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ANNUAL REPORTS: MORE THAN PRETTY PICTURES?

An Address By

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Securities and Exchange Commission

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The Securities Act of 1933, which was the first federal securities legislation of general applicability, was bottomed on a basic conviction: that fundamental to a sound securities market and securities system was honesty in the market place. In the context of the 1933 Act this meant that issuers and controlling persons distributing substantial amounts of securities would be compelled to tell the truth, the whole truth and nothing but the truth, accurately and fairly about the company. The evidences in 1933 were that during the 20's one of the major abuses of the market place was the distribution of securities on the basis of very meager information which was frequently down-right false. If you look back at the offering circulars of the pre-1933 days you will be astonished at their brevity, ambiguity, absence of candor. It was not uncommon for offerings of many millions of dollars to be by the means of a single sheet which did little more than identify the name of the issuer, the name of the security and the amount being offered--in many cases they were not unlike our present "tombstone" ads. On the basis of these "flyers" millions of dollars were committed by the American public and in retrospect it is clear they were the victims of misrepresentations and omissions of a gigantic order.

To remedy this evil in the distribution of securities the Securities Act of 1933 was adopted. It has sometimes been called the "rotten egg" statute because its theory is that it is perfectly alright to sell rotten

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eggs to the public as long as you say clearly that they are rotten - and perhaps tell why and how they became rotten (parenthetically one of our problems at the Commission is that rotten eggs continue to be sold with disclosures often suggesting that they are truly golden geese eggs).

This underlying commitment to disclosure has remained for 40 years a touchstone of the federal system. Through that 40 years a steady succession of Commissioners and staff people have wrestled with the problem of making disclosures better, higher in quality, more meaningful, more understandable and useful. At the same time there has been continuing concern over the means of getting this information into the hands of those who can use it -- not only analysts and professionals, but the ordinary, traditionally designated, "Aunt Jane" investor.

We are in the midst, I think, of what should be a healthy re-examination of this basic premise. Questions are being raised concerning the validity of this disclosure philosophy and the tools of the economist are being used to establish that in truth the considerable expenditures in the cause of disclosure yield no discernible benefit to the investor. Others use less mathematically oriented techniques and conclude that through simple observation of the investment process it is evident that disclosure has meant little - or if perhaps it once did, it no longer does. They suggest that fundamental analysis, which is obviously thoroughly dependent upon the availability of extensive and accurate information, is not as useful as an investment tool as the "random walk" or the focus of attention upon industries, with only secondary concern with the individual companies within the industries.

It is not my purpose today to engage in extensive debate with the critics of disclosure. I have done that recently and I am not so vain as to believe that my arguments have tipped the scale decisively in favor of disclosure.

I will say, though, that notwithstanding these criticisms, the Commission's commitment is plain and the continued direction of its effort is to make important information available as broadly and usefully as it can.

This effort is taking many forms. As many of you probably know the Commission for the past two or three years has been engaged in an extensive effort to revamp and update many of the forms which are required to be filed with the Commission. There is an effort to better mesh these forms and there is concern over the extent to which there may be duplication. Furthermore, anyone who has been a close observer of the activities of the Office of the Chief Accountant of the Commission knows that he, with the support of the Commission, is agressively moving to require financial statements to contain more and more information that may be useful to investors. For instance, the Commission recently adopted revised proposals for disclosure in footnotes of information concerning the capitalized value of financing leases and the impact on income which would derive from such capitalization. And the Commission recently republished for public comment revised proposals calling for increased disclosures of significant accounting policies and the impact of these policies on financial statements. I might note something that may have escaped your attention in the notice accompanying that proposed rule change. To the best of my knowledge, for the first time the Commission has recognized that some of the information mandated by it may be of utility only to professionals and skilled analysts

and might be beyond the ability of the ordinary investor to comprehend. Lest you think this represents a complete turn around, I should add that there is pending a proposal calling for revisions to the Guides for Preparation and Filing of Registration Statements to require an introductory narrative explanation of the Summaries of Earnings and Operations whenever clarification is needed to enable investors to appraise the quality of earnings. The proposal calls for management's analysis of the material changes in the amount and source of revenues and expenses as well as changes in accounting principles or methods or their application that have a material effect on the comparability of net income. This is an effort to afford individual investors a better opportunity to understand the significance of what lies in the figures.

It seems to me that in its efforts to provide access by investors to disclosures mandated by our federal system the Commission has been much too diffident in approaching the annual report. I think all of us recognize that the annual report has become on the American corporate scene a distinctive and rather impressive art form. Not only is it a purveyer of information, but to some extent it is the mirror of management and management's mood of the moment. When profits have been sparse, the annual report will often take on a somewhat spartan appearance. In days of surging profits the annual report will become the very symbol of that prosperity. One need only recall the report issued by one of the conglomerates on the eve of its fall from market favor: the cover was a transparency reminiscent of medieval windows and a large part of the contents was an expression of the management's rather abstract philosophy.

These documents are not cheap. It has been estimated the cost may run more than a dollar a copy. The uses of annual reports are many in addition to communication with shareholders: they may be used to impress suppliers, customers, bankers; they may be used as recruiting mechanisms to secure employees; and sometimes I suppose they are useful to demonstrate to management the creativeness of the company's public relations department.

Notwithstanding their versatility the first and main purpose of the annual report is still to report to the shareholders and I would suggest that a secondary purpose is to inform the securities markets as a whole. You and I know that if we walked into a broker's office tomorrow and asked for information about a company the representative is not likely to pull out of the firm files the last Form 10-K or the most recent Form 8-K. Conceivably he may pluck out a proxy statement. But in all likelihood he will find in the file the annual report of the company and very frequently the judgment he reaches with regard to that security will be based upon the contents of that annual report. Now understand, I am not saying that it is good that the advice of securities dealers be based upon annual reports and not upon filed documents. I am not saying it is a complete satisfaction of his responsibility if he bases recommendations on the annual report. What I am saying, and I think this is accurate reporting, is that the prime source of information in the market place concerning issuers is the annual report.

If that is true, then it may be that some of the efforts of the Commission to get information into the market place have not been as successful as originally hoped for. For example, the so-called "microfiche" program under which for a relatively modest sum anyone can secure reproductions of formal Commission filings, has been useful to those who

know of it and use it. But those users represent a limited band of people. I doubt that the average individual investor is even aware of the existence of this program.

As I mentioned a few moments ago, the Commission has been diffident about the annual report and it has tampered with its contents hesitantly and mainly with a touch-up brush.

The annual report to shareholders has never been required to be "filed" with the Commission in the sense that would expose the authors of its deficiencies to liability under Section 18 of the Securities Exchange Act of 1934. It has never been required to be filed in advance of distribution for review by the Commission's staff in the manner in which proxy material must be filed in advance. The Commission has done very little in the way of enforcement activity with regard to the contents of the annual report. In a few isolated instances it has taken cognizance of deficiencies in annual reports and taken action, but for the most part that action has been infrequent and relatively mild as far as consequences.

I would suggest that in some measure this has been a reflection of the Commission's concern with the absence of any explicit power accorded it to deal with the annual report. This concern has, I believe, blended with a broader concern over the possibility of charges that, by injecting itself more actively into the contents of annual reports, the Commission would be infringing upon freedom of speech. It has been said that the annual report is the "last uncensored opportunity of the company president to speak to his shareholders" and I would suggest that the Commission has been hesitant to open itself to the charge that perhaps it had achieved a totality of of oversight with regard to corporate communications with shareholders.

In 1942 the Commission published for comment rules which would have made the annual report a more explicit part of the proxy solicitation process and necessitated the filing by registrants of annual reports in advance of use; it was contemplated in these proposals that there would be some advance review of the contents of annual reports and they would be regarded as "filed" under the 1934 Act. The proposed extensions of the proxy rules, of which this proposal was a part, met with considerable gun-fire from Congress and as a result the rules were withdrawn. However, it should be noted that Congress did not appear to raise any question concerning the power of the Commission to extend its control of the contents of the annual report in the manner proposed and it does not appear there were any real misgivings on the part of the then Commission at that time in so doing.

At the present time the requirements with regard to the annual report are indeed small. A company which is a "reporting" company, that is, a company listed on a registered securities exchange or a company whose securities are traded over the counter and which has 500 holders of a class of equity securities and a million dollars of assets must furnish an annual report to its shareholders not later than the date upon which it sends its proxy statement for the annual meeting. At the same time copies of the annual report must be mailed to the Commission. These annual reports are not systematically examined by members of the staff and for the most part are placed in the public reference file with regard to the issuer for examination by the public and staff when occasion arises.

As far as contents are concerned the requirements are indeed meager. The annual report must contain a certified balance sheet as of the

conclusion of the most recent fiscal year together with certified income statements for the two years then ended (it was only in 1967 that the second year had to be included). It is required that these financial statements be prepared on the same basis as those which appear in the company's Form 10-K unless there is explanation as to the divergences and the reasons for them. In addition, in the first annual report issued after a company becomes a reporting company it is required to set forth a brief description of its business.

The few detailed mandates with regards to contents of annual reports, however, do not exhaust the Commission's powers over the contents of annual reports. Most of you are, I am sure, familar with Rule 10b-5 which was adopted in 1942 under the Securities Exchange Act of 1934 and which has been a remarkable yeast in the rising and development of the federal securities law. The Commission has power to bring civil actions and recommend criminal prosecution with respect to a vast variety of misconduct proscribed by Rule 10b-5. In addition, federal courts have universally recognized the Rule as a basis for civil actions by private parties. Unquestionably the Commission's power includes the power to institute an action based upon an annual report that contains a misstatement of a material fact or which omits a statement necessary in order to make the statements made not misleading. As I mentioned earlier, the Commission has been very restrained in its exercise of its power under Rule 10b-5 in matters involving annual reports, but nonetheless there is a clear power there to deal with abuses involving them.

A consequence of the Commission hesitancy in developing more explicit standards with regard to the contents of annual reports has been serious deficiencies in the annual reports as means of communicating adequate

information in an accurate fashion to shareholders and the investment community. As one example, in 1969 the Commission adopted amendments to some of its registration forms to require each reporting corporation which had more than one line of business to include sales and profit breakdowns by lines of business. This requirement was extended to the Form 10-K in 1970. The amendments to the forms set forth with some particularity the rules governing the manner of breakdown, the means by which the determination would be made and other specifications of the requirement. It was the hope not only of the Commission but of the accounting profession and leaders among financial executives that these amendments to the forms would lead to similar information being incorporated in annual reports. Fairness requires disclosure that, indeed, in each year since then a larger proportion of reporting companies which have multiple lines of businesses have included information beyond that previously available concerning the sales and, in some cases, profits of lines of business. However,a recent survey disclosed that in a random sampling of 70 multi-line companies which detailed earnings by product or line of business in the Form 10-K, only 45 broke them down in the annual report to shareholders and only 33 of the breakdowns were similar in both the Forms 10-K and the annual report.

Beyond that particular instance, comparisons of the Form 10-Ks of companies and their annual reports to shareholders indicate a number of discrepancies in content and,more important,in candor. While the financial statements in annual reports as has been indicated must conform with those contained in the Form 10-K (or else the differences must be explained), nonetheless the veracity of the financial statements is compromised in many instances by charts, graphs and other expositions of financial information that frequently give a picture significantly different

from that contained in the financial statements. Human nature being what it is, most of us are more prone to pore over graphs and charts, frequently embellished with color and other visual devices, than we are over the sterile numbers in an income statement. Furthermore, in many instances the stark realities of the certified statements contained in annual reports are dulled,if not nullified, by the glowing language of the president's letter.

All has not been a bleak desert, however, with annual reports. Many companies have made a sincere effort to upgrade the informational quality of the annual reports and in some instances companies have sent their Form 10-Ks to shareholders along with graphically somewhat more exciting annual reports; Winnebago Industries has followed this policy since 1971 and in 1973 bound it with the annual report. In other instances companies have invited shareholders to write for the 10-K. Furthermore, I think there has been throughout the corporate community a greater respect for the mandates of disclosure. This is probably derived from two principal sources. One has been an increasing concern felt by corporate managements because of nudgings of their counsel about the consequences under Rule 10b-5 of any corporate originated misstatements or omissions that find their way into the market place. Ever since the Texas Gulf Sulphur case made it unmistakably clear that the "in connection with the purchase or sale of securities" requirement of Rule 10b-5 could be satisfied simply by the existence of a trading market, counsel for publicly held companies have felt keenly the risk of monumental liabilities if corporations made publicly misstatements or failed to make statements necessary to avoid half truths. A second source of increased candor in annual reports, I think, is a growing realization on the part of corporate management that full and candid disclosure to shareholders and the investment community is good

business and that analysts today are sophisticated and quick to recognize (and penalize severely) any phoniness in corporate disclosures.

Having said this, however, I think there is still a significant job for the Commission to do. Too many managements find short run advantage in failing to be candid or in some cases even truthful. While, as I suggest, it can be demonstrated this is not to the long run advantage of the corporation or its shareholders or its management, nonetheless there will always be short term opportunists. Furthermore, I think that even the company which has a policy of fair and frank and complete disclosure would nonetheless appreciate a greater measure of guidance from the Commission as to what is expected with regard to corporate disclosure in the annual report to shareholders.

There has been considerable discussion of the means by which the annual report might be "sanitized". In 1972 the Commission proposed a rule which would require issuers to identify in the Form 10-K those portions of the 10-K not included in the annual report to shareholders. This was followed by a suggestion by former Chairman Casey that the annual report to shareholders contain information identifying those portions of the Form 10-K not included in the annual report, thus hopefully alerting readers to the availability of additional information. In 1972 former Chairman Casey appointed an Advisory Committee for Industrial Issuers (of which I was a member) to make recommendations with regard to the disclosure pattern as it affected industrial issuers. The principal thrust of this report, I think it is fair to say, was the annual report and this committee, composed of a number of lawyers and industrial leaders, as well as investment bankers and accountants, made a series of recommendations with respect to the contents of annual reports.

These recommendations called for the inclusion of the following:

- A brief description of the business which would indicate, in the opinion of management, the general nature and scope of the business;
- line of business disclosures consistent with those in Form 10-K;
- a five-year summary of earnings consistent with Item 2 of Form 10-K;
- explanatory comment on material changes in financial condition and results of operations in the past year, as well as on material non-recurring items;
- identification of principal executive officers and directors and, in the case of "outside" directors, the principal business or professional affiliation of each; comment on significant changes in management or control;
- If not adequately covered in footnotes to the financial statements, disclosure in the text of the report of principal accounting policies and changes in those policies.

The Advisory Committee also recommended that Rules 14a-3 and 14c-3 should be amended to provide that no financial summary of financial information or a comparison of the results of operations or other material financial information,whether it be in a chart, graph, "financial highlights" section or otherwise,shall be presented in a light either more or less favorable than the financial statements included in the report.

In addition to this activity, it is expected that shortly the New York Stock Exchange will publish a "white paper" which will address itself to,among other things,the annual report and will make recommendations for the contents of such reports. Obviously these recommendations are directly

applicable only to companies listed on the New York Stock Exchange, but it is hoped that perhaps they may also provide guidelines for non-NYSE companies in framing their own policies with respect to the annual report.

It is the sad fact that virtually every proposal for enhancing the quality of disclosure or the breadth of its dissemination has been met with critical cries. This is a tradition that goes back to the days when the Securities Act of 1933 was under consideration and I can assure you that, having sat at 500 North Capitol Street for the last two and a half months, the tradition continues strong. Thus I am sure that any proposals for detailing the information to be included in annual reports will be met with outcries, suggestions that we are trying to make annual reports into propectuses, complaints about the additional expense and not a few emotional outbursts against the burgeoning federal bureaucracy. However, forty years of experience, I think, establishes that once industry has attuned itself to new disclosure requirements, they rest lightly and become another part of corporate routine. And I am sure that new specifications in regard to the contents of annual reports would have a similar result.

I think the Commission should face anew the problem of the annual report. I do not believe that it should be filed in advance of its circulation and I do not believe that it should be written as if it were a prospectus. I recognize fully the stultifying nature (not to mention the soporific effect) of much of the prospectus language and I for one would abhor the introduction of this literary style into annual reports. I do not believe that expanded Commission requirements about what must be in the annual reports or the other proposals that I set forth below will necessarily have this result. I think annual reports can retain their artistic splendor, their literary style, their appeal to the reader and their over all attractiveness while

doing a better job of communicating with shareholders and the investment community.

I would purpose the following:

1. The Commission should adopt substantially all, if not all, of the recommendations of the Advisory Committee on Industrial Issuers and mandate the inclusion in annual reports of the information suggested by that group. I would go further and suggest that the Commission staff examine the disclosure requirements of the Form 10-K and determine whether there is additional information contained in that document which should be given the wide circulation afforded by annual reports. I think the means by which issuers incorporate this information in the annual report should be reasonably flexible. If they choose to incorporate it as an appendix following the financial statements, I would suggest that perhaps that should be permitted, provided there was appropriate indication in the forepart of the annual report that such information did appear at the back of the book. If a company choose to reprint in haec verba parts of the 10-K as an appendix of the annual report that, too, I think should be acceptable. To repeat, I think a great deal of latitude should be afforded issuers with respect to the manner in which this additional information is incorporated into the report.

2. The Commission staff should make a greater effort to examine annual reports after they are submitted to the Commission to determine their quality, the extent to which they are being upgraded, their relaibility, and their effectiveness as communicators of corporate information. It is probable that we would have to develop standards for making these evaluations, but I would think that could be readily done.

3. I would suggest that cases in which it appears management has sought to mislead its shareholders and the investment community be referred to our Division of Enforcement for appropriate action. The Commission has been vigorous in enforcing honesty in the markets in other respects; I think in this most important area its efforts should be strengthened.

4. I would suggest that the Commission consider the adoption of a rule which would require that issuers announce to their shareholders the availability of copies of Forms 10-K and 8-K and furnish them without charge to such shareholders as request them. We might also consider the possibility of requiring that copies of such forms be furnished to persons other than shareholders upon payment of a charge sufficient to defray the expense of reproduction and mailing. Discussions with corporate executives would seem to indicate this would not be unduly burdensome or expensive.

Finally, I would urge all of you and the others who are involved in the process of preparing annual reports to take a fresh look at those documents. Judge them not by whether they are artistically attractive, whether the pictures are pretty or the text colorful, but judge them as to whether as a whole they convey honestly and candidly the truth about the issuer - the optimistic and the pessimistic, the good and the bad. To the extent that businessmen and their advisors accomplish an effective and honest job of disclosure voluntarily, the less heavy will be the hand of regulation.