resources, observes that the company would use stock to acquire new companies provided their earning power would be sufficient to insure no dilution of earnings per share to present shareholders. These survey results merely emphasize the obvious--investor interest in earnings, particularly prospects for the future, and diversification which we see going on all about us.

Over the years, many areas of accounting and of financial reporting have undergone evolutionary changes which reflect the joint efforts of the Commission and the accounting profession to provide the best disclosure of financial data in light of changing economic conditions and the increasing complexity of our industrial society. Many other areas have been the subject of recurrent studies by the Commission, sometimes on the basis of registrants' contentions that a particular disclosure practice is harmful to their interests.

An example of the latter situation is our requirement for the disclosure in the income statement of sales and cost of sales, or comparable data for service type companies. This disclosure requirement has been given consideration on four separate occasions. When our accounting rules were originally drafted, incidentally with the help of a committee of prominent practicing accountants and distinguished professors of accounting,

it was considered that this data would be useful and helpful to investors and thus should be required. Objections were raised by some registrants who considered themselves to be single-product companies, on the grounds that disclosure would be harmful to the company in relation to its customers and competitors. In an opinion of 1939 involving the American Sumatra Tobacco Company, the Commission ruled that this information should be disclosed. This action was upheld in an opinion of a U. S. Court of Appeals in 1940.

In 1964, after the Securities Exchange Act was amended to extend its coverage to many over-the-counter companies, similar objections were raised by some of the new registrants on the same grounds as before. We consulted experts and searched current authoritative writings and again concluded that the information should be disclosed as an aid to investors.

At the present time we are hearing a somewhat similar argument in connection with the conglomerate reporting problem, that is, a break-out of sales, cost of sales or an earnings figure on a segmented basis might be harmful to a company in relation to customers, competitors and additionally the trade unions. In the limited areas of disclosure that we have in mind, such as divisional activities, broad product lines, or general market areas, we believe that such harmful effects are even less likely to occur for the diversified companies than for the smaller single-product companies.

Although sales and cost of sales are required in reports filed with the SEC, many registrants in their annual reports to shareholders used a natural classification of expenses format for the income statement that does not disclose cost of sales and a few registrants preferred to start the statement at gross profit or even lower.

Until 1964 we had exercised only limited jurisdiction over the reports to shareholders. In that year we amended our proxy rules (Rule 14a-3), in part because of some serious variances that had recently been noted between the two reports, to require that any material differences between the financial statements in the annual report to shareholders and the report filed with the SEC must be noted and the effect reconciled or explained in the report to shareholders. In accordance with that rule the registrants that use the natural classification of expenses format in the report to shareholders now provide supplemental data on cost of sales and gross profit in conformity with the SEC reports, and, of course, those that omitted sales and cost of sales now include them.

Problems relating to the determination of periodic income and the presentation of meaningful statements of income, particularly in relation to the reporting of extraordinary items, have been the subject of many Commission studies and conferences with representatives of the accounting profession and others. We have always preferred the "all-inclusive income statement" approach in reporting these items. When the Institute was considering the issuance of Accounting Research Bulletin No. 32 on "Income and Earned Surplus" in 1947, we conferred with its representatives and were in close agreement on most of the proposed content but we reached an impasse on the classification of a few items as between income and earned surplus. The "current operating performance" concept of income statement was endorsed in the published bulletin. As a result of these differences the Chief Accountant gave public notice that "the Commission has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of Accounting Research Bulletin No. 32."

Shortly thereafter work was begun on a major revision of our manual of accounting rules, Regulation S-X, in which we proposed to adopt the principle of the all-inclusive income statement. The accounting profession objected to this and to the proposed revision of certain other items on the basis that accounting principles should not be established by rules or regulations of the Commission. In the subsequent rulemaking process this controversy was compromised by the inclusion of the now well-known Item 17 (Special Items) after Net Income or Loss in Rule 5-03 of Regulation S-X. When ARB No. 32 was incorporated into ARB No. 43 in 1954, the SEC solution was also endorsed as an acceptable method although not the preferred one.

However, the problem remained a controversial one and abuses in reporting extraordinary items seemed to increase over the years. There was a marked tendency for companies to report credit items in the income statements and debit items in earned surplus. In view of these abuses the APB restudied this problem and, in its Opinion No. 9 issued in December 1966, made mandatory the use of a substantially all-inclusive income statement. Compliance with this opinion will cause Item 17 of the regulation to fall into disuse and, in fact, we are planning to change this item to conform to Opinion No. 9 in another general revision of Regulation S-X which is in progress.

Opinion No. 9 has effected improvements in another area related to the income statement--the reporting of earnings per share. This figure has also been subject to much abuse in the past. In some instances it has been over-emphasized by separating it from the related earnings data and in other cases improper bases have been used in its calculation. The opinion deals with these situations by a strong recommendation that the figure be placed

on the income statement and by providing specific guidelines regarding the basis of the computation. The requirement to consider senior securities as residual securities in the computation in specified circumstances and the additional requirement for a proforma computation to reflect material potential dilution from convertible securities, options and warrants are particularly timely in view of the increased popularity of various kinds of hybrid securities today.

Although the investor is now getting better factual data regarding earnings per share, there is a question as to whether he is satisfied with anything less than a constantly increasing figure for earnings per share. Some companies, again in the conglomerate area, seem to be catering to this demand to an increasing degree. A recent decrease in the earnings rate of a pioneer conglomerate has evoked comments in the financial press to the effect that the conglomerates' claims of a constant increase through synergism and super-management may not be warranted after all. It appears very unlikely that investors can be satisfied in this respect all of the time.

In our current consideration of the problems related to the extension of reporting requirements to provide for more detailed disclosures on the operations of diversified companies we find an interrelationship with many other areas of accounting. As previously noted, objections similar to those we heard in the 1930's regarding showing sales or earnings have again been raised regarding such disclosures on a segmented basis. Comments have also been made that efforts now to obtain a "break-out" of data on the diversified companies seem contrary to the earlier movement toward more comprehensive consolidation procedures. We do not consider this to be a conflict, however. Rather, we believe that the over-all view of a company

as represented by the consolidated figures and a view of the important segments are significant and useful to the investor.

Some of the problems related to acquisitions and mergers have pertinence here also, since many of the companies commonly referred to as conglomerates have attained diversification through exchange of securities or by cash purchase of control of other companies in quite disparate lines of business. The quality of the reporting to stockholders has varied widely--from complete suppression of the success or failure of the acquired businesses to candid disclosure of the results of operations.

In Chairman Cohen's address to the financial analysts in May 1966, the problems of reporting on a segmented basis were recognized and he suggested that companies could develop methods appropriate to their conditions and define the basis on which the reports were presented--a defined operating profit. An application of this idea just recently came to my attention. In its 1966 report to stockholders a company described the operations of the various components as "continued to develop the establishment of a position of strong acceptance with the consumer," "operated at high levels of production capacity," "continued to increase its earnings," "made significant progress in their operations and in earnings," "did not perform satisfactorily," and a last and important element "was also unsatisfactory." From the fiscal 1967 report we learn that some figures which had been given at the previous annual meeting are now found in the text of the report itself accompanied by a table showing, for three major subdivisions of the business, two-year comparative figures for revenue, profit before selling and administrative expense, interest and taxes, and percent of total for 1967. From the consolidated statement of earnings it can be

seen that all expenses other than "cost of products, supplies and services" amount to about 11% of total costs and of revenues (because of the narrow margin of profit).

Another interesting report for fiscal 1967 for a company in a somewhat similar business reflects the effect of acquisitions during the year in a table showing the percentage of sales and earnings for five categories (four in 1966) by showing fiscal 1966 restated and not restated. These figures are on a "defined" basis--a sentence below the table disclosing that: "For simplicity, and to avoid arbitrary allocations, the foregoing statistics, in the case of sales, are before deducting inter-company sales (about $20 million in each year /total sales and operating revenues were about $1 billion each year/), and in the case of earnings, are before deducting Federal income taxes, interest costs, and expenses of the Chicago Executive Office." Interest and taxes total about $30 million in the consolidated statement of income but executive office expenses are not shown separately. The ten-year summary in this report is a good example of the retroactive restatement specified in APBO No. 10 to include results of operations and balance sheet items of pooled companies prior to acquisition. A footnote to the table reports Sales, Net Income and Net Income Per Share of the most recent four prior years without restatement for pooled companies. This method of reporting avoids the criticism from some quarters that retroactive combination is improper. In the prior year report the table did not reflect the retroactive restatements but a footnote provided the restated data.

Another well-known conglomerate also meets this problem in two ways. The Consolidated Statement of Earnings is in three columns--fiscal 1967 and fiscal 1966 After and Prior to adjustment for 1967 poolings. The

balance sheet for 1966 is only after adjustment. Highlights of Ten Years' Operations is not restated for poolings for years prior to acquisition but a table in the explanatory note reports restated Sales and Revenues, Net Earnings, and Earnings Per Share for four prior years. The Consolidated Statement of Earnings for five years in a recent prospectus for this company shows sales and service revenues as reported in the company's reports to stockholders to which is added the sales of businesses acquired in poolings of interest for years prior to acquisition, thus disclosing the growth of the company's volume by this means. Cost and expenses are on a restated basis but the net earnings so developed are reconciled to the amounts previously shown in the reports to stockholders.

These two examples raise the question of what financial disclosure an investor needs about a company that grows by the merger and acquisition route rather than internally. I have referred to paragraph 27 of Schedule A of the 1933 Act which calls for financial statements for companies acquired after the balance sheet date. To what extent is this principle applicable to annual reports to stockholders? Are the needs of prospective stockholders different from present holders of shares? These and other questions are being asked today as the merger movement continues at a rapid pace. Time does not permit an adequate discussion here of the history of the pooling of interests idea nor of the many variations that have developed in the past twenty years or so. Studies sponsored by the Accounting Principles Board suggest a thorough re-examination of this area of corporate reporting--a general conclusion which I share. However, I do not necessarily agree with the solutions proposed.

The problems of conglomerate reporting, as distinguished from the accounting methods followed in acquisitions and mergers, are being considered

currently by members of the accounting profession and by financial executives and security analysts as well as by the staff of the SEC. The Financial Executives Institute in particular has sponsored a very comprehensive research study with the aim of defining the problems and proposing recommendations for solutions. This project, which was conducted in close cooperation with all interested segments of the investment community and with us, is a good example of the "joint efforts" that we feel are most helpful to us in resolving a problem. A summary of the findings and recommendations of the study was recently issued, and Dr. Robert K. Mautz who directed the research has indicated that a complete report will be published within a few months.

The general thrust of the recommendations is that diversified companies should report the relative contribution by each materially different component to the income of the enterprise. Management should determine the bases for the breakdown within guidelines which are provided, and management should have discretion as to whether the data would be reported in the formal financial statements or elsewhere in the reports to stockholders.

The AICPA had previously issued an advisory statement recommending voluntary disclosure of supplemental financial information as to industry segments of a business, and many prominent professional men and business executives have also recommended this. Chairman Cohen has stated on many occasions that he believes that substantial progress can be made on a voluntary basis. And we have noted considerable improvement in this respect in reports to stockholders for 1966 as compared to 1965. We are hopeful that, in response to the concerted urgings for voluntary disclosures, improvements in the 1967 reports will be even more substantial, so that

any changes that may be necessary in our rules can be on a minimal basis for a minimum number of companies.

So far I have been discussing aspects of the content of the financial statements and provisions of the Securities Acts relating to certification by independent public accountants. This latter point needs some expansion. Above all else it seems to me that the investor needs confidence in the financial statements upon which he is asked to rely as an important factor in deciding whether to buy, sell or hold the securities.

The audit or attest function of the public accounting profession developed from this need for an independent, unbiased assurance of the fairness of the financial statements. Thus the requirement in the various acts that certification of the financial statements be by an independent accountant is a vital safeguard in securing full disclosure in the financial statements. The importance of an auditor's independence is stated in the following words in an auditing standard issued by the Committee on Auditing Procedure of the AICPA, ". . . he must be without bias with respect to the client under audit, since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be."

However, as important as the accountants are in certifying these financial statements, the impression should not be gained that the accountants bear the primary responsibility for them. That responsibility lies with management. In an early decision (In the Matter of Interstate Hosiery Mills, Inc.) the Commission cited a registrant's brief as making much of the confidence which the management "reasonably" reposed in the auditors but then said, "The fundamental and primary responsibility for the accuracy

of the information filed with the Commission and disseminated among investors rests upon management. Management does not discharge its obligations in this respect by the employment of independent public accountants, however reputable. Accountants' certificates are required not as a substitute for management's accounting of its stewardship, but as a check upon that accounting."

The requirement for certification of the financial statements was incorporated into the Securities Act as a result of testimony by a leading accountant of the day who must have convinced the Congress that the profession had reached a responsible stature in the business world and that the accountant's conscience could be depended upon to protect the investor.

Whether there is any connection or not, I find it interesting that A. P. Richardson's little book on "The Ethics of a Profession" was published under the auspices of the American Institute of Accountants in 1931 and that the Vawter Lectures at Northwestern University delivered in 1932 and published in 1933 were devoted to the "Ethical Problems of Modern Accountancy." The first lecture on "The Accountant and The Investor" was by George O. May. Twenty years earlier Sir Arthur Lowes Dickinson, another distinguished partner of Mr. May's firm, wrote "Accounting - Practice and Procedure" in which the final chapter discussed "The Duties and Responsibilities of the Public Accountant." This is a remarkable chapter in its discussion of topics with which we are struggling today. These include: period to be covered by prospectus - duty in selection is primarily to the investor; treatment of unusual profits or losses - should be eliminated or separately stated; fluctuations of profits - averages are taboo; results for broken periods - a warning against annualizing; interest, salaries,

depreciation and renewal in relation to or affecting profits; and finally a warning against estimates of anticipated economies and future earnings.

Despite the author's warning against projections, a paragraph containing a prediction warrants quotation as a closing observation pertinent today:

> "The main desire of some bankers has been to sell the stocks or bonds which they are offering to the public, and make a quick profit on the turnover. Their reputation and standing requires them to take every reasonable precaution to satisfy themselves that the investment they are offering is a thoroughly sound and reliable one; and while it is doubtful if letters from or facts supplied by the vendors are sufficient precautions, yet, as long as the public demands no more, there is no reason why bankers should offer more. In the meantime the natural bias of the promoter helps the banker with a favorable statement, and the verification by a public accountant might show a less favorable condition and diminish the banker's profit. It may be added that the neglect of such obvious precautions by the honest promoter makes the task of the dishonest one comparatively easy, and in the interests of commercial morality and for the better protection of the public it is interesting to note that a change is in progress in this respect, and that the certificate of a reputable public accountant is becoming a much more common feature in prospectuses, and will no doubt soon be as universal here as in Great Britain."

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