FORECASTS: A Changing View From The Securities and Exchange Commission

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For nearly forty years the well-known policy of the Securities and Exchange Commission has been to prohibit the inclusion of projections and forecasts in documents filed with it. While this policy has never been part of a written rule, the administrative practices of the staff in dealing with any data in filings that might be considered a projection has been sufficiently vigorous to make the Commission's position clear.[1]

In the past two years, however, there have been signs of change. First heralded by statements by Chairman William Casey and Commissioner James Needham in late 1971, the movement toward a new policy has been rapid. The Commission within the last twelve months has issued proposed rules calling for cash budget disclosure by companies making initial public offerings, held hearings on the broad subject of forecasts and projections, and issued a statement of position indicating that projections will be permitted under some circumstances in registration statement filed with the Commission and that filing in some form generally will be required when a projection is disclosed outside the corporation.

In the light of such significant change, it seems appropriate to consider the reasons behind the Commission's traditional view, explore the factors which led to change, discuss the policy as it currently exists and speculate in a limited way about the various possible directions in which public corporate forecasting may be headed.

<u>Reasons for Commission's Traditional View</u>

Since the prohibition on forecasts has never been a written one, there have been no official statements of the reasons for the Commission's position in this area. Among the few statements by Commissioners or staff that discuss or rationalize the position, the most quoted is an article by Harry Heller, formerly Assistant Director of the Division of Corporation Finance. In this article, published in 1961, he explained the rationale behind the traditional position as follows:

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[1] The only notable exceptions have been in a few specialized cases involving newly formed realty entities.

> "The answer is that the Securities Act . . . 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 . . . professional training has ever been known to qualify anyone as a clairvoyant, attempts by companies to predict future earnings on their own on on the authority of experts have almost invariably been held . . . to b misleading because they suggest to the investor a competence and authority which in fact does not exist."[2]

The same insistence on disclosure of "hard" facts only as material facts is included in the report on disclosure prepared in 1969 under the direction of then Commissioner Francis Wheat. It cites the same problem of undue reliance by the unsophisticated investor on such projections filed under the securities laws and reviewed by the Commission. It also notes that ". . . projections may change rapidly during a given year as changes occur in the factors on which they are based" and that "[i]nclusion of such changing projections in a prospectus, which might be used long after it became effective would give rise to significant problems."[3]

An overriding factor in both these statements seems to be concern over the lack of understanding on the part of investors of the instability and uncertainty associated with published forecast results. The primary objection has been a perceived lack of objectivity and, in some cases, the conviction that any prognostication was an act of subjectivity akin to crystal ball gazing. This was partially rooted in a firm conviction that the historical cost model was an

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[2] Harry Heller, "Disclosure Requirements under Federal Securities Regulation," The Business Lawyer, January 1961, p. 307.

[3] Francis M. Wheat, Disclosure to Investors – A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts (The Wheat Report), Commerce Clearing House, Inc., 1969, pp. 95-6

exercise in objectivity. Without elaborating upon the possible overstatement of this view, it appears that a more fundamental problem was the lack of guidelines or standards for projections that an issuer, financial analyst, or investor could rely on. Under these circumstances, it was virtually impossible to determine whether a forecast was reasonably based on existing facts or that it had been prepared with reasonable care. There appeared to be no basis for either the preparer or the user to determine whether the projection was prepared in a "good" or "bad" manner in the same way as historical financial statements were said to be well or poorly prepared.

Another concern was related to changes of underlying factors and assumptions over time which nullified forecasts. Some believed there was great danger that the unsophisticated would be misled by depending on such forecasts long after the underlying factors had changed. A more fundamental issue was that such projections were based on an extremely complex and wide array of business and financial factors and assumptions which the reader would not be able to adjust for changes over time while at the same time giving more credence to the published result. Since the assumptions were determined in a subjective manner and since they were not generally disclosed, the potential for misunderstanding of the results and misleading the investor was felt to be very high. In addition, there was no professional expertise available to review and report on forecasts so that the user was left totally to his own devices in appraising them.

Cast upon this sea of uncertainty was the pervasive and even more disturbing issue of liability. There was and is considerable discussion and still more confusion concerning who would be liable or even if there could be liability attached to providers of forecasts. For example, Heller argued that:

> "To permit the inclusion of estimates of future profits, whether made by experts or not, in a prospectus . . . would enable the company to derive the benefits of any inducing effect upon investors such estimates might possess without subjecting the company, its experts

> and the underwriters to liability either at common law or under the Securities Act."[4]

However, the Wheat Report concluded that:

> "Lawyers, underwriters and company officials were generally opposed to the analyst's suggestion [to permit projections of sales and earnings]. Even if projections were not required but only permitted, it was observed that problems of civil liability would be insurmountable unless projections were expressly granted immunity from . . . the [Securities] Act."[5]

Current case laws indicates that neither extreme is true. However, case law has not been particularly comprehensive in its reasoning or in defining the limits of liability and certainly has provided little help in providing standards or guidelines for the development of projections.

These varying uncertainties together with concern over the possibility of misleading investors were the basis of the Commission's long-standing policy of prohibiting forecasts in documents filed with it.

Reasons for Change

The decision of the Commission to reconsider its historical position on forecasts was based on several factors. Perhaps the most significant of these was an increasing recognition of the relevance of future oriented data in investment decision making. It seemed apparent both from formal valuation models which defined value in terms of the discounted present value of future dividends and earnings and from less formal techniques of analysis which emphasized multiples applied to projections of earnings per share for one or two years into the future that securities were being traded primarily on the basis of expectations. While such expectations

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[4] Heller, op cit.

[5] Wheat, op cit.

could be developed in part from the historical financial record of a corporation, it became increasingly difficult to justify a position that specific information about the corporation's future expectations should be denied to investors as a matter of policy.

A second factor in the Commission's decision was the increasing use of budgets and forecasts by corporations and evidence of improving information systems which added a degree of sophistication and reliability to corporate forecasts. When the initial determination to prohibit forecasts was made, the use of corporate budgets was limited and such budgets as were put together frequently were only an accumulation of numbers by the accounting department rather than an integral part of the planning and information system of the firm. Today a whole generation of managers has grown accustomed to the use of a budget as a major tool of management control. Building a budget, justifying it to top management and directors through a review process, updating it as conditions change and explaining variations between actual and budgeted results are well-known techniques. An increasing number of firms employ the services of business economists to review the economic firmament and forecast changes in economic forces affecting the corporation.

While none of these techniques have resulted in forecasts of assured accuracy, the process of forecasting has been better defined and the reliability level has been increased. Major changes in economic conditions still occur with surprising rapidity and random events which may have a dramatic and unexpected effect on an individual firm remain facts of economic life. The existence of such factors will inevitably create situations where major deviations between forecast and actual results occur. Such circumstances, however, should not be permitted to obscure the fact that on the whole greater reliability now exists in forecasts, and the recognition that forecasts and budgets are well understood management tools which can be frequently updated by a modern information system as conditions change.

A third factor in the Commission's determination to review its policy arises from a combination of the first two. As investors have increasingly looked into the future, they have pressed management for forecast data on the reasonable assumption that management data are likely to be the most reliable. At the same time, the improvement in management information systems has made companies more confident in there forecasts. An increasing number of managers therefore have been ready to disclose there forecasts publicly. Some companies have made these disclosures in a systematic and regular way. More have released forecasts occasionally in response to questions or in meetings before groups of analysts and investors. In the past two years there has been a dramatic increase in the number of public forecasts made. Investors and analysts are now accustomed to seeing published estimates and there is little evidence that they have been misled by the uncertainties therein. While standards of forecast preparation and disclosure have not been formalized, current experience makes their development a possibility.

The final factor that led to a re-examination of the Commission's traditional policy was increasing evidence of discriminatory disclosure of forecast data by corporate management. At the same time as many companies announced their projections publicly, a number of others communicated their expectations to a select few. Favored analysts might be advised of current budget data either directly or by letting them know that their estimates were "in the ball park." Through a variety of such devices, many corporations sought to be sure that "market" estimates of their earnings were not far off the mark while still not taking any public position on the projected results. While the overwhelming majority of such efforts were done in good faith, the end result was lack of knowledge as to what forecasts were those of management as opposed to those of analysts working independently. In a few cases there was evidence of selective disclosure to institutional investors interested in the stock and unfair use of such insider information.

These various factors created an environment in which a review of the entire area of forecasting seemed necessary. The review was not limited to the question of whether forecasts should be permitted in filings but necessarily went to the broader issues of the desirability of published forecasts. Hearings were held in November and December 1972 in which testimony was taken from 53 witnesses, many representing major organizations.

The Choices Available

As the testimony came in and was analyzed and discussed by the Commission staff, it soon became apparent that there was little support for a continuation of past policies in the current environment. Even those who felt that the dangers of forecasts outweighed potential benefits agreed that the Commission could not put its head in the sand and ignore the fact that a great deal of forecasting was going on.

If there was a conclusion that forecasts were misleading, therefore, it seemed that some affirmative action would be necessary to reduce the incidence of public forecasts as well as to continue the historical prohibition in Commission filings. This route seemed to have many disadvantages since not only would it deny to investors a kind of data which appeared relevant to their decisions but it would also increase the likelihood of bootlegging forecasts on a selective basis.

A second alternative at the other end of the scale was a policy of requiring projections of all registrants. This was opposed by most of the witnesses at the Commission hearings on a variety of grounds. It was suggested that this was too radical a step, even if tempered by allowing considerable latitude as to the format of projections presented; that it was unfair to expose all registrants to the potential liabilities associated with public forecasts; and that it failed to discriminate between registrants in significantly different economic positions.

Between these two extremes, there was a broad range of possible alternative combining some requirements with some permissiveness. The preponderance of expert testimony suggested solutions in this middle ground, largely based on a permissive approach with some constraints, and this is the solution which the Commission's initial statement of policy adopted.

The Commission's Statements on Forecasts and Projections

To date, the Commission has issued two releases which refer to forecasts and budgets. The first to appear was Release 5276, part of the "Hot Issues" package issued for comment in July 1972. This release proposed an amendment to registration forms which would require registrants filing for the first time and which had not conducted business operations for at least three years to include in their registration statement "a budget of anticipated cash expenditures and resources" as part of a plan of operation for a period of six months to a year in the future. If such a budget was not available, the reason why had to be stated. The proposal also called for disclosure of assumptions and "appropriate caveats as to reliability of estimates," an updating of budgets in the first two annual report filings (on Form 10-K), and an explanation of material variations in actual expenditures from budgets.

While this proposal did require forecasts and projections, its main purpose was not to obtain public earnings forecasts but rather to focus attention on the liquidity needs and resources of new registrants. In the "Hot Issues" hearings, a number of cases had been pointed out where registrants initially went public with a small offering that did not provide sufficient capital for the firm to exist for any substantial period of time. In these cases, the firm planned and required a subsequent offering in a short period of time to achieve economic viability. The proposed disclosure was intended to highlight such situations so that investors in the initial offering would be aware whether or not an additional infusion of capital would be needed in the near future.

In comments on these proposals and in testimony at the forecast hearings, the point was frequently made that companies in their early stages of operations were the least likely to have reliable budgets and questions were raised as to whether such companies were the appropriate ones to make formal budget disclosure. A proposed alternative requirement which called for textual disclosure of expenditure and cash availability plans was felt by most commentators to be a more practical method of achieving the Commission's objectives. No final rules have yet been adopted resulting from these proposals although the Commission has received and studied many comments. It seems likely that such rules will emerge in the near future.

The second release issued by the Commission was a much broader statement of policy in regard to forecasts and projections. This was issued on February 2 (Securities Act Release 5362). In this release the Commission set forth its current position and promised subsequent rule proposals and other memoranda implementing its general approach.

The essence of the policy set forth in the release was that the Commission would not require projections but would permit them in prospectuses under controlled conditions. At the same time, any company which issued a public forecast of any sort would be required to file this forecast with the Commission on a new form, and to set forth in its annual 10-K report a statement of the projection and a comparison of forecast with actual results.

The release, a copy of which is attached to this paper as an appendix, identified forecasts by management as “information of significant importance to investors” and indicated the Commission’s intention to “take the first steps toward integrating projections into the disclosure system” even though it would not require registrants to issue public projections and would permit firms who began public disclosure to halt it at their discretion simply by filing a statement of this decision and the reasons therefor. Steps were also promised to reduce the potential liability exposure created by responsible public forecasts while at the same time warning about increased exposure for companies making projections “without reasonable bases” or those firms which made selective disclosure of forecasts.

The only mandatory requirement for forecasts is the requirement for a public filing of any projection disclosed outside the company so that the information would be available on an equitable basis to all investors. While this preliminary policy statement did not specify in detail what would constitute outside disclosure, it did indicate that a statement confirming the projections of others would represent such disclosure. It follows that the presentation of “ball park” figures, ranges, sales estimates and similar items are likely to constitute public disclosure when the final rules are drafted.

The Commission’s statement also barred for the present time any association of an outside expert with projections included in filings with the Commission. It was felt that the absence of standards made it difficult for an expert to offer any meaningful attestation. This decision did not preclude the use of experts by management in the preparation of forecasts. The Commission also indicated a willingness to reconsider its position in this matter if appropriate standards were developed. This should serve as a challenge to the American Institute of CPAs and other professional bodies.

Proposed rules to implement this policy statement are likely to be published for comment around mid-year and final rules are unlikely to emerge significantly before the end of 1973.

The Implications for the Policy Statement

There have been numerous attempts at interpretation of the Commission's statement of policy regarding projections. Some observers have suggested that the policy will make public forecasting so unattractive that the end result will be a dramatic reduction in the availability of forecast data. They have read the statement as a backhanded prohibition. Other have seen the action as merely a first step toward mandatory forecasts. Neither of these extreme interpretations appear to be supported by the facts of the matter.

In its statement the Commission recognized a reality that does exist: The fact that public forecasts are a part of the reporting environment. The intent was neither to encourage nor discourage public forecasting but to attempt to resolve a number of unanswered questions about the application of the securities laws to projections and to guard against a number of perceived abuses. In an area that was developing rapidly on its own, the Commission sought to provide both assurances and warnings. It modernized its informal rules pertaining to projections in registration statements but did so in a fashion to avoid situations where investors were most likely to be misled. The requirements that forecast disclosure in prospectuses be limited to companies with a history of operations and some experience in internal budgeting and that assumptions be disclosed are evidences of prudence in this regard. At the same time, the mandatory filing requirement associated with any public forecasts was an attempt to prevent the abuse of discriminatory disclosure and to be certain that investors had an opportunity to see budget and actual data compared.

On balance, it would seem likely that the Commission's position will increase somewhat the trend toward more published forecasts. In an investment environment where insider information is anathema and where forecasts are identified as important investment information, it seems likely that corporate managements will want to protect themselves against inadvertent disclosure or misuse of projection data and will therefore prefer a systematic program of disclosure, particularly with the statement of the Commission that a projection not achieved "would not be considered to be a misstatement of a material fact if it were reasonably based in fact, prepared with reasonable care and carefully reviewed."[6]

As corporations and the Commission gain more experience with public forecast data, both will be able to evaluate their experience and see the directions in which to move. The Commission has promised to carefully monitor what it considers to be an experiment which may lead to improved reporting.

What of the Future?

It would seem inappropriate to end a paper on forecasts without indulging in the technique being discussed, even though the code of ethics of the author's profession make it impossible for him to vouch for the achievability of the forecast.

Nevertheless, and with appropriate trepidation in the face of considerable uncertainty, the view is here expressed that forecasting will gradually develop into a routine part of the corporate external information system. This is based on the premise that business operations represent a continuum which cannot be segmented into short periods without placing those periods into a time perspective. A historical perspective tells part of the story but it is only half. Present results must be examined as results of a period midway between the past and the future. They can only be meaningfully interpreted in the light of their impact on future expectations, and well prepared forecasts are an important tool in this regard.

If the joint efforts of the accounting profession, the corporate community and the Commission can develop standards and reduce the uncertainties associated with the decision to

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[6] Securities Act Release No. 5276

publish projections, a potentially important analytical data base will be developed for intelligent professional analysis.