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FORECASTING: A LOOK AT THE FUTURE

An Address By

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Probably at no time since the adoption of the Securities Act of 1933 and the Securities Exchange Act of 1934 has there been as much attention paid to financial reporting as there is being paid today. We have seen in the last few years, particularly in the latter days of its existence, numerous opinions of the Accounting Principles Board. After an extended period of growing disenchantment, that Board has been replaced by the Financial Accounting Standards Board which is now addressing a priority list of some dozen items. Further than that the Securities and Exchange Commission has become significantly more activist than it has been in the past, with the result that in the last three years 33 Accounting Series Releases have been published as contrasted with 119 during the entire preceding 34 years -- a rate of eleven a year versus three and a half a year.

One could ruminate at length on the reasons for this heightened interest in the problems of financial reporting. Certainly, the increased institutionalization of the markets has had much to do with it. These professionals, with increasing amounts of money subject to their discretion, have steadily insisted upon more and better information. In addition to that, there have been a number of financial catastrophes in which it appears that investors have been seriously harmed by the absence of adequate standards of financial reporting.

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Perhaps no subject presently under consideration by those concerned with financial reporting has in the last several years generated as intense and broad an interest as the suggestion made in 1971 by then Chairman William J. Casey that the Commission should consider the abandonment of its historic antagonism toward the inclusion in filed documents of forward-looking data -- estimates, projections, appraisals -- and permit or perhaps even mandate the inclusion of such information in registration statements, prospectuses, proxy statements and other filings with the Commission

To properly understand this proposal by Chairman Casey, I think a very brief glance at the underlying foundations of the federal disclosure system is desirable. In 1933, the Congress adopted the Securities Act of 1933 which established the mandate that substantial amounts of reliable information be furnished to those who purchased securities in distributions. In this Act Congress set forth in a schedule, subject to modification by the Commission, an extensive list of the information which should be furnished to investors. Clearly all of this information was to be of an historical nature and there was no reference in the schedule to anything that might be characterized as forward-looking. In 1934, the Congress adopted the Securities Exchange Act of 1934 which provided a continuous reporting system for companies listed on national securities exchanges. While the detail incorporated in this legislation by Congress with respect to the contents of disclosure was less detailed and comprehensive than the Securities Act of 1933, nonetheless to the extent that guidelines were provided again it seemed apparent that Congress was thinking principally of historical information. However, I think it is important to note that in both cases the regulatory authority --first, the Federal Trade Commission, and in 1934 the Securities and Exchange Commission -- was given virtually plenary power to modify and extend the legislative requirements with respect to disclosure.

From the beginning of its history, the Securities and Exchange Commission has maintained a high degree of skepticism with regard to anything other than historical information. This attitude was well summarized by Harry Heller, a former member of the staff, who said in 1961:

> "For an investor then the important zones of information in respect of the requirements of the Securities Act will be those which are necessary to enable him to reach an informed judgment as to the trend of sales and earnings. . . . [I]t appears desirable to point out some correlative propositions which flow from the major proposition that investment value is a function of an estimate of the future earnings of the entire enterprise, or the earnings particularly attributable to the security in the enterprise being offered, in each case capitalized at a rate appropriate to the degree of the known risks of its business.
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> "The question will be raised, if the determination of future earnings is the prime task confronting the investor, why not require or permit a direct prediction of such earnings? The answer to this is that the Securities Act, like the hero of 'Dragnet', is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that he is as competent as anyone to predict the future from the given facts. Since an expert can speak with authority only as to subjects upon which he has professional knowledge and since no engineering course or other professional training has ever been known to qualify anyone as a clairvoyant, attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which in fact does not exist. Particularly is this true

> where the predictions are set forth in the format of an income account. Here an air of authenticity is conveyed which is belied in many cases by the wholly unreasonable assumptions and conjectures upon which it is based, and which, if adequately disclosed, would make the prediction meaningless."

As a consequence of this attitude, anyone who has ever worked on a registration statement or proxy statement or other document for submission to the Commission knows the almost paranoid hostility that the staff has had toward appraisals, estimates, projections and the like. Often the mildest suggestion of such information would draw stern warnings in letters of comment. This pattern of dedication to the past, if I may call it that, settled into a rigid, inflexible pattern.

This pattern began to erode as the consequence of many factors. For one thing, courts began to recognize that very often historical only information was not sufficient protection for investors. For instance, in one case, Gerstle v. Gamble-Skogmo, the court found a proxy statement wanting which had failed to disclose the appraised value of certain properties of the company being acquired, properties which in accordance with generally accepted accounting principles were carried on the balance sheets contained in the proxy statement at historical cost, less amortization. True, the circumstances of that case were unusual -- the company had been selling off its properties, there were indications that the acquiring company intended to continue to do so, the prices realized upon properties sold were substantially in excess of the values on the balance sheet and so on -- but, nonetheless, this was clear evidence that there are circumstances in which an investor needs so-called "soft information" in order to properly make an investment decision.

Furthermore, there was increased realization that, for all of the hostility of the Commission, there were in the market place innumerable projections and forecasts published in presidents' letters, meetings of analysts, press releases and in many other ways. Experience indicated that many of these were far wide of the mark and it was suspected that in some instances their defects stemmed either from extreme carelessness in preparation or, in some cases, the presence of manipulative purposes. Whatever the motives of publication were, analysts realized the value of such information and steadfastly sought it, and in many instances management reached, I think, a sincere conviction that such information was useful to investors and they were entitled to believe it.

Another factor which I think was instrumental in moving the Commission to re-examine its dedication to historical information was the realization that very often projections were the subject matter of selective disclosure, that is, the information was furnished to selected investors, such as institutions or favored analysts, and was not made available to public investors, including individuals. As you know, the demands that all investors should have equal access to all material information concerning an issuer have been steadily growing. Consequently, the Commission found itself in a bit of a dilemma; on the one side was its historic hostility to "soft information," but on the other side was the simple fact that such information was regarded by many as having value and was being furnished to some investors but not all investors.

Finally, there was the realization that corporations operated in a temporal continuum in which the distinction between historical information and

and forward-looking information was not as distinct as once thought. Increasingly it was recognized that the traditional financial statements reflected many projections and predictions -- the extent to which the value of fixed assets would be realized in the future, estimates with respect to realization of income because of research and development, and so on.

The Commission has begun to respond to these forces in two ways: First, it is seriously considering letting the ancient barriers down and allowing forward looking information to be included, on a purely optional basis, in filings with the Commission. Secondly, it is looking toward the development of a system for regularizing, upgrading and enhancing the reliability of such information.

We realize that the extension of the disclosure system to embrace such forward-looking information is not without problems. There is the problem of reliability. Many companies do not have the internal capacity to develop reliable, probable of achievement, financial forecasts. In some instances the nature of the industry makes accurate forecasting a near impossibility; in other industries, of course, accuracy can be achieved with remarkable regularity. Another problem is the danger that investors may attach too much significance to a forecast and, thus, find expectations disappointed. There is the problem of forecasting obsoleted by internal events or events external to the corporation; I wonder how many forecasts, made with great care and good faith, became obsolete the day the Arab nations imposed their embargo on oil shipments to the United States. There is the question as to whether there should be third party participation, that is, should auditors or perhaps other kinds of experts lend authenticity and reliability to such forecasts by their professional skills? There is the question as to the extent to which forecasts be made mandatory. And, finally, there is the terribly troublesome problem of the potential liability of issuers who publish forecasts when performance misses the mark.

While this issue has come to the forefront of the regulatory scene, the courts have not been silent. In Dolgow v. Anderson a suit was brought against a group of Monsanto executives alleging that they had recklessly and for the purpose of assisting in their own securities transactions made forecasts concerning the future performance of Monsanto which performance did not match. In that case, Judge Weinstein very carefully reviewed the forecasts and the process by which they were established. He stated clearly that liability would not follow because the forecast proved wrong if it had been prepared with appropriate care. He said:

> "Monsanto's management demanded that the internal documents and estimates be honest. The divisions made every effort to be accurate and honest in their forecast. The internal estimates were made honestly, were reasonable and were the best estimate of the people in Monsanto most qualified to make them.
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> "The widespread participation by staff members at all levels of Monsanto in the preparation and review of these internal documents, as well as the participation by persons at the top level who are not defendants, confirm the conclusion that the estimates shown in these documents fairly reflected information on raw cost, product sales, and price and other data available to Monsanto."

Just last week Judge Constance Baker Motley of the Southern District of New York commented further on this subject in dealing with a statement in a Douglas Aircraft prospectus that read: "it is very likely that net income, if any, for fiscal 1966 will be nominal . . ." This statement, only mildly forward-looking, since at that time the year referred to was over half gone, was inaccurate because the actual results showed a loss of $52 million. Once again, the court focused upon the process by which the projection was developed and, unlike the Dolgow case, found that process wanting. The court also indicated that "any assumptions underlying the projection must be disclosed if their validity is sufficiently in doubt that a reasonably prudent investor, if he knew of the underlying assumptions, might be deterred from crediting the forecast." Interestingly, Judge Motley said that one of the pieces of information which should have been disclosed in that connection was the accuracy of previous corporate forecasts, and, as she found, in that respect, in at least eight instances in 1966, the corporation was wanting. Other factors that the court said had bearing on the reasonableness of the forecast were the care exercised in the preparation and review of cost and sales estimates, doubts expressed by those engaged in the reviewing process, the reasonableness of the underlying assumptions and any facts not known to management that were accessible in the exercise of reasonable care.

While it may appear that Judge Motley went beyond the Dolgow case, I think upon close analysis, however, any extension is not of such a nature as to pose severe problems for management. It might also be important to note that the Dolgow case was decided under the looser standards of Rule 10b-5, while the Beecher v. Able case was decided under Section 11 of the Securiti[es] Act of 1933, the section which governs registration statements for the distribution of securities and which provides no defenses for issuers. Traditionally these standards have been regarded as more severe and have demanded a more conservative statement than Rule 10b-5.

While these pressures for enhanced disclosure of "soft information" were occurring, writers and other scholars were turning their attention to the problem and, for the most part, these writers, analyzing the history of the disclosure system and other relevant data, urged the Commission to relax its opposition. One of these critics, Professor Homer Kripke, put the case in this fashion:

> "We would not think much of a military general staff or intelligence staff which told field commanders they were not going to give him their estimates as to the enemy's strength and dispositions for fear they might not be accurate or complete, but would prefer to give him something that they were sure was reliable, like information about the enemy's dispositions in World War II. And yet this is essentially comparable to what the Commission is doing"

In response to these new insights, the Commission in November 1972 ordered hearings on the subject. During the course of these hearings, extensive testimony was offered with respect to these problems and numerous submissions were made. It is very difficult out of these documents and testimony to detect any sort of consensus, although I think it is fair to say that the most abiding concern was that of liability.

Following these hearings, in February 1973 the Commission published a release which indicated the direction of its thinking. This release did not solicit comment but, rather, indicated that the Commission was in the process of developing rules incorporating the principles contained in the release, and that in due time these rules would be published for comment.

I would like to summarize for you and briefly comment upon these proposals.

First of all, and in my estimation most important, the Commission made clear that it would not be mandatory for any company to publish forecasts, either in filings with the Commission, or otherwise. This reflected a recognition that many companies are not in a position to make accurate forecasts, that many historically, like, I believe U. S. Steel, have not issued forecasts publicly, that many companies, rightly or wrongly, fear liability. Thus, the decision to publish forecasts was left in each instance to the individual issuer.

Second, the Commission would permit companies that report under the 1934 Act and which meet certain other criteria relating to earnings history and budgeting experience to incorporate "soft information" in filings with the Commission -- prospectuses, proxy statements, Forms 10-K, etc.

Third, any projections contained in the filed documents would have to meet certain standards. For instance, they would have to state the assumptions upon which they were made, set forth at least sales and earnings, the data would have to be in reasonably definite form -- I think this would indicate they should be numerically stated, but either a range or a simple figure would be permitted, and the forecasts should cover a reasonable period. Speaking only for myself, I would think that a forecast during a year which went no further than the end of the following fiscal year would be within the bounds of reasonableness.

Recognizing the swiftness with which the financial scene changes, the Commission would require that any forecast filed would have to be updated on a regular basis and whenever the issuer materially changed its projection and the issuer would have to state the reasons for the variation. What would be regarded as "regular" updating? It seems to me that probably Form 10-Q would be an appropriate medium through which such changes might be made.

Would issuers be compelled to continue forever filing forecasts once they commenced the process? The answer is no, although any issuer terminating the filing of forecasts would have to state its decision and the reasons therefor. Since the market place will undoubtedly attach a degree of importance to the fact that a company cannot, or no longer chooses to, make predictions, it was felt that there would be a strong incentive for continued forecasting. A disclosure that forecasting is being discontinued because the company's internal controls have proved inadequate is surely not one that is calculated to increase confidence in the market place.

Next, the Commission would not require or permit third party verification, at least for now. We recognize that to a limited extent the auditing profession has been involved in England in assessing the reasonableness of the assumptions upon which projections are based and the accuracy of calculations. It may be that eventually it would be desirable to include accountants in this process in this country. However, initially, the Commission would not do so since there are presently generally accepted principles or policies with respect to such matters. An interesting sidelight: rather quickly after the Commission indicated its interest in projections, two firms, non-accounting, announced their readiness to act as authenticating experts with respect to projections.

In its release, the Commission also indicated interest and concern with projections that are made outside official filings. The Commission indicated that it would require that whenever a company made a public projection through whatever medium it would be required to file that projection on a special form with the Commission. This is obviously an effort to introduce higher standards of responsibility into the preparation and publication of all projections and assure that they are adequately publicized and that there is no selective disclosure. In this connection, the Commission would require that with respect to any projection, whether filed or not, there must be put in the issuer's Form 10-K a statement of the projection made, the circumstances under which it was made and a comparison of the projection with actual results. It has seemed to me for some time that one of the surest ways of securing higher integrity in projections would be to require companies to expose over a period of time the extent to which their projections were proven out. It seems to me this is extremely valuable information -- and it so seemed to Judge Motley -- in assessing the reliability of projections.

It might be noted that the release, in dealing with disclosures other than those contained in formal filings with the Commission, does not deal with such matters as updating, statements of assumptions and the like. What consideration the staff is giving these matters I frankly do not know at the moment; however, I think if we are to have an adequate and reliable system with respect to the preparation and dissemination of forecasts attention should be given to such matters in connection with all forecasts, not just those contained in prospectuses, 10-K's, proxy statements and other such filings with the Commission.

The Commission proposes to adopt rules which would indicate the circumstances under which a projection would not be misleading. The release makes it clear that a projection is not a promise. I would suggest that these rules would make clear that the simple fact of a projection not having been met would not in and of itself constitute the projection a misleading statement for any purposes of liability under the securities laws. When I was in practice, I represented a committee of the American Bar Association in testifying at the Commission's Forecast Hearings and at that time we suggested, and I believe our suggestion was received sympathetically, that any such rules should provide that a projection would not be deemed misleading if it were reasonably prepared, properly updated, based in fact and bore the evidences of responsibility in its preparation.

In conjunction with this, the Commission proposes to release standards to be followed by anyone making projections in which it would state that it has reservations with regard to the publication of projections by any companies with limited histories of operations. The Commission indicated that it has doubts that such companies could meet the standards necessary to avoid liability. Obviously, the dangers are magnified in the case of companies which have not had extensive experience in the preparation of projections and which have not had the opportunity to compare for some period of time the results of operations with those anticipated. Thus, the Commission would not confine projections to those companies which have a sufficient experience to indicate a capacity to deal with this problem well, but would urge companies other than those to forego forecasts. Furthermore, the Commission indicated that it would emphasize in this release the adverse consequences of selective disclosure of material information.

While many of us have been speculating about and discussing these matters, others have been doing something about it. At the beginning of 1973 the head of Fuqua Industries, Inc., based in Atlanta, Georgia, announced that, recognizing the possibility that sometime in the future forecasting might be required, Fuqua would commence issuing annual forecasts and would periodically update them. The documents it has published in connection with this endeavor are most interesting reading and provide a most imaginative example of the manner in which a business engaged in several lines of business can effectively deal with the problem of forecasts. These statements, I think, provide a good example of the sort of additional management discussion which forecasting can elicit. It should be noted that despite a number of unforeseen developments with respect to various of its activities its corporate-wide forecast hit surprisingly close to the mark.

Since February 1973 when the Commission published its release with respect to forecasts, a new conceptual development with respect to financial reporting has emerged. That is so-called "differential disclosure." As we all know, not all investors come in the same shape and sizes. Many of them have limited ability to understand financial information, many of them, despite limitations, make their own investment decisions, many of them rely upon adviser on the other hand, there are many investors who are extraordinarily astute and skillful at the interpretation of complex financial data, and there are, of course, many professionals who have this ability. In Securities Act Release No. 5427, issued in August 1973, the Commission proposed an amendment to Rule 3-08 of Regulation S-X pertaining to disclosure with respect to accounting principles and the consequences of selection among them. In this release the Commission said:

"The proposals set forth in this release are primarily designed to assist professional analysts who have the responsibility of developing an understanding in depth of corporate activity. They are not primarily intended to serve the direct needs of the 'average investor." Such an investor does not usually have the time to study or the training necessary to fully understand the data which are called for herein. It is not appropriate, however, for such data to be unavailable to the average investor who does wish to devote the time necessary to consider it. By being included in financial statements filed with the Commission, therefore, data will become 'data of public record' and, hence, available to all. Disclosure will not be discriminatory even though usage will mostly be by professionals. Data of this kind would not be expected to be sent routinely to all shareholders, although it would be useful if its availability was mentioned in communications with shareholders and if management took steps to make it available on request."

This concept was also expressed in Accounting Series Releases Nos. 147 and 148 pertaining to disclosure with respect to income tax allocation and compensating balances.

The concept of differential disclosure not only contemplates a larger quantity of information being made available to large investors but it also contemplates more adequate and understandable summarization of such information in the documents that become readily available to smaller investors, such as the annual report. Furnishing to smaller, less sophisticated investors documents containing both the summarized disclosure and the extensive details would in many instances, we believe, defeat the very purposes of disclosure by confusing the small investor.

It seems to me that this concept of differential disclosure has peculiar relevance to forecasting. I foresee that an issuer's Form 10-K could contain very extensive information with respect to the assumptions upon which the forecast was built, assumptions that could be dealt with very intelligently and skillfully by trained analysts. These assumptions would, however, be summarized fairly and understandably in the annual report and other documents circulated widely among investors.

I would underline again the very first of the statements I have made with regard to the Commission's approach, namely, that the Commission would not require anyone to make a projection under any circumstances. It is only concerned that those who choose to make projections do so responsibly, systematically and in a manner that minimizes the possibility of projections being misleading.

Now when is all this going to come about? The staff believes it will have recommendations with respect to rules to the Commission before mid-year. Hopefully the Commission will react promptly to the recommendations and publish them for comment. For a matter of this importance a sufficient period of comment followed by a careful consideration and assimilation of comments will be necessary, with the result that final action by the Commission before the end of the year is doubtful. However, hopefully early in 1975 this historic change will become reality.

Projections are unquestionably the most significant financial information that is presently largely unregulated. In my estimation there will be transitional problems; there will be faltering in the process of compliance with whatever the Commission proposes; there will be apprehensions which only time will quiet. However, these apprehensions, these fumblings, these difficulties have been characteristic of every significant step forward in financial disclosure, starting with the Securities Act of 1933, which led to the forbidding prediction that requiring such disclosure and imposing such liabilities would hasten the restoration of Wall Street to bucolic simplicity. That didn't happen. Similarly, the financial world did not collapse when periodic reporting was instituted or when it was extended to over-the-counter companies; it did not suffer a fatal wound when proxy solicitations became subject to regulation. And while Section 16(b) has undoubtedly lightened the pockets of many executives, nonetheless it has not effectively barred the accumulation of vast fortunes by insiders trading legally in their stocks.

To end on a projective note: five years from now this debate will be interesting history but will not have scarred or maimed the financial markets of this country.