

Notes

Disclosure of Future-Oriented Information Under the Securities Laws

A central goal of the Securities Act of 1933¹ and the Securities Exchange Act of 1934² is to provide a fair and efficient market for investment securities.³ Accordingly, the Acts pursue a policy of full disclosure of material information to investors.⁴ Thus, business enterprises subject to the Acts must include prescribed information in periodic reports filed with the Securities and Exchange Commission (SEC)⁵ and in reports sent directly to shareholders.⁶

Nevertheless, there is substantial evidence that the disclosures now required by the SEC are not fulfilling the purposes of the Acts: investors are unable to make realistic choices based on available information, while insiders continue to enjoy significant advantages.⁷ This Note argues that a major reason for this failure is that information disclosed in corporate filings is an inadequate and unreliable basis for investment decisions. To implement the goals of securities regulation, the SEC should require formal disclosure of financial forecasts by management.

1. 15 U.S.C. §§ 77a-77aa (1976).

2. 15 U.S.C. §§ 78a-78kk (1976).

3. 15 U.S.C. § 78b (1976) (aim of regulation is to "insure the maintenance of fair and honest markets"). Regulation of securities markets is designed both to protect investors and the broader public interest. Friend, *The SEC and the Economic Performance of Securities Markets*, in *ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES* 186 (H. Manne ed. 1969). Congress intended to protect investors from the abuses associated with securities markets, see Tracey & MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025 (1934) (1934 Act designed to correct evils of market), and to ensure the efficiency of those markets by allocating capital to the most efficient users, see Friend, *supra*, at 190 ("[A]llocational efficiency has been regarded as the most important economic function performed by the securities markets . . .")

4. See 15 U.S.C. §§ 77g, 78b (1976). The securities laws seek to compel disclosure of material information to investors so that they can "evaluate the securities of . . . companies on an informed and realistic basis." 38 SEC ANN. REP. 23 (1972). Information is "material" when "a reasonable investor might [consider the information] important" in making an investment decision. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

5. 15 U.S.C. § 78m (1976); see *id.* § 78l(g) (enterprises with more than \$1,000,000 in assets and more than 500 shareholders must report).

6. *Id.* §§ 77a-77aa (registration of securities offerings); *id.* § 78n(a) (proxy rules); *id.* § 78n(d) (tender offers).

7. See pp. 343-45 *infra*.

Future-Oriented Disclosure

Future-oriented information that includes detailed cash flows,⁸ unlike current SEC-mandated disclosures, would provide investors with information that is relevant, reliable, and susceptible to meaningful comparison. Because financial forecasts comport with the broad purposes of disclosure regulation, and because objections to such forecasts are no longer valid, a carefully conceived mandatory disclosure policy should be implemented by the SEC.⁹ This Note suggests guidelines for such a policy.

I. Financial Forecasts and the Goals of Disclosure

Disclosure of financial forecasts should be required only if the information so provided serves the goals of SEC disclosure regulation. Analysis of the content of such disclosures indicates that they further relevant goals by providing the basis for an informed investment decision.

A. *The Goals of Disclosure*

One goal of Congress in mandating full disclosure of material information to investors was to promote optimal allocation of capital by providing an efficient market for securities transactions.¹⁰ Capital

8. Cash flow statements summarize entries made in the company's cash accounts and are valuable because they are unaffected by accounting methods. See M. GORDON & G. SHILLINGLAW, *ACCOUNTING: A MANAGEMENT APPROACH* 84-87 (5th ed. 1974).

9. The SEC is authorized to prescribe rules and regulations to protect investors and to ensure fair dealing in securities. See 15 U.S.C. § 78m(a) (1976).

Reliance on the securities market to ensure access to information is problematic because information does not constitute a private good that can be sold in the marketplace. Exclusive access by the "purchaser," therefore, cannot be guaranteed by the "seller." Gonedes & Dopuch, *Capital Market Equilibrium, Information Production, and Selecting Accounting Techniques: Theoretical Framework and Review of Empirical Work*, in J. ACCOUNTING RESEARCH 48, 65 (Supp. 1974).

In the absence of the disclosure requirements imposed by federal law, investors would be seriously handicapped in securing information that is sufficient, reliable, and timely. REPORT OF THE ADVISORY COMMITTEE ON CORPORATE DISCLOSURE TO THE SECURITIES AND EXCHANGE COMMISSION XVIII-XXXI (1977) [hereinafter cited as ADVISORY COMMITTEE REPORT]; see Ronen, *The Effect of Insider Trading Rules on Information Generation and Disclosure by Corporations*, 52 ACCOUNTING REV. 438 (1977) (market forces are insufficient to compel adequate disclosure).

10. Capital is allocated equitably and efficiently when savings are channelled to the most promising investment opportunity. See J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 8 (3d ed. 1974) (firm will attract capital only when its investment opportunities justify use of that capital). An "efficient market" is generally understood to mean a market "in which prices always fully reflect available information." Note, *The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031, 1031 (1977). In a perfectly efficient market, the market price of a security will always equal its investment value and the price will always be "fair." *Id.* at 1069. Capital market efficiency cannot be addressed without attention to the

markets operate most efficiently when investors have equal access to widely disseminated financial information.¹¹ When reliable information is limited, the cost of capital rises because firms must pay a "signalling premium"¹² in order to encourage investors to supply funds. When information is not accessible to investors on an equal basis, the cost of capital rises because firms must pay an "unfairness premium"¹³ in order to compensate for uncertainty.¹⁴ Thus, when the market is operating efficiently, the firm will communicate information regarding its true or "intrinsic" value¹⁵ to investors and the cost of capital will approach the fair and equitable ideal.

A second goal of disclosure is to ensure fairness to the average investor, the investor who is not knowledgeable about the securities market and who does not deal in securities or market information as a professional.¹⁶ Disclosure protects the investor by ensuring that

quality and quantity of available information. ADVISORY COMMITTEE REPORT, *supra* note 9, at XXXIII-XXXIV.

Markets that allocate capital through investment decisions have a profound influence on the stability and growth of the national economy. R. WEST & S. TINIC, *THE ECONOMICS OF THE STOCK MARKET* 4-6 (1971); FINANCIAL ACCOUNTING STANDARDS BOARD, *CONCEPTUAL FRAMEWORK FOR FINANCIAL ACCOUNTING AND REPORTING: ELEMENTS OF FINANCIAL STATEMENTS AND THEIR MEASUREMENT* 3-4 (1976) [hereinafter cited as FASB CONCEPTUAL FRAMEWORK]. In enacting the securities laws, Congress was primarily concerned with remedying the "misdirection" of capital resources. H.R. REP. NO. 85, 73d Cong., 1st Sess. 2-3 (1933). This Note addresses the efficiency of capital markets by considering both information quality and quantity.

11. See Tracey & MacChesney, *supra* note 3, at 1026 ("[t]he best market is always the broadest market, the one where the greatest number of buyers and sellers are assembled"); cf. Ronen, *The Need for Accounting Objectives in an Efficient Market*, in 2 *OBJECTIVES OF FINANCIAL STATEMENTS* 36, 42 (J. Cramer & G. Sorter eds. 1974) (when number of participants in marketplace is great, process is efficient).

12. Firms must "signal" investors by offering a premium on returns when the information system does not permit firms to reach a broad range of investors with news of the firm's potential. Some firms regularly attract and hold the interest of analysts and institutional investors, while other firms are less favored and must attract investors by more aggressive means. Thus informal disclosure of future-oriented information may be more expensive for some firms than it is for others—*i.e.*, those that are regularly followed by market professionals. See p. 353 *infra*.

13. Investors demand an "unfairness premium" when they lose confidence in securities markets because insiders, analysts, and institutional investors use otherwise nonpublic information to their own advantage. Investors may also demand an unfairness premium when managements disclose positive information more freely than negative information.

14. See FASB CONCEPTUAL FRAMEWORK, *supra* note 10, at 4 ("[S]kepticism creates artificial uncertainty—the appearance of greater riskiness—which has a cost: Investors . . . demand a higher price to compensate for the perceived higher risk.")

15. See B. GRAHAM & P. DODD, *SECURITY ANALYSIS* 17 (1934) (firm's intrinsic value is "that value which is justified by the facts").

16. See 1 SEC ANN. REP. 27 (1935) (securities laws intended "to place adequate and true information before the investor"); V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE* 716-17 (1972) (disclosure intended to protect investors by equalizing access to relevant information of small investor and market professional or corporate insider).

Future-Oriented Disclosure

securities are purchased at a fair price:¹⁷ the market price of a security will approach its true value only when the market is operating efficiently to reflect reliable information. Full disclosure also provides the investor access to a broad range of investment opportunities and permits informed decisions that are most suited to the individual's investment objectives.

B. Information Needed by Investors

In order to make a realistic, informed investment decision, investors need information about the future of the firm. Investors are interested in increasing their wealth; they may look principally to the prospect of receiving cash now (dividend income) or in the future (appreciation, liquidation).¹⁸ Their investment decisions, therefore, are based primarily on the firm's future sources of cash, the amounts of cash anticipated by the firm, and the timing of cash transactions. Such information bears directly upon the firm's ability to pay dividends and hence upon the market price of the firm's securities. Historical information is relevant to these inquiries only insofar as it provides insight about the future:¹⁹ future sales, costs, and management performance.²⁰

17. Although the SEC has stressed its role as the "protector" of investors, *see* Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311, 315 (1974) (SEC policies result in overprotection of small investor), it is clear that the securities laws were intended to stabilize the securities markets by providing information to market professionals and thus indirectly protect less sophisticated investors. *See* Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172 (1933) (effect of 1933 Act was, *inter alia*, to place in market "a body of facts which, operating indirectly through investment services and expert investors, [tends] to produce more accurate appraisal of the worth of the security").

18. *See* FASB CONCEPTUAL FRAMEWORK, *supra* note 10, at 26 ("investors . . . are basically interested in cash inflows to themselves"). Cash may be realized from income (dividends) or appreciation (cash received upon sale of the security, based upon another investor's expectation of income and appreciation), or both. *Id.* Whether the investor seeks normal returns or superior (speculative) returns depends upon his preference for risk and liquidity. *See* Tobin, *Liquidity Preference as Behavior Towards Risk*, 6 REV. ECON. STUD. 65 (1958). Indeed, most investors "speculate" to some degree by purchasing securities that they perceive to be undervalued by the market. *See* note 22 *infra*. In any event, investors are interested in the "cash consequences of their economic decisions." AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, REPORT OF THE STUDY GROUP ON THE OBJECTIVES OF FINANCIAL STATEMENTS, OBJECTIVES OF FINANCIAL STATEMENTS 13 (1973) [hereinafter cited as AICPA STUDY GROUP].

19. FINANCIAL ANALYSTS FEDERATION, DISCLOSURE OF CORPORATE FORECASTS TO THE INVESTOR 90 (1973) [hereinafter cited as FAF STUDY]; *see* Kripke, *A Search for a Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 298 (1975) (figures about the past "are totally irrelevant to a current or prospective investor").

20. *See* D. BELLEMORE & J. RITCHIE, INVESTMENTS 324-26 (4th ed. 1974) (professional analysts project sales by studying industry trends, volume, competition, and pricing practices; they then project major items of expense, both recurring and nonrecurring, including taxes).

Future-oriented information, however, permits the investor to determine a security's "investment value"²¹ and to compare it with current market price. This comparison may confirm the expectations of others who anticipate normal returns, or it may reveal that the market has undervalued (or overvalued) the security so that superior returns are available.²²

Investment decisions are not made solely by considering a single security in isolation.²³ The investor also requires future-oriented information pertaining to other securities in order to make a meaningful comparison.²⁴ The investor considers the return and risk characteristics of a set of securities and chooses the combination that satisfies his overall investment objectives.²⁵ Comparability across a wide

21. The investment value of the firm must be distinguished from the market price of the security. The investment value of the firm is defined as its intrinsic value, see B. GRAHAM & D. DODD, *supra* note 15, at 17, or the "present value of a stream of cash to the investor, discounted at a rate that reflects the risk of the investment." Hagaman & Jensen, *Investment Value and Security Analysis*, FINANCIAL ANALYSTS J., Mar.-Apr. 1977, at 64; cf. J. WILLIAMS, *THE THEORY OF INVESTMENT VALUE* 55 (1938) ("Let us define the investment value of a stock as the present worth of all the dividends to be paid upon it.") Investment values are relatively fixed and change "only in response to changes in the company's fortunes or in investors' requirements for a level of return" whereas the market price of a stock responds to the volatility of the trading market. Hagaman & Jensen, *supra*, at 64.

22. A substantial body of financial theory asserts that there is no premium or superior return available for "nonsystematic" risks—those risks that are firm-specific, because they are not associated with general market movement. See J. LORIE & M. HAMILTON, *THE STOCK MARKET: THEORIES AND EVIDENCE* 70-124 (1973). But others argue that investors can expect rewards for the assumption of nonsystematic risks. See J. FRANCIS & S. ARCHER, *PORTFOLIO ANALYSIS* 175-80, 182-94 (1971) (rationality of investing in undervalued securities to achieve superior returns); Bines, *Modern Portfolio Theory and Investment Management Law: Refinement of Legal Doctrine*, 76 COLUM. L. REV. 721, 761-63 (1976) (accepting unsystematic risk to achieve superior returns is rational investment objective). Moreover, the investment community behaves as if undervaluation can be detected. See ADVISORY COMMITTEE REPORT, *supra* note 9, at 36-93 (security analysts search for information that is firm-specific).

23. The rational investor not only seeks the individual security with the highest return relative to associated risk, but also seeks the most promising combination of securities for his portfolio. See Kripke, *An Opportunity for Fundamental Thinking—The SEC's Advisory Committee on Corporate Disclosure*, in SEC '77, at 80 (S. Glasser ed. 1977) ("It is thus a wholly impracticable goal to think that a securities decision can be made intelligently from disclosure documents relating to a single company.") (emphasis in original).

24. Measuring and comparing the expected performance of securities of companies within a given industry is an important analytic tool for investment decisions. ADVISORY COMMITTEE REPORT, *supra* note 9, at 50. Evaluation of corporate performance requires "analysis of each segment" of the industry as well as the "relationship of those segments to the whole," *id.* at D-20, and standardization of industry reporting will, therefore, benefit investors. *Id.* at D-19.

25. Investors expect to be compensated with higher returns if they assume greater risks and will choose only those investment opportunities that offer the highest return for any level of risk. H. MARKOWITZ, *PORTFOLIO SELECTION: EFFICIENT DIVERSIFICATION OF INVESTMENTS* 5-7 (1959).

Future-Oriented Disclosure

range of investment opportunities, therefore, is necessary to ensure an optimal investment decision.

The investor also requires information concerning the reliability of his investment decision—the potential impact of future events on the security's value.²⁶ Comparing the performance of an individual security with the performance of the market for all securities is one way to test the reliability of the investment value.²⁷ By considering a security's volatility—its tendency to move with general stock prices—the investor can assess the impact of exogenous events on the security's return. In assessing reliability, the investor also examines firm-specific factors,²⁸ such as management's expected response to future events. Thus detailed financial information, including management's plans for investments, financing, and dividends, is highly relevant to the investor's assessment of the reliability of his decision.²⁹

Future-oriented information is essential because it permits the investor to anticipate management's response to future events, and to correct his investment choices accordingly. Thus it is the extent to which the projection is adaptable to subsequent events that measures its trustworthiness rather than the accuracy of a specific numerical projection.

II. The Inadequacy of Present Disclosure Regulations

The SEC's present disclosure policy assumes that an investor's need for future-oriented information can be met by a record of manage-

26. Cf. Libby & Rollinson, *Securities Law of Materiality as it May Relate to "Optional" Publication of Projections*, 31 BUS. LAW. 701, 703 (1976) (forecasts "may be revised dramatically and frequently"). Revisions are often appropriate regardless of whether new information is firm-specific or more general: a ban on aspirin will have an impact on a pharmaceutical company's sales and cash flow; a rise in interest rates will influence the growth of a capital-intensive firm planning new offerings.

27. Comparison of individual securities in order to achieve the benefits of diversification can be complex. See J. LORIE & M. HAMILTON, *supra* note 22, at 198 (comparing 1,000 securities required 501,500 statistical inputs). But "since almost all securities are significantly correlated with the market as a whole," the performance of a single security can be compared with the performance of the securities market in general. *Id.* at 199.

28. The investor assesses both growth and risk by forecasting systematic changes that may affect the reliability of the value of the security, that is, the risk of the risk. See Fouse, *Risk and Liquidity Revisited*, FINANCIAL ANALYSTS J., Jan.-Feb. 1977, at 41 (breaking down discount factor implicitly used by market and analyzing its components permits assessment of forecast's sensitivity to changes in general interest levels and firm-specific events).

29. The detail in financial reports should be sufficient to permit backward-looking "[c]omparison of evolving [plans that] are perhaps the most useful tool for management appraisal by outside investors." Libby & Rollinson, *supra* note 26, at 703.

ment's past performance³⁰—historic earnings.³¹ Recent studies, however, offer evidence that securities markets may not be functioning efficiently under this "surrogate" theory.³² Moreover, financial analysts and professional investors are relying less on information available in formal reports, such as earnings statements, and are seeking future-

30. See Kripke, *supra* note 19, at 294 (SEC relies on two unarticulated assumptions: (i) "the past foretells the future reasonably well" and historical information "will be a reasonable basis for prediction of the future;" and (ii) "the standard accounting model, based on reporting the past on a historical cost basis, reasonably corresponds with reality").

31. In the early days of federal regulation of securities markets, this assumption may have been more valid than it is today. It was apparently a "common precept" in the decade following enactment of the securities laws to substitute earnings for dividends in valuation models. See J. WILLIAMS, *supra* note 21, at 57-58 (dividends, not earnings, determine value); Hawkins, *Toward an Old Theory of Equity Valuation*, FINANCIAL ANALYSTS J., Nov.-Dec. 1977, at 48, 49 ("[i]nvestors have focused on earnings per share growth, rather than dividend growth, despite the fact that [traditional valuation] models focus on dividends"). Since flexible accounting principles permitted managements to "smooth" earnings so that they paralleled cash flows to the investor, see Ronen, Sadan & Snow, *Income Smoothing: A Review*, 1 ACCOUNTING J. 11, 12 (1977) (income smoothing is "dampening of fluctuations about some level of earnings that is currently considered to be normal for the firm"), past earnings offered an effective substitute for information about future dividends. See Kripke, *supra* note 19, at 294.

Smoothing income permits management to reduce the variability of earnings that might be interpreted negatively by investors, thus reducing the tendency to discount the value of the firm's shares. Managements may also smooth income to reduce the stock's systematic risk—that is, its covariance with market returns. Ronen, Sadan & Snow, *supra*, at 12. For a description of how smoothing is accomplished, see *id.* at 13.

32. Studies indicate that insiders consistently out-perform the market. See Finnerty, *Insiders and Market Efficiency*, 31 J. FINANCE 1141, 1148 (1976) ("Insiders can and do identify profitable as well as unprofitable situations within their corporations."); Jaffe, *The Effect of Regulation Changes on Insider Trading*, 5 BELL J. ECON. & MANAGEMENT SCI. 93, 101-15 (1974); Pratt & DeVere, *Relationship Between Insider Trading and Rates of Return for NYSE Common Stocks, 1960-1966*, in MODERN DEVELOPMENTS IN INVESTMENT MANAGEMENT 268-79 (J. Lorie & R. Brealey eds. 1972). Moreover, there is evidence that some investors have attained superior results. See Basu, *Investment Performance of Common Stocks in Relation to their Price-Earnings Ratios: A Test of the Efficient Market Hypothesis*, 32 J. FINANCE 663 (1977) (portfolios consisting of carefully selected securities achieve significantly higher returns than randomly selected securities); Beebower & Bergstrom, *A Performance Analysis of Pension and Profit-Sharing Portfolios: 1966-1975*, FINANCIAL ANALYSTS J., May-June 1977, at 31 (managers with superior performances in one period continued to perform better in second period). Although market efficiency demands that a relatively large number of operators act on accurate information so that the market can produce accurate results, Ronen, *supra* note 11, at 42, studies indicate that there is both periodic and systematic inefficiency in the dissemination of information, see Garbade & Wiesen, *The Materiality of Inside Information: An Application of Capital Market Analysis*, in SALOMON BROTHERS CENTER FOR THE STUDY OF FINANCIAL INSTITUTIONS WORKING PAPER No. 74 (1976) (time lags can be several trading days); Zeikel, *The Random Walk and Murphy's Law*, 1 J. PORTFOLIO MANAGEMENT 20 (1974) (time lags follow release of new information). Indeed some studies question whether management control of non-public information is socially desirable. See May & Sundem, *Cost of Information and Security Prices: Market Association Tests for Accounting Policy Decisions*, 48 ACCOUNTING REV. 80 (1973) (social benefit can be derived from release of information now withheld by management).

Future-Oriented Disclosure

oriented information directly from managements.³³ The assumption that past values and trends are a reasonable guide to future values and trends is no longer valid,³⁴ for inflation renders historic values less indicative of future values,³⁵ and the complexity and sophistication of corporate affairs have made such comparisons problematic.³⁶ The SEC has recognized these problems and has attempted to reform historic reporting through supplementary disclosures, such as statements of "replacement costs" of assets³⁷ and "changes in financial position."³⁸ In addition, the SEC now permits disclosure of single-figure earnings forecasts.³⁹ Yet none of these reforms assures investors of access to reliable future-oriented information necessary for realistic investment decisionmaking.

33. ADVISORY COMMITTEE REPORT, *supra* note 9, at 55. ("[M]anagements' own projections of the company's performance [are] considered by analysts as being vital information in the first instance rather than simply confirmatory of the analysts' projection.")

34. See Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1188-89 (1970) ("At the time [the SEC's views] were established, they were reasonable . . . Unfortunately, however, the views continue to the present day when they no longer seem reasonable.")

35. See Charles, *Inflation Accounting*, 9 REV. SEC. REG. 951, 952 (1976).

36. See De Lancey, *A.P.B. Opinion No. 15 (Earnings Per Share) from a Lawyer's Standpoint*, 25 BUS. LAW. 419, 434 (1970) (primary earnings per share may be incomprehensible to all but a few); Kripke, *supra* note 34, at 1167 ("[M]odern accounting has become increasingly complex."); cf. Mims, *Pressuring the FASB to Broaden Its Reach*, BUS. WEEK, Nov. 28, 1977, at 96 (preparers and users complain that today's financial statements are weighted down with complex and confusing footnotes that are becoming increasingly incomprehensible); *The Global Snares for Corporate Accountants*, BUS. WEEK, July 25, 1977, at 162 (two companies with identical sales and costs show profits 100% apart by employing alternative but acceptable accounting practices). For examples of accepted accounting devices used to present earnings in a favorable light, see Briloff, *Dirty Pooling*, 42 ACCOUNTING REV. 489 (1967) ("dirty pooling"); Gunther, *Part Purchase—Part Pooling—The Infusion of Confusion into Fusion*, 39 N.Y. CPA 241 (1969) (partial pooling).

37. Securities Act Release No. 5695, 17 C.F.R. § 210.3-17 (1977), *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,212 (certain registrants must disclose estimated current replacement cost of inventories and productive capacity and approximate cost of sales and depreciation based on replacement cost for two most recent fiscal years).

38. The Accounting Principles Board (APB) issued a formal opinion in 1963 that encouraged presentation of a statement of sources and uses of funds. APB Opinion No. 3, *reprinted in* 2 APB ACCOUNTING PRINCIPLES (CCH) 6511 (1963). In 1971, the APB issued an opinion that required a statement summarizing the "changes in financial position" of a business enterprise. APB Opinion No. 19, *reprinted in id.* at 6679. These pronouncements are adopted as rules by the SEC. See Accounting Series Release No. 150 (Dec. 20, 1973), 5 FED. SEC. L. REP. (CCH) ¶ 72,172.

39. See Securities Act Release No. 5362 (Feb. 2, 1973), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,211, at 82,667. Although the SEC did not explicitly adopt a specific rule governing these disclosures, it suggested that a projection should "be expressed as an exact figure or within a reasonable range." *Id.* Thus, the SEC does not suggest that projections include any underlying detail. See Securities Act Release No. 5699 (Apr. 23, 1976), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,200 (effect of amendment to proxy rules, 14a-9, 17 C.F.R. § 240.14a-9 (1977), is merely "to remove predictions of future earnings from the list of examples as to what may be misleading in a proxy statement").

A. *Problems with Historic Reporting*

Although historic cost accounting exudes "an aura of precision and exactitude,"⁴⁰ its flexible reporting rules result in a lack of uniformity⁴¹ that prevents intelligent comparison of financial reports.⁴² Because traditional reporting demands periodic accounting for events that actually affect several reporting periods, the economic consequences of past events must be predicted or estimated.⁴³ In so doing, enterprises may choose from alternative accounting principles; however, the alternative chosen is not always disclosed to investors.⁴⁴ Thus the financial reports of various enterprises may reflect different computational assumptions that make comparison difficult, if not impossible.⁴⁵

In addition to impeding meaningful comparisons among securities, historic cost accounting yields inaccurate information concerning as-

40. FINANCIAL ACCOUNTING STANDARDS BOARD, *SCOPE AND IMPLICATIONS OF THE CONCEPTUAL FRAMEWORK PROJECT 2* (1976).

41. See Heller, *Disclosure Requirements Under Federal Securities Regulation*, 16 *BUS. LAW.* 300, 310 (1961) (reporting enterprises may select accounting alternatives in order to influence earnings). Flexibility is permitted only to the extent that firms conform with generally accepted accounting principles articulated by authoritative bodies. For a history of the accounting profession's development of such principles, see D. KIESO & J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 7-18 (1974).

42. But see AICPA STUDY GROUP, *supra* note 18, at 16 ("[C]omparability should be the overriding consideration for choosing among methods.")

43. COMMISSION ON AUDITORS' RESPONSIBILITIES, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, *REPORT, CONCLUSIONS, AND RECOMMENDATIONS* 23 (1978) (report of commission chaired by M. Cohen) (financial statement amounts must often be determined on basis of best estimates that management can make at time) [hereinafter cited as COHEN COMMISSION].

This process of estimation is usually implemented through use of accrual accounting which recognizes the financial effects of transactions and other events when they occur rather than when cash is received or paid.

44. See *The Global Snares for Corporate Accountants*, *BUS. WEEK*, July 25, 1977, at 162 ("[T]he choice of a particular accounting treatment can drastically reduce or boost reported profits. But the problem is that a company may not spell out in its financial statements which methods it uses.") For example, net income may vary according to the predicted life chosen for a given asset. A firm that purchases an asset for \$1,000 can, hypothetically, depreciate that asset over a useful life of 10, 20, or 50 years. Using straight-line depreciation, yearly charges equal the cost of the asset divided by the useful life. Thus, if the asset produces \$100 of gross income each year, the reported net income (gross income less yearly depreciation) can equal \$0, \$50, or \$80, depending on the useful life selected. Accountants are thus permitted to smooth income by changing the predicted lives of assets without disclosure. See D. KIESO & J. WEYGANDT, *supra* note 41, at 490 (accepted accounting methods require no entry when change in estimate occurs).

45. Whether differences in accounting principles can be adjusted by market professionals to a form that permits comparability (given that computational assumptions are disclosed) is less important than whether adjustments can be made efficiently, so that the market price will reflect the security's intrinsic value within a reasonable period of time. Studies show that periodic inefficiencies do exist. See Brown, *Earnings Changes, Stock Prices, and Market Efficiency*, 33 *J. FINANCE* 17 (1978) (adjustment takes approximately 45 days); cf. Kaplan & Roll, *Investor Evaluation of Accounting Information: Some Empirical Evidence*, 45 *J. BUS.* 225 (1972) (changes in accounting techniques affected stock prices for no more than one quarter after disclosure).

Future-Oriented Disclosure

set values. The values of assets are recorded at their original costs and are systematically reduced by depreciation charges over future periods.⁴⁶ Because the market values of assets may appreciate at the same time that accounting values are depreciating, the historical cost model severely understates the value of assets.⁴⁷ Such inaccuracy impairs the investor's ability to value the enterprise. Insiders may reap profits by acquiring companies the assets of which are grossly undervalued.⁴⁸

B. Problems with Earnings Statements

Historic reporting has traditionally relied upon the earnings statement as the primary method of advising investors of the firm's capacity to generate cash. However, the earnings statement, both because it is based on historic information and because it reports "income"⁴⁹ rather than cash flow, does not adequately inform investors of the firm's future cash-generating capacity. Such information is extremely important to investors.⁵⁰

The concept of income embodied in the earnings statement suffers from severe definitional problems.⁵¹ These problems, in addition to the lack of uniformity in accounting methods,⁵² permit management to manipulate earnings data.⁵³

46. In the example given, note 44 *supra*, the value of the \$1000 asset depreciated over a life of 50 years would decrease in this manner:

At Year	=	1	5	10	20
Book Value	=	\$980	\$900	\$800	\$600

47. When inflation is 5% per year, for example, the cost to replace the asset could increase in this manner:

At Year	=	1	5	10	20
Replacement Cost	=	\$1050	\$1276	\$1629	\$3207

See Securities Act Release No. 5608 (Aug 27, 1975), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,270 (SEC recognized that valuation of firm is difficult during periods of inflation when historical cost accounting distorts values of assets).

48. See *Gerstle v. Gamble-Skogmo, Inc.*, 298 F. Supp. 66 (E.D.N.Y. 1969), *modified*, 478 F.2d 1281 (2d Cir. 1973) (management failed to disclose information concerning unrealized appreciation of assets); *Speed v. Transamerica Corp.*, 99 F. Supp. 808 (D. Del. 1951) (management failed to disclose information concerning unrealized appreciation of inventories).

49. Income, although not yet clearly defined, is determined by matching costs against revenues, and by making necessary allocations of cost to related reporting periods. But commentators question whether "income" has economic meaning. See Treynor, *The Trouble with Earnings*, FINANCIAL ANALYSTS J., Sept.-Oct. 1972, at 43.

50. See Sorter, Gans, Rosenfield, Shannon & Streit, *Earning Power and Cash Generating Ability*, in 2 OBJECTIVES OF FINANCIAL STATEMENTS, *supra* note 11, at 112 (enterprises that are successful at generating cash said to possess earning power).

51. *But cf.* Sorter, *Accounting Income and Economic Income*, in 2 OBJECTIVES OF FINANCIAL STATEMENTS, *supra* note 11, at 108 (problem of definition is avoided by using concept of cash flows).

52. See p. 346 *supra* (earnings subject to discretionary estimates).

53. See Ronen, Sadan & Snow, *supra* note 31 (income smoothing). An additional element of confusion is introduced when projections are used, because they are then compared to statements of actual earnings, which themselves constitute predictions about unrealized events.

Moreover, earnings reported under the historical cost accounting model do not accurately reflect the amount of cash available for future distribution or reinvestment.⁵⁴ Accounting values and depreciation charges based on historical cost do not address the cost of asset replacement during periods of inflation.⁵⁵ Companies have had to use earnings from operations to replace exhausted assets in order to maintain existing levels of operations, and have been unable to use such earnings to finance new projects.⁵⁶ Thus investors can no longer assume that reinvested earnings will lead to dividends or dividend growth.

Earnings statements are currently less representative of actual cash flows than they have been in the past, because income is now influenced by non-cash events⁵⁷ such as changes in foreign exchange rates,⁵⁸ but is not adjusted to reflect near-cash events such as unrealized losses on highly liquid assets such as marketable securities.⁵⁹ In addition, earnings statements are an unreliable surrogate for cash-flow information because they do not disclose situations in which the capital structure of the firm will not support the additional borrowing necessary to continue dividends when cash generated from operations is insufficient.⁶⁰

Because historic earnings reports fail to disclose material information affecting the firm's future cash flows, the investor cannot assess

54. Hawkins, *supra* note 31, at 50; see H. BIERMAN & S. SMIDT, *THE CAPITAL BUDGETING DECISION* 108-44 (3d ed. 1971) ("The earnings figures resulting from current accounting practices are not usable.")

55. See Hawkins, *supra* note 31, at 50 (as inflation rates increase, charges against income understate capital required to replace productive assets and inventory).

56. *Id.* ("Companies had to use earnings to finance the status quo rather than to finance growth.")

57. For instance, research and development expenditures must be set off against income immediately, and are not allocated to years of expected benefits. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 2: ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS (1974). As a result, income will be higher in future periods when benefit from such expenditures is realized without further cash outflow.

58. See FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 8: ACCOUNTING FOR THE TRANSLATION OF FOREIGN CURRENCY TRANSACTIONS AND FOREIGN CURRENCY FINANCIAL STATEMENTS (1975).

59. See FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 12: ACCOUNTING FOR CERTAIN MARKETABLE SECURITIES (1975). Because managements are denied flexibility in reporting near-cash and non-cash events, they can no longer smooth earnings in order to parallel cash flows to the investor. *Cf.* FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 5: ACCOUNTING FOR CONTINGENCIES (1975) (limiting management discretion in treatment of reserves). The FASB takes the position that minimizing fluctuations in performance is the function of financial analysis and *not* the function of financial reporting. See FINANCIAL ACCOUNTING STANDARDS BOARD, ROUNDTABLE DISCUSSION ON THE CONCEPTUAL FRAMEWORK PROJECT 2 (1977) (accounting profession should not minimize reporting of fluctuations because investors will not be confused).

60. Hawkins, *supra* note 31, at 49-50; see Cobbs, *The Tax that is Killing Investment*, *BUS. WEEK*, Jan. 16, 1978, at 16 ("The ratio of debt to equity in many industries is close to the danger point.")

the reliability of his investment decision.⁶¹ Without an objective standard for measuring management's past performance, the investor cannot predict management's ability to respond to future developments.⁶²

The SEC has attempted to remove distortions in historic reports due to inflation by requiring larger firms to restate the value of their assets in terms of current replacement costs.⁶³ Current earnings are then restated using more realistic depreciation charges. Replacement cost earnings are unhelpful, however, both because estimates of replacement costs are highly subjective and because they do not apply to all assets and liabilities affected by inflation.⁶⁴ More importantly, statements of replacement cost earnings do not inform the investor *if* or *when* cash may be required in order to replace assets.⁶⁵

C. Problems with Cash Flow Statements

Although the deficiencies of earnings statements are widely recognized, it is frequently argued that market professionals can compensate effectively by simply deriving cash flow statements from the information already disclosed. Indeed, cash flow information can be extremely valuable to the investor.

Proper interpretation of cash flow data facilitates an assessment of a firm's dividend policy and long-term growth or liquidation potential. Cash flow projections also promote the reliability of future-oriented information. Because cash forecast data is stated in current dollars relating to the current business cycle, the financial information is only minimally distorted by inflation. Moreover, the investor values information about cash flows because cash is unaffected by the choice of

61. Mims, *Pressuring the FASB to Broaden Its Reach*, BUS. WEEK, Nov. 28, 1977, at 96 (quoting SEC Chairman Harold Williams). Many corporate managers are rewarded for producing illusory profits and are "running an operation which, in real terms, is dissipating its capital." *Id.*

62. See Libby & Rollinson, *supra* note 26, at 703 (without adequate future-oriented information investor is unable to assess quality of management's plans and performance).

63. Securities Act Release No. 5695, 17 C.F.R. § 210.3-17 (1977), *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,212.

64. See Chambers, *The Delusions of Replacement Cost Accounting*, FINANCIAL ANALYSTS J., July-Aug. 1977, at 51 ("Whatever else may be said about it, distributable income [under replacement cost accounting] is hypothetical. . . .") Moreover, not all assets affected by inflation are included in replacement cost statements. See *id.* at 52 (replacement cost "deals only with changes in the costs of tangible, non-monetary assets"). For example, replacement cost accounting ignores both the current market price of debt and current interest rates. See Largay & Livingstone, *Current Value Accounting Neglects Liabilities*, FINANCIAL ANALYSTS J., Mar.-Apr. 1978, at 65 (impact of inflation on liability accounting is substantial). There is, therefore, an inability to make meaningful comparisons, even among companies within the same industry.

65. See Chambers, *supra* note 64, at 49, 51 (replacement cost earnings do not reflect cash).

accounting methods;⁶⁶ cash therefore represents objective information not subject to manipulation by management.

Nevertheless, cash flow statements, without more, can be insufficient and potentially misleading.⁶⁷ For example, a firm with cash available for current dividends may, in fact, be liquidating; a firm experiencing a "cash crunch" may be sacrificing current dividends in favor of future growth. Indeed, the concept of income was developed in order to represent cash flows more accurately over time⁶⁸—to permit an accounting for events such as capital expenditures that benefit future periods.⁶⁹ Managements that include cash flow figures in annual reports, particularly when "cash flow per share" is stressed, are criticized when such information is unsupported by the firm's actual sources and uses of cash.⁷⁰

To satisfy the investors' need for information about cash while at the same time limiting the potential for management abuse of such data, the SEC now requires a statement of the firm's "changes in financial position," commonly called a statement of "working capital."⁷¹ The information provided permits use of the balance sheet, income statement, and the working capital statement in order to derive cash flows.

Although the working capital statement eliminates the potential for misleading the investor through undue emphasis on "cash flow per share" information and mediates the gap between basic financial statements and the firm's actual sources and uses of cash, its own shortcomings have been heavily criticized.⁷² The working capital statement is considered a rich man's tool, since it requires further operation by

66. Because cash is unaffected by accounting methods, R. Brief & J. Owen, *Cash Flows, Accounting Data and Performance Measures* (Mar. 3, 1978) (unpublished paper presented to New York University Accounting Workshop) (on file with *Yale Law Journal*), it is not subject to definitional problems. See Sorter, *supra* note 51, at 108 (problem of definition avoided by using concept of cash flow).

67. Cf. Mason, *'Cash Flow' Analysis and Funds Statement*, in AICPA ACCOUNTING RESEARCH STUDY No. 2 (1961) (encouraging sounder understanding of cash flow in light of frequent misuse of cash flow figures).

68. Cf. Ronen, Sadan & Snow, *supra* note 31, at 12 (normalizing cash flows reduces firm's risk).

69. See generally Watts & Zimmerman, *The Demand For and Supply of Accounting Theories: The Market for Excuses* 36-38 (Jan. 1978) (unpublished Working Paper No. GPB 77-7, Graduate School of Management, University of Rochester) (theories and origins of "income").

70. See D. BELLEMORE & J. RITCHIE, *supra* note 20, at 179-80.

71. See note 38 *supra*. The working capital statement, also called the "sources and uses of funds statement" or "funds statement," is permitted to take a number of forms, and lack of uniformity in both terminology and form makes comparisons among companies problematic.

72. See G. WELSCH, C. ZLATKOVICH & J. WHITE, *INTERMEDIATE ACCOUNTING* 1013-15 (3d ed. 1972).

Future-Oriented Disclosure

experts in order to derive cash flows. Hence, the working capital statement magnifies inequalities among investors; the statement provides access to cash flow information only to those investors who can afford the cost of expert analysis. The problem is further magnified with respect to financial forecasts because cash flows would have to be derived from both the working capital statement and the balance sheet.

D. *Problems with SEC Forecasting Policy*

As the problems with historical cost accounting have become increasingly apparent and the usefulness of historic reports as surrogates for future values and cash flows has become more doubtful, the SEC has moved toward permitting direct disclosure of future-oriented information. The SEC has departed from its longstanding prohibition of projections and currently permits voluntary disclosure of single-figure earnings forecasts.⁷³ But this policy has failed to alleviate structural market inefficiency and unfairness to investors, because the disclosure scheme fails to mandate detailed projections that include cash flows.

The SEC's policy of voluntary disclosure of future-oriented information has encouraged a "black market" of information in which firms practice selective disclosure—disclosure to some but not all individuals.⁷⁴ Aggressive analysts and professional investors seek nonpublic, future-oriented information directly from managements,⁷⁵ because it helps them construct a superior forecast or confirm a current analysis.

The existence of this black market reduces the overall efficiency of

73. See note 39 *supra*. The SEC commenced a study of financial forecasting in 1972. Exchange Act Release No. 9844 (Nov. 1, 1972), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,075. After examining its position, the SEC acknowledged that financial forecasts were widely relied upon and would not be considered misleading if "reasonably based in fact, prepared with reasonable care and carefully reviewed." Exchange Act Release No. 9984 (Feb. 2, 1973), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,211, at 82,668. "Information gathered at the hearings reinforced the Commission's own observation that management's assessment of a company's future performance is information of *significant* importance to the investor . . . and that such information should be available . . . on an equitable basis to all investors." *Id.* at 82,667 (emphasis added). Although predictions of earnings were at one time considered misleading by the SEC, earnings projections are now permitted. Securities Act Release No. 5699 (Apr. 23, 1976), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,202 (longstanding policy generally not to permit projections may have served as impediment to disclosure of projections to investors); see Schneider, *Financial Projections*, 7 REV. SEC. REG. 907 (1974) (SEC statement "signalled a reversal of [its] historical position").

74. See ADVISORY COMMITTEE REPORT, *supra* note 9, at XVIII (large numbers of professionals constantly seek out information); Gray, *Proposal for Systematic Disclosure of Corporate Forecasts*, FINANCIAL ANALYSTS J., Jan.-Feb. 1973, at 65 (analysts regularly receive nonpublic information from corporate managements). This practice is clearly illegal. Issuers have a responsibility to disclose material facts, both favorable and unfavorable, and to do so without selective disclosure to analysts. Securities Act Release No. 5699 (Apr. 23, 1976), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,202-03.

75. See ADVISORY COMMITTEE REPORT, *supra* note 9, at 56.

securities markets. The securities laws are premised on the existence of a broad market made up of many investors. The underlying theory suggests that concurrent investment analyses by sophisticated professionals result in accurate market prices.⁷⁶ A small submarket made up of investors with inside information, therefore, tends to distort the accuracy of market prices.⁷⁷

Moreover, the SEC's present policy of permitting, without requiring, disclosure of financial forecasts is unfair to investors because it permits managements to suppress and to control information flows. Managements withhold adverse information in the hope that circumstances will improve and release positive information at times of maximum impact.⁷⁸ As a result, managements have substituted "information smoothing" for "income smoothing."⁷⁹ Investors cannot rely on traditional safeguards afforded formal disclosure, such as periodic reporting⁸⁰ and independent reviews,⁸¹ to counteract this form of manipulation. Thus, investor confidence in securities markets is undermined.

The current SEC policy promotes further structural market inefficiency because voluntary disclosure of financial forecasts does not

76. See Ronen, *supra* note 11, at 42.

77. The SEC has expressed concern over the practice of selective disclosure. See Securities Act Release No. 5699 (Apr. 23, 1976), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,202-03 (warning issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable). The practice is clearly condemned by the securities laws, see 15 U.S.C. § 78j(b) (1976) (antifraud provisions), and by the courts, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 848, 852 (2d Cir. 1968) (securities laws violated when those who have access to material nonpublic information divulge that information to "tippees").

78. Ronen, *supra* note 11, at 50-51. Release of positive information tends to be timed shortly before new issues are offered even though the practice is illegal. *Id.*; see Lurie & Pastena, *How Promptly Do Corporations Disclose Their Problems?* FINANCIAL ANALYSTS J., Sept.-Oct. 1975, at 58 (empirical studies indicate that firms' disclosures of events that adversely affect income are clustered toward end of fiscal year). Often management conceals bad news hoping that it will be temporary, ADVISORY COMMITTEE REPORT, *supra* note 9, at XXVIII, but such concealment also serves management's self-interest in job security, *id.*

79. See note 31 *supra* (income smoothing). Information smoothing, on the other hand, is the conscious manipulation of information in order to present the firm's position in the best possible light. See FAF STUDY, *supra* note 19, at 51 (quoting former SEC Chairman William J. Casey) ("present disclosure system operates to block the very information in which the investor is most interested . . . while simultaneously allowing . . . private forecasts which are unregulated"). Information smoothing is, of course, illegal. See note 74 *supra*.

80. 15 U.S.C. § 78m(d) (1976) (firms must file periodic financial report with SEC). Reports are also required for other events. See *id.* § 78n(a) (proxy solicitations); *id.* § 78n(d) (tender offers).

81. Financial statements that accompany registration statements required by Schedule A (25)-(26), 15 U.S.C. § 77g (1976), must be certified by an independent accountant. *Id.* § 77aa(25)-(26).

Future-Oriented Disclosure

permit broad comparison among firms. Under the SEC's voluntary forecasting policy some, but not all, companies will report forecasts. Because only one firm in ten whose securities are publicly traded is regularly followed by one or more analysts,⁸² it is doubtful that all information will be efficiently reflected in market prices. Thus an investor's present opportunities to compare an individual security against the market and against similar securities render a realistic and informed investment decision unlikely.

III. Meeting Traditional Objections to Forecasting

Because the SEC's disclosure policy is inadequate to meet the informational needs of investors and to provide an efficient market for securities transactions, and because future-oriented information serves both these goals, the SEC should consider mandating disclosure of earnings and cash flow forecasts. Indeed, the future-oriented information essential to investors is now generated by management in the form of internal projections.⁸³ Moreover, traditional objections to such forecasts do not pose a significant danger to a well-planned SEC policy mandating projections.

A. *Fear that Projections May Mislead Investors*

One group of traditional objections to forecasts rests on the assertion that forecasts will exacerbate market inefficiency because investors will be confused by the disclosures or misled by management manipulation of them. Such fears are unfounded, however, and cannot be considered a basis for opposition to a carefully drafted disclosure plan.

1. *Investor Confusion*

Some experts have opposed disclosure of management forecasts based on fears that investors will tend to accept projections as statements of determinate fact.⁸⁴ Such fears are misplaced, however, because both

82. ADVISORY COMMITTEE REPORT, *supra* note 9, at XXII-III.

83. See FAF STUDY, *supra* note 19, at 36 ("Most companies already have an ample internal documentation for forecasting through formal budgets and other planning documents characteristic of well managed companies."); Kripke, *supra* note 34, at 1197 (corporations use projections as basis for decisions as to borrowing, building new plants, establishing new branches, ordering materials, hiring and training labor); Ruder, *Disclosure of Financial Projections—Developments, Problems and Techniques*, in PLI FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 12 (1974) ("[T]here seems little doubt that managements of most American businesses regularly produce forecasts for internal use.")

84. See Heller, *supra* note 41, at 307 (opinions stated by management accepted as fact because they "suggest to the investor a competence and authority which in fact does not exist").

professional and less sophisticated investors seem to understand the tentative nature of forecasts.⁸⁵ Investors have had access to projections under SEC rules since 1976, and available evidence indicates that the predicted confusion has not materialized.⁸⁶ Many disclosures mandated under current SEC rules are based on informed predictions and judgments concerning the consequences of past events.⁸⁷ Moreover, estimates of current values, such as the replacement costs of assets, are now required for some reporting enterprises.⁸⁸

Any danger that the average investor will be misled by management projections can be mitigated by clearly segregating forecast data from historic reports in the firm's financial statements and by alerting the investor to the tentative nature of projections. In addition, management can be required to state a "point range"⁸⁹ that indicates the minimum and maximum outcomes expected in each projected category. Investors provided with this range can assess the riskiness of management's forecast. Given an expected range of outcomes, the relationship of a particular item to a key variable, such as sales, can be set forth.⁹⁰

85. FAF Study, *supra* note 19, at 36 ("[M]any of the fears and problems [associated with financial forecasting] have been grossly exaggerated.") Both professional and less sophisticated investors, "who [behave] to a surprising degree like financial analysts," maintain a "healthy skepticism" toward management forecasts. *Staff Survey Analyzes Use of SEC Documents*, N.Y.L.J., Dec. 19, 1977, at 36, col. 6. See Securities Act Release No. 5581 (Apr. 28, 1975), [1974-1975] FED. L. REP. (CCH) ¶ 80,167, at 85,301 (management's assessment of firm's future performance is important and should be able to be understood by investor in light of assumptions made).

86. See Securities Act Release No. 5362 (Feb. 2, 1973), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,211, at 82,666 (SEC acknowledged projections are widely used and are not misleading if "reasonable, based in fact, prepared with care, and adequately reviewed"); cf. Securities Act Release No. 9844 (Nov. 1, 1972), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,075 (SEC study on feasibility of formal disclosure of projections).

87. See p. 346 *supra*. A *prediction* is an estimate of the economic impact of events occurring in past accounting periods. *Forecasts* or *projections* are estimates of performance expected in future periods. Commentators have suggested that predictions and projections are indistinguishable. See Hakansson, *Interim Disclosure and Public Forecasts: An Economic Analysis and a Framework for Choice*, 52 ACCOUNTING REV. 396, 397 (1977) (there may be no difference between interim reports that are predictions, and forecasts).

88. See pp. 345, 349 & notes 37, 63-65 *supra*.

89. The point range, a single figure forecast accompanied by its expected deviation, is more informative than a simple range that focuses on the end points rather than the median. Should companies choose a simple range, any variation in actual performance would create a margin of error double that of a point range. Elgers & May, *Problems with SEC's Forecast Guidelines*, CPA J., Mar. 1978, at 21-22. The standard deviation, the measure of variability used in a point range, should qualify each component estimated.

90. The relationship of an item to a key variable is useful because some projected figures are subject to either economies or diseconomies of scale. For example, less cash may be necessary for maintenance expenditures as sales increase. Conversely, the same sales increase may necessitate increased advertising expenditures. The relationship of each cash forecast component (maintenance, advertising) to the key variable (sales) will be valid only for some range of activity. This range should be announced as an assumption.

Moreover, the assumptions underlying a particular forecast can be disclosed. In fact, a requirement that relevant assumptions be presented along with projections has received judicial support.⁹¹ An additional safeguard can be implemented by requiring management to supplement a forecast in the event of material deviations from articulated projections.⁹² Such a requirement will render financial forecasts self-correcting. Investors can continually adjust their investments based on the degree of coincidence between subsequent events and original assumptions. Disclosures of financial projections, incorporating these safeguards, are probably less misleading than information currently available in the so-called black market.

2. Management Manipulation

Because projections are estimates of the future, it has been suggested that an unscrupulous management can defraud investors by manipulating projections to indicate results favorable to the firm.⁹³ Under a carefully planned regulatory mechanism, however, both the SEC and investors can monitor management practices vigilantly.

Manipulation is discouraged most effectively when the market itself is able to detect, expose, and censure any unreasonable differences between projected and actual performance. This can be accomplished by requiring management to present a variance analysis discussing

91. *Beecher v. Able*, 374 F. Supp. 341, 348 (S.D.N.Y. 1974). The court held that assumptions "bearing on the reasonableness of a forecast" must be disclosed, *id.*, but offered no standards for the articulation of such assumptions. For a suggested standard of relevance, see Elgers & Clark, *The Role of Assumptions in Financial Forecasts*, J. ACCOUNTANCY, July 1974, at 65 ("Only those assumptions should be disclosed whose violation would significantly alter the estimate, causing the investor to make a decision different from one based on the original forecast."); *id.* ("All-embracing assumptions and those relating to the general accuracy of the estimates should be avoided."); *cf.* Securities Act Release No. 5699 (Apr. 23, 1976), [1975-1976] FED. SEC. L. REP. (CCH) ¶ 80,461, at 86,201 (projections must have reasonable basis, must be presented in appropriate format, and must facilitate investor understanding of their basis and limitations). Commentators have stated that an assumption is *unreasonable* if "chosen in reckless disregard of available contradicting [*sic*] information," Carmichael, *Financial Forecasts—The Potential Role of Independent CPAs*, J. ACCOUNTANCY, Sept. 1974, at 85, and that "[t]he reader should be able to understand the implications of assumptions and so help in forming a judgment as to the reasonableness of the forecast and to the main uncertainties attached to it." Elgers & Clark, *supra*, at 65.

92. *Cf.* Securities Act Release No. 5092 (Oct. 15, 1970), [1970-1971] FED. SEC. L. REP. (CCH) ¶ 77,915, at 80,035 (obligation to make full and prompt announcements of material facts notwithstanding all other reporting requirements); Dayan, *Correcting Errors in the Press*, 5 REV. SEC. REG. 941 (1972).

93. See Heller, *supra* note 41, at 306-07 (companies might present over-optimistic views of expected results). Many believe that earnings forecasts, asset appraisals, or any other information based on opinions or estimates are inherently manipulative. See *In re Thomas Bond, Inc.*, 5 S.E.C. 60, 71 (1939) (forecasts give false appearance of precision that renders them inherently misleading).

material variations between projected and actual results. In fact, because detailed forecasts of cash flows can be compared to actual cash flow information unaffected by accounting methods, they are potentially less vulnerable to manipulation than single-figure earnings forecasts. Forecasts should therefore provide the investor with detailed information concerning significant components⁹⁴ of the firm's recurring and nonrecurring cash flows.⁹⁵ Moreover, required articulation of underlying assumptions eliminates many avenues of potential ambiguity that might otherwise be subject to intentional manipulation.⁹⁶

The SEC can also foster the disclosure of good faith projections by requiring review of management data by an independent auditor before its dissemination to the public.⁹⁷ Furthermore, courts are likely to hold managements liable for misleading investors unless forecasts are reasonable and based on facts.⁹⁸

B. *Fear of Excessive Costs*

Even if projections provide essential information to investors, managements have traditionally argued that mandatory disclosure would impose excessive costs. The pecuniary costs of disclosure, however, are

94. The SEC currently uses the term "significant" to designate components, such as materials, advertising, and research and development, that should be independently presented in financial statements. A component should be considered "significant" when it has either a 10% impact on sales or a 2% impact on income. See Securities Act Release No. 5488, 17 C.F.R. § 210.1-02(u) (1977), reprinted in 5 FED. SEC. L. REP. (CCH) ¶ 72,177 (using 10% rule for reporting "significant" subsidiaries).

95. Recurring and nonrecurring cash flows should be clearly segregated. The former should include results of operations and related projected dividends. The latter should include sales and purchases of capital assets, acquisitions and divestitures, refunding of debt or new offerings, and share repurchases or new equity issues.

96. See p. 355 *supra*.

97. See Carmichael, *supra* note 91, at 85 (investors and regulators will expect CPAs to provide safeguard against unscrupulous and inept preparers); Corless & Norgaard, *User Reactions to CPA Reports on Forecasts*, J. ACCOUNTANCY, Aug. 1974, at 54 (CPA's report would increase user confidence in forecasted data, particularly when user is unsophisticated). But see COHEN COMMISSION, *supra* note 43, at 69 (financial forecasts should be audited only after process of preparing forecasts is standardized); cf. ADVISORY COMMITTEE REPORT, *supra* note 9, at D-36 (concluding that "third party review of management projections should be permitted but not required").

Moreover, the Commission on Auditor's Responsibilities has suggested that the audit function be extended to include "understanding of the process used by the company to prepare significant financial information released regularly during the year," and to "review the company's financial reporting process for preparing quarterly information released to the public." COHEN COMMISSION, *supra* note 43, at 61-63. Should these procedures be adopted, a forecast review, based on a previously audited system of internal controls, would be highly simplified.

98. See *Beecher v. Able*, 374 F. Supp. 341, 348 (S.D.N.Y. 1974). Liability under section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976), and section 10(b) of the Securities Exchange Act of 1934, *id.* § 78j(b), will be found against executives and experts guilty of manipulation of financial forecasts in bad faith, either by smoothing information or by fraudulently representing opinions without a reasonable basis for the belief stated.

probably not significant⁹⁹ because all public companies are now required to maintain systems of internal control¹⁰⁰ and because most businesses regularly generate projections for internal use.¹⁰¹

Although public disclosure of these projections will not significantly increase the costs of accumulating and disseminating information, managements have also claimed that disclosure will lead to competitive injury to the firm, distortion of management decisions, and excessive legal liability. Because these costs can be minimized by a carefully drafted disclosure plan, the potential harm to the firm is outweighed by the advantages of disclosure to the investor.

1. *Competitive Injury*

Managements appear to be most concerned that disclosure of financial projections will weaken the firm's competitive position.¹⁰² Studies have concluded, however, that there is no "significant competitive cost associated with current reporting requirements."¹⁰³ Since man-

99. See FAF STUDY, *supra* note 19, at 39 ("[M]ore systematic disclosure of management forecasts should not impose any significant additional costs. The information is already available . . ."); cf. ADVISORY COMMITTEE REPORT, *supra* note 9, at 26-27 (costs of preparing currently required Form 8-k range from \$289 for firms with assets in excess of \$1 billion to \$686 for firms with less than \$100 million in assets); Ronen, *A Test of the Feasibility of Preparing Discounted Cash Flow Accounting Statements*, in 2 OBJECTIVES OF FINANCIAL STATEMENTS, *supra* note 11, at 211 (preparing financial statements and financial forecasts based on discounted cash flow accounting for firms with assets of \$8,565,000 involves approximately 40 hours).

100. Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494 (1977) (to be codified in 15 U.S.C. § 78q(b)) (requiring that every issuer subject to periodic filing requirements "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that . . . transactions are recorded . . . as necessary to permit preparation of financial statements").

101. Kripke, *supra* note 34, at 1197-98 ("[M]ost sizeable corporations use projections of future sales and revenues and capital needs as the basis for making very important decisions as to borrowing, building new plants, establishing new branches, ordering materials, hiring and training labor, etc. . . . [and are] in a better position than the public to forecast where the company is going. . . ."); Mann, *Prospectuses: Unreadable or Just Unread?—A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 222, 230 (1971) ("[C]orporate management is constantly planning future expansion and making financial commitments on the basis of [available] internal projections.")

102. The foremost unstated objection to disclosure of projections stems from management's "natural desire to profit from hard-earned inside information." Libby & Rollinson, *supra* note 26, at 704. "[T]ipping one's hand to the competition" is a traditional argument against disclosure generally. *Id.* at 704. This argument has been addressed by Congress on many occasions. Cf. H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13 (1934), reprinted in 5 J. ELLENBERGER & E. MAHAR, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934 (1973) ("[T]he idea that a fair report of corporate assets and profits give [sic] unfair advantage to competitors is no longer seriously entertained by any modern businessman.") [hereinafter cited as H.R. REP. NO. 1383]. But see H. MANNE, INSIDER TRADING AND THE STOCK MARKET (1966) (insiders should not only be permitted to retain proprietary information but should also be permitted to trade on such information as incentive).

103. ADVISORY COMMITTEE REPORT, *supra* note 9, at 22-23.

agements are already disclosing forecasts to selected analysts,¹⁰⁴ formal dissemination to the public is unlikely to injure the company. Moreover, sensitive plans for future financing and investment are already governed by existing disclosure rules relating to new offerings,¹⁰⁵ tender offers¹⁰⁶ and mergers.¹⁰⁷ These disclosures have not had a detrimental effect. Indeed, the suppression of material adverse information that would injure a firm's competitive position has been illegal for some time.¹⁰⁸

Under a carefully conceived disclosure plan, management would not be required to reveal inchoate plans or delicate negotiations until arrangements are concrete.¹⁰⁹ Revelation of such information is not necessary to the realization of the purpose of a disclosure requirement: providing an indication to investors of the direction and magnitude of management plans.

2. *Distortion of Management Decisions*

It has been suggested that if management is forced to disclose its goals, the threat of liability or embarrassment will foster a blind pursuit of stated prognostications rather than a flexible response to unforeseen events. Management should feel no such pressure, however, if a revised approach is the result of exogenous factors. Moreover, management can explain its actions by isolating the impact of events beyond its control or by pointing to previously disclosed assumptions that were not borne out by subsequent events.

A detailed projection that includes a variance analysis thus provides an invaluable device for evaluating management performance. An investor can assess management's ability to present rational expectations, to realize stated goals, and to respond appropriately to events beyond its control. Investors are concerned with management's planning ability as well as with the fulfillment of specific projections.¹¹⁰ Hence, managements are rewarded for formulating reasonable plans

104. See pp. 351-52 & notes 74-81 *supra*.

105. 15 U.S.C. § 77aa (1976).

106. *Id.* § 78n(d).

107. *Id.* § 78n(a) (governing proxy solicitations required by most state statutes for consummation of merger).

108. See Securities Act Release No. 5092 (Oct. 15, 1970), [1970-1971] FED. SEC. L. REP. (CCH) ¶ 77,915, at 80,035 (obligation to make full and prompt announcements of material facts notwithstanding all other reporting requirements).

109. See Brudney, *A Note on Chilling Tender Solicitations*, 21 RUTGERS L. REV. 609, 621 (1967) (disclosure obligations should be curtailed when disclosure might prevent consummation of advantageous transaction and when information is highly indefinite).

110. See ADVISORY COMMITTEE REPORT, *supra* note 9, at 50-51' (analysis addresses not only management's response to economic events but also *changes* in responsiveness of company to economic events).

Future-Oriented Disclosure

and solving problems creatively.¹¹¹ There is no special reward for the management that can fulfill prophecies with precision.¹¹²

3. Risk of Legal Liability

Managements have also feared mandatory disclosure of forecasts because of the threat of legal liability should stated projections not be realized.¹¹³ It is well established, however, that projections made in good faith cannot result in liability under federal securities law.¹¹⁴ Indeed, because projections are crucial factors in the investment decision, they might be considered material information that must be disclosed.¹¹⁵ Contrary to management fears, courts have not held man-

111. See Mann, *supra* note 101, at 230.

112. Cf. Carmichael, *supra* note 91, at 84 (accuracy is not objective of publishing forecasts). But see Ruland, *The Accuracy of Forecasts by Management and by Financial Analysts*, 53 ACCOUNTING REV. 439, 446 (1978) (accuracy of analyst's forecasts increased by availability of management forecasts).

113. See Herwitz, *The Risk of Liability for Forecasting*, in 2 OBJECTIVES OF FINANCIAL STATEMENTS, *supra* note 11, at 250 (fear that "crushing burden of liability, out of all proportion to the magnitude of the defendant's fault" would result); cf. *id.* at 247 (distinguishing between *risk of being sued* and *risk of liability*, since forecasts that go awry "will present a very inviting target to potential shareholder litigants").

114. See, e.g., Securities Exchange Act Release No. 9984 (Feb. 2, 1973), [1972-1973] FED. SEC. L. REP. (CCH) ¶ 79,211, at 82,666; A. BROMBERG, SECURITIES LAW § 5.3 (1974); A. JACOBS, THE IMPACT OF RULE 10B-5, at 3-56 (1977).

Managements fear that suits will be based on section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (1976), and section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976). Under § 77k, however, the issuer is protected from frivolous suits through exercise of the court's discretion: "[I]f the court believes the suit . . . to [be] without merit," the plaintiff may be directed to post a bond for the costs that may be assessed against him in the event an adverse judgment is rendered. *Id.* § 77k(e). See *Straus v. Holiday Inns, Inc.*, No. 77-383 (S.D.N.Y. Apr. 6, 1978) (bond must be posted when claim is "so utterly lacking in merit as to border on the frivolous"). There are a number of restrictions applicable to suits brought under § 78j(b). See, e.g., *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976) (management must have scienter in order to be held liable); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975) (private right of action confined to purchasers and sellers of securities). Thus the securities laws shield managements from claims that are obviously without merit.

115. See Schneider, *Financial Projections—Practical Problems of Disclosure*, in PLI FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 47, 50-54 (1974) (issuer's choice to project or not to project may turn out to be illusory because of duty to disclose material information); Libby & Rollinson, *supra* note 26, at 703 (management projections clearly material information). The Supreme Court has defined materiality as those facts that a "reasonable investor might have considered . . . important in the making of [his] decision." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). The SEC has found materiality when a fact "was of such importance that it could be expected to affect the judgment of investors . . . [or] to affect materially the market price of the stock." *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 937 (1968). Financial forecasts would seem to fall under these definitions of material information because they contain management data that investors consider highly pertinent. FAF STUDY, *supra* note 19, at 70 (materiality of forecasts to investors seems to be assumed both administratively and judicially). A projection or forecast is a fact. See ALI FED. SEC. CODE § 234A (Reporter's Revision of Tent. Drafts Nos. 1-3, 1974). A projection will usually be a material fact within almost "any definition of materiality," Ruder, *supra* note 83, at 35-36, and "will

agements liable solely for inaccurate forecasts of future performance.¹¹⁶ At least one court has concluded that projections that represent a fair and accurate reflection of best estimates available to management do not impose liability on the issuer.¹¹⁷ The SEC should adopt a similar position.¹¹⁸ In any event, management should not be required to disclose information that violates the fiduciary duty owed to shareholders.¹¹⁹

IV. Proposed Guidelines for Financial Forecasts

The future-oriented information required by investors cannot be obtained from currently available disclosures,¹²⁰ and selective disclosure of forecast data is both inequitable and inefficient.¹²¹ Since a carefully conceived disclosure policy will not present significant disadvantages, managements should be required to disclose formal finan-

certainly be material if it deviates from well known public estimates." *Id.* at 18. *See* Libby & Rollinson, *supra* note 26, at 701 ("[p]ermitting projections to be included in prospectuses and other filings with the [SEC] will, because of the materiality of such projections, eventually result in a court-imposed mandate to include said projections in SEC filings if management has and uses the projections for any purpose.")

It is, therefore, doubtful whether a firm can offer its shares for sale without disclosing *adverse* material forecasts. *See* FAF STUDY, *supra* note 19, at 26 ("Management forecast information is of such importance to investors that it would seem to fall in the class of information subject to insider trading rules.") Similarly, companies that buy their own securities may be precluded from doing so if the firm's nonpublic internal forecast is highly favorable. *See* Ruder, *supra* note 83, at 14 ("If the corporation's projections are materially different from the projections that are in common use by outsiders, I would regard company activity in purchasing stock based upon those projections as being in violation of Rule 10b-5.")

116. *See* Marx v. Computer Sciences Corp., 507 F.2d 485 (9th Cir. 1974) (issuer will not be held accountable unless reckless or grossly negligent in preparation of projection); Milberg v. Western Pac. R.R., 51 F.R.D. 280, 282 (S.D.N.Y. 1970), *dismissed*, 443 F.2d 1301 (2d Cir. 1971) (investor cannot reasonably expect projections to be infallible). The claim that regulated forecasts will invite lawsuits is unpersuasive. *See* FAF STUDY, *supra* note 19, at 68 ("The result of this profusion of unregulated forecasts . . . has *not* been a spate of lawsuits over the adequacy of the forecasts.")

117. Dolgow v. Anderson, 53 F.R.D. 664, 670 (E.D.N.Y. 1971), *aff'd*, 464 F.2d 437 (2d Cir. 1972); *cf.* Beecher v. Able, 374 F. Supp. 341 (S.D.N.Y. 1974) (projections unreasonable because key assumptions not disclosed, *i.e.*, forecast did not convey management consensus of best estimate).

118. Similar "safe harbour" rules have been provided for preparers of supplementary replacement cost data. *See* Securities Act Release No. 5695, 17 C.F.R. § 210.3-17(g) (1977), *reprinted in* 5 FED. SEC. L. REP. (CCH) ¶ 72,212, at 62,508 (no liability for current replacement cost information unless prepared without reasonable basis or disclosed other than in good faith).

119. *See* V. BRUDNEY & M. CHIRELSTEIN, *supra* note 16, at 717 (conflicting tensions between investor's need for disclosure of relevant information and harm that may come from such disclosure). For example, merger or contract negotiations in progress, if disclosed, could defeat the firm's competitive advantage—and thus the shareholder's interests.

120. *See* pp. 343-53 *supra*.

121. *See* pp. 351-53 *supra*.

Future-Oriented Disclosure

cial forecasts. Indeed, it is arguable that the SEC has a statutory duty to ensure access to such information.¹²²

Financial forecasts should be mandatory¹²³ for most public companies in order to facilitate comparison among a broad range of investment opportunities¹²⁴ and to mitigate the structural inefficiency of the present selective disclosure system.¹²⁵ Forecasts should provide detailed information concerning cash flows,¹²⁶ including point ranges and key variables.¹²⁷ The forecast should also disclose relevant assumptions that underlie projections¹²⁸ and include a variance analysis of projected and actual results.¹²⁹

Moreover, formal forecasts should include safeguards that ensure that projections are both reliable and self-correcting. The tentative nature of the information presented should therefore be indicated by clearly segregating forecasts from historic reports.¹³⁰ In addition, forecasts should be carefully reviewed by independent accountants.¹³¹

122. The statutory duty to report to investors, imposed on managements by the securities laws, formalized management's common law duty of stewardship, or responsibility for the safekeeping of assets entrusted to its custody. See FINANCIAL ACCOUNTING STANDARDS BOARD, TENTATIVE CONCLUSIONS ON OBJECTIVES OF FINANCIAL STATEMENTS OF BUSINESS ENTERPRISES 58-59 (1976) (accounting and reporting developed from steward's duty to medieval lord of manor and demonstrated that administrators had honestly and properly cared for monies and other property for which they were responsible). In recommending passage of the Securities Act of 1933, President Roosevelt alluded to "the ancient truth" that "those who manage . . . corporations [*i.e.*, those who use] other people's money are trustees acting for others" and that "no essentially important element attending [an] issue [should] be concealed from the buying public." 77 CONG. REC. 937 (1933). Under evolving standards of accountability, management's duty now extends to a duty to increase as well as to preserve wealth. See AICPA STUDY GROUP, *supra* note 18, at 26 ("An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise resources effectively in achieving the primary enterprise goal."); Rosenfield, *Stewardship*, in 2 OBJECTIVE OF FINANCIAL STATEMENTS, *supra* note 11, at 123-40 (relating stewardship and accountability to economic decisions of investors that concern future). Since wealth is defined, under modern financial theory, as the present interest in future returns, see note 21 *supra*, management's duty to report extends to that information. Thus, management's plans for the owner's wealth, namely financial projections, are subject to disclosure requirements just as is information concerning historic performance. In fact, Congress recognized that prior to enactment of the securities laws managements maintained their control of the shareholders' interests without an "adequate explanation of the management policies they intend[ed] to pursue." H.R. REP. NO. 1383, *supra* note 102, at 13-14.

123. In order to make financial forecasts mandatory, the SEC would have to amend Regulation S-X, 17 C.F.R. § 210 (1977). The requirement need not be applicable to all firms immediately. To effectuate the goals set forth in this Note, it need initially apply only to firms with assets in excess of \$100,000,000.

124. See p. 342 *supra*.

125. See pp. 351-53 *supra*.

126. See p. 356 *supra*.

127. See p. 354 *supra*.

128. See p. 355 *supra*.

129. See pp. 355-56 *supra*.

130. See p. 354 *supra*.

131. See p. 356 *supra*.

Finally, the SEC should require immediate correction whenever newly available information indicates material deviation from a prior forecast.¹³²

As a guide to courts on questions of liability, the SEC should adopt a policy position that both permits management to be flexible in its future behavior and protects investors from management manipulation.¹³³ Such an administrative policy would limit liability to situations in which forecast information: was prepared without a reasonable basis for belief; was disclosed in bad faith; or was not carefully reviewed by management and by independent accountants.¹³⁴ Moreover, managements should not be required to project the consequences of delicate negotiations or highly uncertain events.¹³⁵

A regulation conforming to the guidelines suggested in this Note will ensure that the investor is provided with reliable future-oriented information and thus reduce the unfairness inherent in current disclosure requirements. The availability of such information will enhance the efficiency of securities markets and more equitably allocate capital resources. Such a regulation, therefore, furthers the twin goals of federal securities regulation.¹³⁶

132. See p. 355 *supra*.

133. See pp. 358-59 *supra*.

134. See p. 360 *supra*.

135. See p. 358 *supra*.

136. See p. 338 & note 3 *supra*.