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**News
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Remarks of

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SEC DISCLOSURE ISSUES: BREAKING NEW GROUND

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

I. Introduction

It is a great pleasure to address the annual meeting of the National Association of Corporate Treasurers. As Treasurers and Chief Financial Officers of many of America's leading corporations, you undoubtedly recognize the importance of meaningful corporate financial disclosure to the health of our capital markets. My remarks today, entitled "SEC Disclosure Issues: Breaking New Ground," deal with several disclosure areas that may be of interest to you.

Given the tremendous changes taking place in today's markets for corporate securities, the Commission is continually reassessing the disclosure obligations it imposes on corporate issuers. The Commission's rules and regulations are constantly being reevaluated and updated, and since accounting standards play a crucial role in the quality of corporate disclosure, the Commission is vitally concerned with changes and proposed changes in the accounting area.

Several major disclosure issues facing the Commission today break new ground. In this talk, I will identify and discuss briefly issues regarding: management's discussion and analysis, standard setting by the Financial Accounting Standards Board, management reports, timely review of quarterly financial information, and international disclosure initiatives.

II. Management's Discussion and Analysis

As you know, full financial disclosure includes not only the content of financial statements, 1/ but other components as well. The narrative information contained in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) 2/ and required to be disclosed at least quarterly 3/ is especially important to investor evaluation of a company's performance. As the Commission has noted in the past, "MD&A is intended to give the investor an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company." 4/ The MD&A item calls upon management to discuss the dynamics of the business as well as to analyze the financials.

In the past few years, the Commission has focused both on the adequacy of current MD&A requirements, and on the degree of compliance with those requirements. In 1987, the Commission issued a concept release 5/ concerning the adequacy of the MD&A requirements and the costs and benefits of certain proposals made by some members of the accounting profession relating to

1/ See Subpart 300 of Regulation S-K, 17 CFR 229.300.

2/ Item 303 of Regulation S-K, 17 CFR 229.303.

3/ See Part I, Item 2 of Form 10-Q.

4/ Securities Act Release No. 6711 (April 24, 1987) [52 FR 13715, at 13717].

5/ Securities Act Release No. 6711, supra n.4.

MD&A. In early 1988, the staff of the Commission's Division of Corporation Finance began to assess the adequacy of MD&A disclosures in order to identify common areas of deficiency. The first phase of that project has been completed, the second phase is close to completion, and a third phase has been launched.

For each of the 359 companies involved in the first two phases, a full review was given to the most recent 10-K and subsequent reports. Of these 359 companies, 124 have filed amendments in response to staff comments, more than one-half of which substantively expanded MD&A. Seven referrals also were made to the Division of Enforcement. In general, the review has suggested that there is a great deal of room for improvement in MD&A disclosures.

Next week the Commission will consider whether to provide guidance on MD&A, by issuing an interpretative release. The release will address several general topics and some specific matters. By way of anticipating some of the general topics that may be covered, let me pose some questions.

1. What disclosure duty exists when a trend, demand, commitment, event or uncertainty is both presently known to management and reasonably likely to have material effects on the company's financial condition or results of operations?
2. What should be contained in discussions of liquidity and capital resources, both short and long term?

3. What detail is required in disclosure regarding material year-to-year changes in line items?
4. What material changes regarding interim periods must be disclosed?

In addition to the general topics, the release is likely to focus on several specific areas of current importance. As the Commission has indicated in Congressional testimony, substantial concerns exist regarding risks relating to highly leveraged loans and investments, sometimes involving so-called less than investment grade or "junk" bonds. ^{6/} Greater risks may be associated with participation in highly leveraged loans and investments, and MD&A disclosure regarding relevant lending and investment policies, the amount and type of holdings, and the potential risks inherent in such holdings may be required.

Another focus of the release is likely to be preliminary merger negotiations. The MD&A item could be read literally to impose a duty to disclose merger negotiations as known events or uncertainties reasonably likely to have material effects on future financial condition or results of operations. In contrast, the Commission has indicated its awareness that premature disclosure may jeopardize completion of an

^{6/} Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the House Committee on Ways and Means concerning Leveraged Buyouts, January 31, 1989, at 54-57.

acquisition. These potentially conflicting positions are likely to be addressed in the MD&A release.

III. Current Financial Accounting Standards Board Issues

Underlying the MD&A, of course, are the registrant's financial statements. While the Securities Act of 1933 gave the Commission the authority to prescribe accounting standards to be followed in the preparation of the financial statements of reporting companies, the Commission has looked to the private sector, particularly to the Financial Accounting Standards Board (the FASB), to help establish those standards. The Commission actively oversees the work of the FASB by closely monitoring the development of new standards and by addressing the subsequent implementation and interpretation of the standards.

Last year, the business community raised criticisms regarding the FASB's structure, deliberative process, and responsiveness to the business community. In response to the expressed concerns, FASB's parent organization, the Financial Accounting Foundation, established a Special Advisory Group to assess these concerns. That group's report concludes that "the structure for private sector standard-setting is sound" but that "certain refinements may serve to further strengthen" that process. ^{1/} I agree that some changes may be needed, but I share the Advisory Group's view that "nothing should be done to

^{1/} Report of Special Advisory Group, To the Board of Trustees Financial Accounting Foundation (March 1989), at 1.

impair, in fact or perception, the independence and objectivity of the FASB." 8/

Of course, concern regarding the FASB did not arise in a vacuum. Two matters in particular have caused intense corporate concern: 1) disclosures regarding financial instruments, and 2) accounting for post-retirement benefits, such as health care.

The financial instruments project was prompted by a specific request from the SEC that the FASB address accounting and disclosure issues related to complex instruments such as repurchase and reverse repurchase agreements, 9/ collateralized mortgage obligations, financial guarantees, interest rate swaps, common stocks with put features, and loan strips. The Commission was concerned about the accounting treatment of and adequacy of disclosure about the nature, extent, and impact of these instruments.

As expected, the issue has proved to be extremely complex. The phase one exposure draft 10/ dealing with disclosure met considerable opposition. Critics argued that the proposed

8/ See Remarks of David S. Ruder, Chairman, United States Securities and Exchange Commission, Before the AICPA Sixteenth National Conference on Current SEC Developments, January 10, 1989.

9/ Also known as "repos" and "reverse repos."

10/ Exposure Draft, Proposed Statement of Financial Accounting Standards, Disclosures about Financial Instruments, Financial Accounting Standards Board, November 30, 1987.

disclosures were too complex, too difficult to prepare, and of questionable value to the users of financial statements. In response to those concerns, the FASB has been conducting research regarding alternative disclosures and has appointed a twenty member task force to assist in all phases of the financial instruments project. A narrowed disclosure approach focusing on off balance sheet financing is being pursued in this phase of the project.

Recognition and measurement issues are being considered in phase two of the project. The FASB is attempting to use a fundamental financial instruments approach, based on the premise that all financial instruments have a few building blocks as their foundations.

The second critical matter is the FASB's project on accounting for post-retirement benefits other than pensions. This issue has captured national attention because of the magnitude of the potential liabilities involved and eye-catching headlines, such as the February 27, 1989 Fortune magazine article entitled "The Killer Cost Stalking Business." The FASB is focusing on the appropriate valuation and accounting for such benefits, particularly retiree health plans. Critics have raised concerns about potential measurement problems resulting from the uncertainties regarding the timing and amount of potential benefit payments. Others have questioned whether companies, faced with the possibility of drastic reductions in reported earnings will attempt to abandon

their commitments to former employees or to curtail the extension of such benefits to future retirees. The FASB is currently conducting a field test of the proposed standard 11/ in conjunction with a national accounting firm and approximately twenty-five companies, and will hold public hearings on the exposure draft in New York and Washington prior to moving forward.

IV. Report on Management's Responsibilities

Considerable attention also has been focused recently on management's responsibilities in connection with the establishment and maintenance of a system of internal accounting controls. Section 13(b)(2) of the Securities Exchange Act of 1934, which contains portions of the Foreign Corrupt Practices Act, requires reporting issuers to have a system of internal accounting controls sufficient to provide reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in accordance with generally accepted accounting principles. 12/ The October 1987 final report of the National Commission on Fraudulent Financial Reporting, 13/ commonly known as the

11/ Exposure Draft, Proposed Statement of Financial Accounting Standards, Employers' Accounting for Postretirement Benefits Other than Pensions, Financial Accounting Standards Board (February 14, 1989). Comment period expires August 14, 1989.

12/ 15 U.S.C. 78m(b)(2).

13/ Report of the National Commission on Fraudulent Financial Reporting (October 1987) (Treadway Report).

Treadway Commission, emphasized that the prevention and detection of fraudulent financial reporting must start with the entity preparing the financial statements, and that the "tone at the top" set by management of an entity is critically important. 14/ The Treadway Commission recommended that each company's annual report to shareholders contain a report by management that would acknowledge its responsibilities for financial reporting and assess the effectiveness of the company's internal controls. 15/ In 1988, the Commission proposed a rule that would require a management report on internal controls to be included in the annual report. 16/

The management report would be particularly important because it would be considered by the auditor in the context of recently adopted and previously existing professional standards. Auditors are now required to gain an understanding of a company's internal control structure in all audits, irrespective of whether they intend to rely on the controls in conducting the audit. 17/ They also are required to communicate to management and to the audit committee significant

14/ Treadway Report, supra n.13, at 11.

15/ Treadway Report, supra n.13, at 44.

16/ Securities Act Release No. 6789 (July 19, 1988) [53 FR 28009].

17/ Statement on Auditing Standards No. 55, Consideration of the Internal Control Structure in a Financial Statement Audit, Auditing Standards Board (April 1988), effective for audits of financial statements for periods beginning on or after January 1, 1990 with early application permissible.

deficiencies in the design or operation of the control structure, including material weaknesses that come to the auditor's attention during an audit of the financial statements. 18/

Under the Commission's proposed rule, auditors would be required to read the required management report on controls, 19/ and would do so armed with knowledge acquired in their analysis of the control structures. In the event that the auditor noted a material inconsistency or misstatement in the management report, the auditor would be required to inform the company. If the company failed to take steps to correct the report, the auditor would be required to take appropriate action, including disclosure of its concerns or resignation from the engagement. In the latter case, the disagreement regarding the management report would be disclosed in the company's Form 8-K required to be filed to report a change of accountants. 20/

18/ Statement on Auditing Standards No. 60, Communication of Internal Control Structure Related Matters Noted in an Audit, Auditing Standards Board (April 1988), effective for audits of financial statements for periods beginning on or after January 1, 1989 with early application permissible.

19/ Statement on Auditing Standards No. 8, Other Information in Documents Containing Audited Financial Statements, Auditing Standards Board (December 1975).

20/ Securities Act Release No. 6766 (April 12, 1988) [53 FR 12924]; Securities Act Release No. 6822 (March 2, 1989) [54 FR 9970].

The interaction between the Commission's disclosure requirements and professional auditing standards is important. Here, the accountant would review the internal control systems, read and compare the Commission mandated management report on controls, and cause management to correct deficiencies. If deficiencies were not corrected, the accountant would resign, and Form 8-K would force disclosure to the Commission of the resignation and the underlying disagreement.

The Commission has received approximately 190 comment letters on the management report proposals. A preliminary review of the comment letters indicates that a majority of commentators support the proposed report of management's responsibilities. Many of the supporting commentators already provide such management reports voluntarily. Supporting commentators expressed the belief that the management report will further the Commission's stated objectives of improved public understanding of the respective roles of management and the public accountants. Opposing commentators stated that the report should continue to be voluntary, rather than required, and noted that the recently revised auditor's report 21/ contains a statement that primary responsibility for the

21/ Statement on Auditing Standards No. 58, Reports on Audited Financial Statements, Auditing Standards Board (April 1988), effective for reports issued or reissued on or after January 1, 1989 with early application permissible.

preparation of financial statements resides with management. 22/ Many of the commentators expressed concerns, however, regarding those parts of the proposal that would require management to assess the effectiveness of the registrant's internal control system. Some accountants expressed concerns regarding the degree of comfort that investors may take from the auditor's association with the management report. The staff of the Commission is currently reviewing the comments and will make a recommendation to the Commission within the next few months.

V. Timely Review of Quarterly Financial Information

Since 1975, the Commission has required that independent accountants review quarterly financial information filed with the annual financial statements of larger, more widely traded companies meeting specified criteria. 23/ This requirement was adopted with the expectation that greater care and attention would be devoted to quarterly reports, thereby increasing the likelihood that management would discover needed adjustments on a timely basis. It also was thought that such a requirement would improve individual company reporting by bringing the professional expertise of independent accountants to bear on

22/ Additionally, a large majority of commentators have opposed the portion of the proposal requiring disclosure of management's responses to significant recommendations concerning internal controls made by the company's internal auditors and independent accountants.

23/ See Item 302(a) of Regulation S-K, 17 CFR 229.302(a).

the quarterly reporting process. Although the Commission has not required reviews to be completed before the quarterly information is filed with the Commission, review before filing has been encouraged by the Commission in order to avoid revisions of quarterly information in the year-end statements.

In its 1987 final report, the Treadway Commission recommended that the SEC require independent public accountants to review quarterly financial data of all public companies before the data are released to the public. 24/ The Treadway Commission believed that timely auditor involvement would improve the reliability of quarterly reporting and increase the likelihood of preventing and detecting fraudulent financial reporting.

Last October, the SEC voted to issue a concept release to solicit public comment on whether rule proposals should be made to require timely review of financial information covering quarterly and other interim periods. The concept release is in the final stages of preparation. It is hoped that the concept release will provoke comment on the questions whether and how auditor involvement with interim financial information might be expanded. One suggestion would require all registrants, not just larger companies, to include interim data in the audited annual financial statements. Another possibility is a

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② requirement that interim financial data be reviewed before

24/ Treadway Report, supra n.13, at 53.

3) being filed with the Commission. A third suggestion is that an independent accountant's report, issued upon completion of the review, be required to be included in the Form 10-Q.

The costs associated with timely reviews of interim financial information are of particular concern. The Treadway Commission addressed the cost/benefit issue and concluded that the benefits would justify the costs. It found that the costs of failing to implement its recommendations could be the potential loss of confidence by investors in corporate management and the financial reporting system - costs far larger and more important than the costs of implementation. The Commission will ask for your views on the costs and benefits.

A requirement of timely review of interim financial data may affect other aspects of financial reporting. For example, such a requirement might delay the release of companies' quarterly earnings. The possibility of such a requirement also raises some fundamental questions concerning the emphasis that is being placed on quarterly results. Some commentators believe that the emphasis on quarterly results has negative rather than positive consequences. They note that many other countries require only semi-annual, not quarterly, reporting and ask whether the focus on quarterly data in the United States forces U.S. managers to concentrate on short-term rather than long-term goals.

VI. International Disclosure Initiatives

As noted in the Commission's November 1988 Policy

Statement on Regulation of International Securities Markets:

The world's markets for equity and debt securities have become increasingly automated and linked. Driven by new technology, investors' desires to enter foreign markets, and issuers' efforts to obtain low cost capital, the trend toward internationalization of the securities markets undoubtedly will continue. 25/

The continuing trend toward internationalization will increase the need for, and the benefits to be derived from, mutually agreeable international accounting principles. Such standards would reduce the regulatory burdens resulting from current disparities between the various national accounting standards. Accordingly, securities regulators and members of the accounting profession throughout the world are engaged in efforts to revise and adjust international accounting standards in order to increase comparability and reduce costs.

In an effort to address accounting differences, the SEC's staff is working with international organizations such as the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) in efforts to review international accounting standards. IASC is addressing problems of the completeness and lack of specificity

25/ Policy Statement of the United States Securities and Exchange Commission: Regulation of International Securities Markets, International Series Release No. 1, 43 SEC Docket 128 (November 14, 1988).

in some of the international accounting standards and hopes to reduce the number of free choice accounting options permitted under some of the standards. Where options cannot be eliminated, the group seeks to specify one method as the benchmark (or "preferred" method) for international filings.

At its November 1988 meeting in Copenhagen, the IASC Board approved publication of an Exposure Draft for public comment. 26/ This draft was released on January 1, 1989, and represents the first phase of the project -- proposed changes to deal with the question of accounting options in existing international standards. The issues addressed in the Exposure Draft include several in each of the following areas: revenue recognition; business combinations; investments; retirement benefits; and, as you might expect, foreign currency translation. In the U.S., the business combination issues are likely to be the most controversial because of the strict limitations that the proposal would place on the use of the pooling of interests method of accounting. The Exposure Draft, which has an exposure period of nine months, ending September 30, 1989, deserves careful consideration and comment, since it

26/ "Comparability of Financial Statements, Proposed Amendments to International Accounting Standards 2, 5, 8, 9, 11, 16, 17, 18, 19, 21, 22, 23 and 25," International Accounting Standards Committee (January 1, 1989).

represents an important first step in assessing the feasibility of the IASC project. 27/

The FASB also has indicated an increased desire to participate in the development and harmonization of international accounting standards. In a June 23, 1988 presentation to the IASC, Dennis Beresford, Chairman of the FASB, spoke of several initiatives to be undertaken by the FASB, indicating that a FASB Board member has been designated as liaison representative to the IASC, and is a member of the IASC consultive group, which meets regularly with the IASC Board to discuss projects. 28/

The Commission, the FASB, and the accounting profession should devote increasing attention to international accounting issues in the years to come. As transnational capital formation continues to be facilitated by the increased internationalization of the securities markets, the need to minimize differences in accounting principles also will increase.

27/ At its April 12-14 meetings, the IASC Board reached major decisions regarding the adoption of a conceptual framework, the formation of a steering committee to upgrade the disclosure and implementation guidance in IASC standards, and the addition of projects on topics not covered by current IASC standards. In addition, Arthur Wyatt, a former FASB board member, was selected as Chairman Designate of the IASC Board. His term will begin in June 1990 and run through 1992.

28/ Address by Dennis R. Beresford, Chairman of the Financial Accounting Standards Board, Meeting of the International Accounting Standards Committee, June 23, 1988.

VII. Conclusion

The Commission continues to move forward on many issues in the realm of corporate disclosure and, in particular, financial disclosure, including accounting. The United States disclosure system and its system for adopting accounting principles, auditing standards, and auditor independence standards are well established and function well. Our challenge in coming years will be to seek high quality accounting and disclosure, without jeopardizing our competitive position in the world's financial markets. The task of reaching international agreement on accounting matters is complicated and will take time. Nevertheless, we must act with open minds in order to achieve a useful worldwide disclosure system.