REMARKS BY JAMES J. NEEDHAM, CHAIRMAN,
NEW YORK STOCK EXCHANGE, INC.
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CURRENT FINANCIAL REPORTING ISSUES

The prospect of speaking here today set me to reminiscing fondly about the good old days in public accounting. In those days, as you'll recall, the "third market" meant the increasing demand for management services on the part of clients. Those were the days, too, when fees were not particularly negotiable; and institutional membership, far from being an issue of the day, referred to membership in the American Institute.

We meet today in Bermuda where the climate may be said to exert a "sunny" influence on the economy. Unfortunately, this is in sharp contrast to the current reality in the United States where the climate overshadows a robust economy. Of course, the climate I have reference to, in general, stems from the seeming erosion of established and even sacred institutions, beliefs and values, in terms of the threat to the value of the dollar; the challenge to the Presidency; the need for controls in a peacetime, free enterprise economy; Vietnam; the Middle East tension; the "energy crisis," and the consequent uncertainty engendered by the rapid, accelerating and unsettling pace of these developments.

Today I would like to discuss the climate of financial reporting, which is not unrelated to the general climate, and what can be done to improve it.

One of the more striking aspects of the climate is that the volume of criticism of financial reporting continues at a high level. This criticism has certain implications which are both instructive and disturbing. Let us examine two of them.

Primarily, there seems to be a great concern, which is shared by many investors, that the financial statements do not convey sufficient, meaningful information to the investor. It is this feeling, incidentally, which may well account, in part, for the relative lack of participation of small investors in the securities markets at the present time. In short, at times the volume of criticism appears to exceed the volume of trading.

Recently the Exchange's annual estimate of shareownership in America showed a decline in the number of individuals who own stock -- the first such decline in more than twenty years. A top SEC official has, in fact, warned that the individual investor has acquired the status of an "endangered species." Marshall Armstrong characterized the problem in financial reporting, recently, as one of both reliable information and belief in its reliability.

The second implication one gleans from some of the criticism goes further but has much less validity.

We have all been shocked of late by a succession of scandals of varying magnitude. Some have speculated that these scandals herald a drastic decline in American morality which is mirrored in corporate financial reporting. I do not subscribe to this extreme view. However, we do find ourselves in a climate where, as we have seen, individual investors are described as endangered, where belief in the reliability of financial statements is at issue, and where Watergate and Equity Funding have recently exacerbated the credibility problem. If, on the one hand, we reject the notion of a drastic decline in morality, perhaps, on the other hand, this is an appropriate time for all of us to rededicate ourselves and our organizations to the highest

principles of conduct in personal and professional activities.

What can the accounting profession do in this connection?

There has been great emphasis of late on improving the mechanism for setting financial reporting standards and on defining the objectives of financial statements. This emphasis is appropriate and timely. However, another closely related problem which has not been given appropriate attention is that of enforcing existing standards.

The New York Stock Exchange's reply to the American Institute of CPA's Trueblood Group recommended that another equally prestigious Study Group be formed to study the whole enforcement issue. The proceedings of the last Seaview Symposium, on ethics and financial reporting, indicated a feeling on the part of some participants that an institutional vehicle of some sort was needed to address this problem.

Enforcement of financial reporting standards must, of necessity, start with the public accounting profession. Today, there is substantial room for improvement in the profession's enforcement activities. The status quo in this area is not acceptable. The public interest and the integrity of the profession are at issue.

The Exchange also recognizes an obligation here -- to provide the best markets possible and, at the same time, to provide guidance in an effort to achieve appropriate disclosure of material corporate information. As a part of this effort, the staff of the Exchange has circulated a "white paper" setting forth a number of recommendations for improved disclosures in reports to shareholders. I will have more to say about the "white paper" later.

A related obligation, in my view, is to point up specific financial reporting problems which are in need of resolution and to work with appropriate groups in resolving them. Historically, the Exchange, rather than issuing public pronouncements on accounting principles,

has preferred to work with the AICPA. We shall continue to work with the AICPA and the new Financial Accounting Standards Board.

The credibility of the FASB is critical to any effort to improve the climate of financial reporting. It is no secret that the Accounting Principles Board foundered in part as the result of political pressure. It is to be hoped that all concerned will strive to insulate the new standards' setting mechanism from unwarranted pressures. The investment credit and leasing debacles must not be repeated if the FASB is to function properly -- or, indeed, to survive.

Reginald Jones, Chairman of the Board of General Electric Co., recently stated:

> "We must recognize that the new Board will not be a cure-all for every ailment. We must recognize that with its first decision, the new Board is going to gore somebody's ox -- and that will be time for us to pull together -- not to splinter apart.
>
> "...let's not forget that if we falter, government stands ready to do for us what we can't do for ourselves."

What are some of the problems the FASB must come to grips with? A real problem affecting comparability of financial data and, ultimately, investor confidence has been the existence of alternative accounting principles which are all generally accepted. One has only to survey the financial statements for examples -- inventory, depreciation, deferred charges, and the like. A further complicating factor is the wide diversity of accounting practice within industries. It is clear that one of the mandates of the new FASB is to reduce the availability of alternative principles. Clearly, today, there is too much room for play in this area, too much maneuverability, and too much emphasis on keeping things that way. The Exchange and the APB have worked with selected industries in the past, and this would appear to be a good approach for the future as well.

Timing of income realization is a persistent problem which crops up all too frequently, particularly as new industries evolve. Modular housing, franchise accounting, retail land

accounting, real estate transactions generally, computer lessors, and the home study course area are recent examples of this phenomenon. The realization rules and their implementation require continued tightening and surveillance. The problem appears to be particularly acute where cash flow and accrual accounting income differ materially.

Carl Tietjen, partner of Price Waterhouse, touched on this theme in an article in the January 1973 CPA Journal, and I quote:

> "An important reason for the decline in credibility of financial reports during the past decade is the growing disparity between reported income and the underlying movement of cash...Some businessmen have updated the old adage to read 'Two birds in the bush are worth more than one in the hand.' Of course, profits on the two birds in the bush are recorded in the period in which they are first sighted." End of quote.

The matter of deferred charges is a problem area referred to in correspondence with the Exchange in the 1930s by George O. May, then a leading figure in the accounting profession. It remains a problem area today. In late 1972, then-SEC Chairman Casey noted that investors have been "shell-shocked by surprise writeoffs." In our experience at the Exchange, many such writeoffs have been the result, at least in part, of deferred charges.

Improved product-line reporting is a problem that is becoming widely recognized. Recently the FASB listed line-of-business reporting as a high priority topic. In an article in the December 1972 Financial Executive, Chuck Hornbostel, President of The Financial Executives Institute, asked:

> "Why can't business management make positive efforts to increase its disclosure voluntarily before we are forced to do so? ...The SEC has been urging companies to break down sales and income by divisions or segments. Despite this pressure - which has been going on for a number of years - only approximately half of the reports my colleague studied contain this information. The SEC, especially, has leaned over backwards to keep from establishing detailed rules for segmented disclosure and has repeatedly asked industry to develop its own definitions and standards for such disclosure. Why can't we do this?

We, at the Exchange, also wonder why.

There are, of course, other problems whose resolution would improve the climate. I have reference to leases and materiality which, I might add, the FASB has on its initial agenda: liquidity; business combinations; extractive and real estate industries accounting; accounting for marketable securities; "slow" depreciation accounting in technology industries; depreciation generally; inventories; and certainly, interim reporting.

Writing footnotes in simple English rather than "accountantese" would be a major breakthrough. Presently, and ironically, accountants are chided for the obscure way in which they write -- by, of all people, lawyers! It seems to me that simplicity, to the extent feasible, and understandability, as a bare minimum, should be prime objectives of good financial reporting. Poorly written footnotes can be misleading and can raise serious credibility questions.

United States investors are acknowledged to be the best-informed in the world. Yet, the quality of current financial information, as we have noted, has been criticized in many quarters. A credibility gap of no mean proportions has arisen between preparers of financial information and consumers. This state of affairs has obvious implications for the New York Stock Exchange and its listed companies.

Annual and quarterly earnings reports exert a profound effect on the Exchange marketplace. If their credibility is at issue or if their calibre is not of the highest, the Exchange mechanism is affected adversely. In an even broader perspective, proper allocation of resources and a smoothly functioning economy depend in large measure on the reliability of such reports. Anything that can contribute to their calibre and credibility is thus of great significance to investors and citizens. Other organizations are addressing aspects of the credibility problem and we applaud and support their efforts. The Exchange, however, is uniquely qualified by long experience and familiarity with the needs of the marketplace, is uniquely affected by the

credibility question, and has a responsibility to address the problem.

The Exchange, in cooperation with listed companies, has worked for many years to foster a continuous, evolutionary improvement in financial reporting and disclosure. It is now necessary to accept the challenge of the times and to pursue, with renewed vigor, excellence in financial reporting and disclosure.

I referred earlier to the Exchange's "white paper" on financial reporting and disclosure which will be mailed to each listed company. It would seem that certain of the recommendations included in this paper, if implemented generally, would improve the climate we have been exploring.

For example, all available evidence suggests that formation of a Corporate Audit Committee, composed of qualified outside directors, contributes to the objectivity and credibility of corporate financial reports and supports the independence of outside auditors. Specific functions of such a committee may vary but commonly include recommending the selection of auditors, reviewing the adequacy of internal controls, reviewing the company's accounting principles and practices, and reviewing the scope and results of the audit.

Audit committee review normally includes assessment of the accounting principles of the company as compared with those of the industry -- whether such principles are conservative or liberal, whether the company is employing preferable methods, and what audit adjustments have been proposed and adopted in the course of the audit.

Today there is a great emphasis on a market standard which is referred to as the "quality of earnings." The term implies going beyond the standard auditor's certificate to assess the source and probability of recurrence of net income. Where a company is perceived as consistently adopting the most liberal accounting methods or consistently disclosing less

information than necessary for evaluation of key accounting practices -- a penalty is invariably levied by the market in terms of a sharply lowered price-earnings ratio. A conscientious Audit Committee review, of the type discussed, can probably do much to avoid such an occurrence.

We have recommended that a minimum of three outside directors be included on the Board of a listed company -- in recognition of the benefits that accrue from outside representation and in order to facilitate our recommendation on audit committees. As you know, the Exchange has followed its own advice -- 10 of the 21 members of our Board are now outside directors.

Certain information filed with the SEC should be included in the annual report to shareholders. I am thinking, specifically, of line-of-business reporting, information relative to conflicts of interest, five-year debt maturities and five-year summaries of earnings.

Financial highlights, president's letters, five-year summaries and other statistical data should be consistent with audited financial information. I believe that the auditor should be concerned, in the public interest, where this is not the case.

The Exchange's draft white paper also contains recommendations for a "variance analysis" or comparison of operations of the current versus the prior year, disclosure of significant details of deferred charges, and disclosure relative to material reserves.

Two rather simple but potentially quite useful recommendations have recently been added to the draft white paper:

First, there would appear to be great merit in providing investors with additional information relative to their present or potential investments. A "Summary of Market Performance" in proximity to the five-year summary of earnings could provide valuable information to many investors. Such a five-year summary would include the common stock

price range, the price-earnings ratio range, dividends and book value for each year of the summary.

Second, in many cases the relationships between common stock, warrants and convertible debt and equity are unclear even to experienced investors. Where this situation pertains, the relative values of outstanding securities are not reflected in the marketplace. This is clearly not in the interests of the issuing company or investors.

To address this situation, we will recommend a table or descriptive paragraph in proximity to the five-year summary, setting forth the relationships between convertible securities, warrants and common stock, in terms of market value of underlying common, expiration date, market price of convertible security or warrant where applicable, number of shares of common receivable on conversion, conversion costs and similar information tailored to individual companies' capital structures.

In view of their great impact on the market, it would seem appropriate for quarterly reports to be mailed to shareholders. Also, bearing in mind such impact, it would appear desirable for listed companies to consult with their independent auditors prior to publication of the quarterly report. Such consultation might include discussion of the company's progress since the annual report or last interim report, new reporting problems and their resolution, and an up-date on the status of issues discussed in connection with the most recent annual audit.

Today there is general agreement on the merit of full disclosure. One aspect of this is clearly what to disclose -- which various groups are addressing. The other question is how to make disclosures readily available to investors. This question has caused me great concern of late. The difficulty is the lack of ready access to the myriad information "publicly" released. This includes annual reports, 10-K's, prospectuses, quarterly reports and 10-Q's, listing

applications, recent company press releases, etc. Leaving aside the question of equal access to inside information, it would seem that everyone should have equal access to public information at minimal cost and effort. This is an ideal we must strive for if full disclosure is truly to be achieved.

If, at times, we are critical of financial reporting, and if, at times, we are critical of the accounting profession, it would seem that we should be equally critical of the environment in which the accounting profession finds itself. Here, too, there is room for improvement.

In this connection, it seems to me that the unreasonable liability exposure of accountants must be dealt with since, in my view, this factor contributes to the climate we have described. The public interest demands that an appropriate level of liability exposure be maintained. On the other hand, it would seem necessary to limit liability exposure to levels that permit the accounting profession to respond to the evolving needs of investors and that assure a viable, attractive accounting profession.

I have covered a good deal of territory today. Most importantly, I have tried to convey the Exchange's views, concerns, and efforts to improve the current financial reporting climate. It is clear that no one has all the answers. The private and public sectors must work together. No one group or organization can do the job alone. The New York Stock Exchange is prepared to do its part to help improve the climate. We look forward to working with the accounting profession, the FASB, and other regulatory bodies, in this most important endeavor.

Thank you.