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THE SEC AND CORPORATE FINANCIAL DISCLOSURE: A VIEW FROM THE PRESS

Robert MIMS *

Robert Mims focuses on the major issues during the recent "era of corporate disclosure." While observing that the SEC's corporate financial mandates have served well in providing for the free flow of timely, accurate and useful information, the author argues that some of the same problems resurface regularly to hamper disclosure. Mims applauds the SEC's deference to the private sector in formulating accounting guidelines and he hopes for continued cooperation between the Commission and the financial press in furthering the goals of the disclosure system.

For those who cover the world of corporate finance and accounting in the business press, the words "Securities and Exchange Commission" immediately trigger the response "disclosure." In undertaking my assignment for this discussion paper, I took a nostalgic return trip through more than fifteen years of clippings from stories I had written for *Business Week*. While my stint at the magazine does not come close to spanning the history of this noted governmental agency and touches only a small part of its mandate, it does encompass what has undoubtedly been one of the SEC's most active, turbulent, and interesting periods – the years centering on the decade of the 1970s, which could be rightly termed "the new era of corporate financial disclosure." What follows are some observations on the key issues that were singled out for interpretation to our readers during a period that began with the booming go-go-stock days on Wall Street, coupled with a binge of litigation against accountants, and unwound in a roller coaster economic setting amid successive throes of inflation, stagflation, recession, and recovery. And just in case life got a little dull, there always were those around who continued to press for new interpretations of the age-old issue: Who should devise the rules for corporate financial accountability and how?

Taken together, my two main observations from my journey into the past are a paradox. In reviewing a decade and a half of problems, pronouncements, and assorted crises, I am struck by how far we have come in financial reporting. In the 1960s, a financial journalist who really did his or her job had

* Scoreboards Editor, *Business Week*.

to trek down to the SEC Library and pore over the 10-K report for clues to events that might sway a particular company's economic fortunes. Now it is a welcome relief to find much of the key data at one's immediate disposal in the annual report to shareholders. At the same time, many of the same problems still are with us – those that resurface with some regularity, albeit in new guises. For example, it took approximately ten years of actual effort (preceded, no doubt, by an equal number of years of mere talk) to get breakdowns of company sales and earnings by broad business lines [1]. I understand that there is now some thought about requiring the same kind of product-line data in quarterly reports. Of course, many of those who oppose this proposal were those who opposed any kind of required product-line revelations a decade ago.

Despite the frustrations with a system that may take ten years or more to effect such relatively simple, straightforward proposals, I think that we must applaud the SEC's early decision to look to the professional, nongovernmental sector for the major leadership in setting the nation's actual accounting rules, as well as its continued vigorous defense of that position. It may be an imperfect system but, like democracy, it is preferable to the alternatives [2]. Between the demands, on the one hand, of securities analysts, who would like every conveivable scrap of corporate data, and journalists, who want to have everything they want as soon as they weant it; and, on the other hand, corporate executives who would prefer to reveal absolutely nothing about company financial matters, there is a reasonable middle range of financial disclosure that works to the mutual benefit of all interested parties, including the public at large. In an atmosphere of creative tension, the SEC and its counterparts from business and the accounting profession together can point with pride to a stream of corporate disclosure procedures that have established and maintained U.S. financial reporting as the best on the globe.

The absence of fixed, uniform accounting principles can be irritating. Trying to compare the performance of a company that utilizes a LIFO inventory system with one that uses FIFO is problematic; so is trying to compare a company that uses accelerated depreciation for both tax and book reporting with a company that employs the straight-line method for shareholder reports. But the financial reporting system has been radically altered in less than twenty years so that better data are available. For example, annual reports to shareholders now contain essentially the same information as 10-K reports [3], quarterly breakdowns are made of sales, profits and income [4], audited balance sheets for the two mosts recent fiscal years must be furnished to securities holders [5], and minimal management analysis of financial condition must be included [6].

Yet despite the move toward greater disclosure, these rules and others have not been met with unqualified success. Particularly noteworthy were the Alphonse–Gaston gyrations in the middle 1970s between the SEC and the Financial Accounting Standards Board (FASB) over inflation accounting [7].

While siding with those who assert the superiority of some kind of replacement or current-value measurement for inventory and fixed assets [8], I believe that almost any attempt at inflation accounting is better than none at all. The controversy essentially confused and soured most of the business community toward the whole notion of accounting for changing prices. In addition, there was no inflation-accounting requirement in place at the very time inflation was beginning to soar. Only now, when no one is worrying much about inflation, are we beginning to get meaningful multi-year inflation-adjusted data. In hindsight, the public would have been far better served had the proposed and tested price-level method, or a vastly simplified version, been utilized immediately. Then the vast energy spent on all the debates about methodology and superiority could have been directed at some of the anomalies, such as the accounting in industries where prices actually were falling.

Despite the lessening of inflation in the past few years, I believe that inflation accounting is extremely important. What disturbs me is that almost no one else does. Inflation accounting has not been given a fair test; too little attention and imagination have been given to ways in which the new information can be used and interpreted. I have reviewed the data on changing prices for approximately 500 of the nation's largest corporations for the past five years. When one-third of that group fails to include the related historical-cost numbers alongside its five-year inflation-adjusted figures, thereby forcing readers to go to five or six other separate places in the annual report to make comparisons, then something is amiss in the disclosure system.

In addition to the dispute over inflation accounting, the confusion between the SEC and the FASB over oil and gas accounting was unfortunate [9]. The FASB badly underestimated the economic and political implications of the issue. This strained its relationship with the SEC at the very time both organizations were under considerable fire from critics. Neither group can afford a replay of such a scene in the years ahead.

Even though most of the recent attempts at greater disclosure have been welcomed, some of the SEC's actions are disturbing. It is difficult to understand the SEC's continual moves to encourage official corporate financial forecasts – particularly forecasts of future earnings [10]. No doubt the SEC believes that the public should have access to the informal forecasts that have always been available to securities analysts, but what happens when those forecasts begin to go awry? We at *Business Week* feel that once an official earnings projection is made, management will try to meet that projection, even if it means taking hasty year-end actions that could jeopardize the health of the company or, worse, manipulating the financial figures. Rather than encouraging corporate forecasts, we believe they should be discouraged [11].

Moreover, I also am quite skeptical about the SEC's recent blessing of the change in the way the nation's banks report their income. In an era when both corporate management and Wall Street traders tended to focus on earnings per share and were rewarded for spectacular short-term results, it was always instructive to point to banking as an industry that actually had two income numbers, one from operations and another that incorporated factors somewhat removed from the day-to-day operations, and to suggest that the rest of corporate America could benefit from such a dual income statement presentation. Alas, that example no longer is possible, at least until the FASB gets its financial statement revision project off the back burner. At a time when a close look at the health of bank earnings becomes more critical, it now is far harder to trace the sources of their reported annual or quarterly income. The change also makes it far easier for bank executives to "manage" earnings simply by timing the sale of securities.

In my area at *Business Week*, the dozen annual and quarterly scoreboards of corporate performance, my goal is to get relevant financial data to our readers as quickly as possible. One of the key factors that has enabled financial reporters to do a far beter job during the past decade has been the development of vastly improved quarterly financial reporting, including income statement data and more detailed balance sheet information. As a result, it is possible to update such things as debt positions, fixed-charge coverage ratios, current ratios, and net worth at any time during the year; it was not that long ago when we had to wait for an annual report. We also applaud the new efforts to add additional information to those quarterly reports [12].

For most users of financial reporting the demand is always for more immediate disclosure. In the 1970s, I recall difficulties in doing some halfway realistic financial analysis on Jimmy Ling's far-flung empire based upon his published reports. Often, by the time those documents were issued, he already had acquired a half dozen new companies, spun off a handful of other operations, and completely revamped the remaining financial structure. These days, far more stringent disclosure requirements, including more detailed quarterly filings, make a similar task much more manageable.

While I recall the welcome day it was in the late 1960s when the SEC turned to the private sector to provide more widespread and rapid access to its 10-K reports, many of us now eagerly await the next logical step in that chain: the dissemination of financial reports via electronic networks, and again apparently through nongovernmental means. In an age when more rapid communication is not only possible but demanded, I would urge the SEC to use this opportunity to shorten the deadlines for such filings. But fully as important as timeliness these days is the quality of financial reports. For the most part, we have a very good set of disclosure rules. The time has come to concentrate on the quality of the financial reports based on those regulations. I am delighted that the SEC recently has given top priority to the enforcement of existing disclosure requirements [13]. It is important for those who prepare documents to be continually reminded that someone out there does care about what is being presented and is taking a look at its fairness and completeness.

Staring down from my bookshelf is a light green 1,760-page tome entitled *The Accounting Establishment* (Metcalf Report) [14], issued almost eight years ago. In my opinion, this report represents the biggest wild goose chase that I have ever encountered in my journalistic career. It is not at all comforting to think that such a circus is about to begin again, orchestrated by some of the same instant experts and "professional" critics. Who knows what the effort will produce this time around? It is a little humbling to realize just how vulnerable a system for corporate financial reporting we do have. In addition, it serves as another example of how many of the issues in financial accountability are continually recycled.

Finally, as the SEC is in the midst of a new controversy concerning insider trading and the financial press [15], I cannot help but recall that one of my earliest introductions to the SEC came from coverage of the legendary *Texas Gulf Sulphur* case [16]. One wishes that the facts were such that produced clear-cut, black-and-white conclusions. But in this, as in many ground-breaking issues, there seem to be shades of gray. I can only hope that clarity rather than confusion comes from any legal decision and that the working relationship between the SEC and the financial press – generally an arms-length one of understanding and mutual respect for fifty years – does not become an adversary relationship. We both have too much interest in the broader concern for the widespread free flow of timely, accurate, and useful corporate financial information to allow that to occur.

Notes

[1] SEC Securities Act Rel. No. 5135, Adoption of Amendments to Forms S-1, S-9 and S-11 (Feb. 26, 1971); *see generally* Bus. Wk., Apr. 3, 1971, at 65.

[2] A prominent example of a less preferable alternative accounting system is the one suggested by the Senate Subcommittee on Reports, Accounting, and Management in the Metcalf Report. Staff of Senate Subcommittee on Reports, Accounting and Management of the Committee on Government Operations, 94th Cong., 2d Sess, The Accounting Establishment 20–25 (Comm. Print 1976) [hereinafter cited as the Accounting Establishment]. The Report sought sweeping governmental involvement of accounting and auditing rulemaking. Specifically, the Metcalf Report urged the establishment of accounting guidelines through government agencies. Private accounting firms would be specifically excluded from any involvement in the rulemaking process. The Report also called for legislation which would compel the largest CPA firms to issue financial and operational data statements. These firms would also be barred from any nonaccounting, management consulting functions. The Report further urged regulations which would force corporations to change their auditors on a periodic basis. *See also Accounting and Auditing Practices and Procedures: Hearings Before the Subcommittee on Reports, Accounting and Management,* 95th Cong., 1st Sess. 1–7 (1977) (statement of Senator Lee Metcalf, Subcomm. Chairman); Bus. Wk., Jan. 31, 1977 at 76.

[3] "The SEC ultimately deferred to the FASB, which has adopted a current cost accounting measurement for depreciation and cost of goods sold." Loss, Fundamentals of Securities Regulation 488 (1983); Whitney, *Disclosure in the Annual Report to Shareholders,* Fifth Annual Institute on Securities Regulation 105 (1974).

[4] Accounting Regulation S-K, 17 C.F.R. § 229.302 (1984).

[5] 17 C.F.R. § 240.14a-3(b)(1) (1984); 17 C.F.R. § 240.14c-3(a)(1) (1984).

[6] 17 C.F.R. § 240.14a-3(b)(5)(ii) (1984).

[7] Bus. Wk., Feb. 10, 1975, at 93; May 5, 1975, at 72; Aug. 9, 1976, at 52; *see also* Bus. Wk., Sept. 14, 1974, at 91; Oct. 26, 1977, at 109.

[8] The SEC ultimately deferred to the FASB which has adopted the current cost accounting system. SEC Accounting Series Rel. No. 271, Deletion of Requirement to Disclose Replacement Cost Information (Oct. 23, 1979). Previous to that release, the Commission had adopted the replacement cost method of inflation accounting. SEC Accounting Series Rel. No. 190, Notice of Adoption of Amendments to Regulation S-X Requiring Disclosure of Certain Replacement Cost Data (Mar. 23, 1976). For reports of replacement cost accounting, *see* Bus. Wk., Aug. 9, 1976, at 54; Dec. 27, 1976, at 71; June 20, 1977, at 85; Oct. 17, 1977, at 68; *See also* June 27, 1977, at 48 (current value accounting).

[9] *See* Bus. Wk., Feb. 9, 1976, at 81; Aug. 1, 1977, at 50; Oct. 10, 1977, at 41; *see generally* SEC Accounting Series Rel. No. 300, Accounting Changes by Oil and Gas Producers (Oct. 8, 1981).

[10] *See* Bus. Wk., July 27, 1974, at 60; Oct. 27, 1980, at 145; *see also* Loss, *supra* note 3, at 163–65.

[11] Bus. Wk., July 27, 1974, at 80 (editorial).

[12] *See* SEC Accounting Series Rel. No. 286, New Interim Financial Information Provisions and Revision of Form 10-Q for Quarterly Reporting (Feb. 9, 1981).

[13] 48 SEC Ann. Rep., at iii (1982).

[14] The Accounting Establishment, *supra* note 2.

[15] Most prominent in the controversy is the insider trading case involving R. Foster Winans, a former *Wall Street Journal* reporter convicted of passing insider information to investment brokers. United States v. Winans, 1985 Fed. Sec. L. Rep. (CCH) ¶ 92,085 (S.D.N.Y. June 24, 1985).

[16] Mitchell v. Texas Gulf Sulphur, 446 F.2d 90 (10th Cir.) *cert. denied,* 404 U.S. 1004 (1971).

Robert Mims is a Phi Beta Kappa graduate of the University of Texas at Austin with undergraduate and graduate degrees in journalism and English. He also holds an M.B.A. degree from Columbia University's Graduate School of Business. As Scoreboards Editor of *Business Week* magazine, he regularly tracks the financial performance of the nation's 1,200 largest publicly owned corporations. In the course of his 17-year career with the magazine, he has headed both that publication's finance and accounting sections and reported on significant issues involving the SEC and corporate disclosure.