BRITISH PROFIT FORECASTING SYSTEM: MODEL OR MISTAKE FOR THE UNITED STATES?

Prior to the purchase of corporate stocks or securities, the investor—be he institutional or individual—will scrutinize the detailed financial history of the issuing company. From this analysis the investor will draw conclusions regarding the future performance of the company. He "[W]ill attach due weight to any projections of profits and earnings which the management of the company may have seen fit to make available."[1]

To fully comprehend the importance of the profit forecast to the British investor, it is important to examine the three components that control the securitites regulation in that country. These three factors include the Companies Act of 1948,[2] the relative lack of marketing of securities in London,[3] and the dominant position of the London Stock Exchange.[4] In fact, the latter[5] de-

1. Address by John Hull, Director General of the Panel on Take-Overs and Mergers, before the Northwestern University Graduate School of Management, April 2, 1973, copy provided by Northwestern University Graduate School of Management, on file in CALIF. W. INT'L L.J. offices. [Hereinafter cited as Hull Address].

2. Companies Act of 1948, 11 & 12 Geo. 6, c.38, *as amended*, Companies Act of 1967, c.81. For example:

> The Companies Act of 1948 contains regulations of the type one would expect to see in a state corporation statute, as well as restrictions on the public offer of securities.

Knauss, *Securities Regulation in the United Kingdom*, 5 VAND. J. TRANSNAT'L L. 47, 49 (1971).

Sections 1-5 of the act contain the provisions for the formation of the company. Sections 37-46 of the act contain the necessary requirements for the prospectus and the criminal liability involved for the misstatements in the prospectus.

3. Dean Knauss states that:

> [The second basic aspect of securities regulation in the United Kingdom] is the relative lack of marketing of securities in England. The customer's account representative is unknown in the London market, and there are virtually no branch offices of the major brokerage firms.
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> . . . .
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> In this regard, it is indicative that individual British stockbrokers, in contrast to their American counterparts, usually are not compensated within their firm on a commission basis. Instead, members and employees of the London firms are generally paid a salary or receive a share of profits that has neither direct nor indirect relationship to the volume of sales and trading.

Id., at 51-2.

4. The London Stock Exchange has adopted this position:

> [S]ince there is no over-the-counter market in England as it is known in the United States, there are few large issues of securities, other than by "private companies," that do not obtain a quotation on the London Exchange.

Id., at 51.

5. The pertinent rule for admission to the London Stock Exchange re-

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mands that a prospectus offering securities to the public include a statement discussing the financial and trading prospects of the company.[6] The rationale of this rule is that "[T]he management of a company must of necessity have a view as to the future profitability of the company; the prospective investor . . . is entitled to be let into the secret."[7]

This effort to voluntarily disclose financial predictions has not been exhibited by the United States financial community. However, there appears to be a strong current of new thought on the entire subject of expanded financial disclosure,[8] as evidenced by the recent public hearings of the Securities and Exchange Commission on *Estimates, Forecasts and Projections of Economic Performance.*[9] In a recent edition of the *Wall Street Journal* it was predicted that:

> [T]he Securities and Exchange Commission will break a 40-year-old tradition and allow, perhaps even move to require, companies to insert predictions of future sales and earnings in reports they must file with the agency.[10]

This decision by the Securities and Exchange Commission seems to have been prompted by efforts to "[E]liminate advantages that company insiders now enjoy because they see the internal forecasts that every well-managed concern prepares."[11] With this in mind, it is the purpose of this Comment to examine the present

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quires:

> A statement as to the financial and trading prospects of the Company or Group, together with any material information which may be relevant thereto, including, where known to the directors, special trade factors or risks (if any) which are not mentioned elsewhere in the prospectus and which are unlikely to be known or anticipated by the general public, which could materially affect the profits, and details of any waiver of future dividends.

FEDERATION OF STOCK EXCHANGES IN GREAT BRITAIN AND IRELAND, ADMISSION OF SECURITIES TO QUOTATION 66, ser. 34 (London 1972). [Hereinafter cited as ADMISSION OF SECURITIES TO QUOTATION].

6. Grenside, *Accountants' Reports on Profit Forecasts in the U.K.*, J. ACCOUNTANCY 47 (May 1970) [hereinafter cited as *Accountants' Reports*].

7. *See* Hull Address, *supra* note 1.

8. *Id.*

9. *See, e.g.*, Statement of D. Carmichael at *Hearings on Estimates, Forecasts and Projections of Economic Performance* before the Securities and Exchange Commission, Washington, D.C. (Dec. 7, 1972).

10. Wall Street Journal, Dec. 11, 1972, at 12, col. 3. That prediction was borne out by the Securities and Exchange Commission's statement that it had decided to propose that companies be allowed to include profit forecasts in reports filed with the agency. *See* Wall Street Journal, Feb. 2, 1973, at 2, col. 2.

11. Wall Street Journal, Dec. 11, 1972, at 12, col. 3.

guidelines of profit forecasting in the United Kingdom and then to ascertain whether such a practice could be implemented in the United States.

I. THE ENGLISH SYSTEM

As defined by the Institute of Chartered Accountants in England and Wales, a profit forecast is "[A]ny estimate of financial results made (a) in advance of the completion of audited financial statements for an expired accounting period, (b) for a current (or unexpired) accounting period, or (c) for a future accounting period."[12] The Institute has indicated that most companies prepare forecasts for their internal use only, although there are times when, for specific reasons,[13] these forecasts are disclosed to outsiders. At such times, accountants are asked to analyze the forecasts and report their findings to the board of directors.[14]

Forecasts appear in the United Kingdom in two instances: first, when a company desires to be listed on the London Stock Exchange; and second, during a struggle for corporate control which is called a take-over bid.[15] In an effort to clarify the problems associated with each situation they will be investigated individually.

There are two situations in which a British company seeks to have its securities quoted on the London Stock Exchange: (1) when no portion of its capital has been quoted;[16] and, (2) when some part of its capital has already been quoted.[17] It should be noted that British firms rarely "go public" on a purely promo-

12. INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES, ACCOUNTANTS' REPORTS ON PROFIT FORECASTS (S15) 1 (London 1969). [Hereinafter cited as ACCOUNTANTS' REPORT ON PROFIT FORECASTS]. This report replaces Statement S11 issued in 1968.

13. As will be discussed later in this Comment, one of the reasons why the accountants might be willing to share the internal forecast with outsiders is to prevent a take-over. *See* text accompanying note 37 *infra*.

14. *See* ACCOUNTANTS' REPORTS ON PROFIT FORECASTS, supra note 12.

15. Referred to as a tender offer in the United States. Address by Eli Goldston, President, Eastern Gas and Fuel Associates before the Securities and Exchange Commission, *Hearing on Use of Earnings Forecasts*, Washington, D.C. (Dec. 7, 1972). (Copy provided by Douglas R. Carmichael, Director of Technical Research of the American Institute of Certified Public Accountants on file with the CALIF. W. INT'L L.J. offices). [Hereinafter cited as Goldston Address].

16. ADMISSION OF SECURITIES TO QUOTATION, *supra* note 5, at 64.

17. *Id.*, at 71. Issues already quoted on the London Stock Exchange are subject to a forecast statement similar to that required for initial quotation. That is:

A statement as to the financial and trading prospects of the Company

tional basis. Typically, a new enterprise relies on merchant bankers[18] or private investors for its capital during the first five to ten years of its existence, so that when it goes public it has a record on which forecasts may be based.[19] Therefore, "[B]y the time the general public is approached for capital, the situation is quite different from an American 'hot issue' which often may represent a purely promotional assembly of public capital to exploit an untested idea."[20]

England's financial community has not limited use of the profit forecast merely to the prevention of "hot issue" fever. It has instituted several other mechanical practices which work to defeat the usual financial speculator. For instance, an investor is required to make full payment in advance when subscribing to a new issue.[21] Despite this requirement, the new issues are vastly oversubscribed and the extent of prorating is not immediately known. As a result, the investor who wants to turn an immediate profit by reselling a new issue finds his funds effectively impounded. Since he faces the prospect of pro rata assignment of the available shares, he is extremely unlikely to indulge in precipitous resale.[22]

An analysis of a British Profit Forecast indicates that it is a condensed version of what the American financial community would consider necessary in such a document.[23] Normally, the British version contains only:

> or Group, together with any material information which may be relevant thereto, including all special trade factors or risks (if any) which are not mentioned elsewhere in the prospectus and which are unlikely to be known or anticipated by the general public, which could materially affect the profits, and details of any waiver of future dividends.

Id., at 73.

18. Dev and Webb, *The Accuracy of Company Profit Forecasts*, 4 J. BUS. FINANCE 30 (1972). *See* Table 4. [Hereinafter cited as Dev and Webb].

19. Goldston Address, *supra* note 15. One of the areas in which the Federation of Stock Exchanges requires a report by the auditors of a company is:

> [W]ith respect to the profits or losses of the Company in respect of each of the ten completed financial years immediately preceding the publication of the Prospectus or in respect of each of the years since the incorporation of the Company, if this occurred less than ten years prior to such publication; and, if in respect of a period ending on a date earlier than three months before such publication no accounts have been made up, a statement of the fact; . . . .

See ADMISSION OF SECURITIES TO QUOTATIONS, *supra* note 5, at 67.

20. Golston Address, *supra* note 15.

21. *Id.*

22. *Id.*

23. For instance:

> [A] forecast of profits before tax, estimated taxes on the forecasted profit, projected dividend payment dates and amounts, and the dividend yield and price earnings ratio calculated by reference to the offer price. The information normally relates to the expected profitability of the current year and sometimes may be issued only one or two months before [fiscal] year end.[24]

Once the profit forecast is completed by the company and is ready for inclusion in the prospectus or circular,[25] the merchant bankers request that the accountant report to them on the current trading, future prospect and working capital position of the company in a comfort letter.[26] This instrument is a private communication between the accountant and the merchant banker,[27] delineating the assumptions on which the profit forecast has been prepared, and also emphasizing that the reported forecast is the

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> An accountants' report on the accounting bases and calculations for profit forecasts might, in appropriate circumstances, where there are no grounds for qualifications, read as follows:
> To the directors of X Ltd.
> We have reviewed the accounting bases and calculations for the profit forecasts of X Ltd. (for which the directors are solely responsible) for the periods . . . set out on pages . . . of this circular. The forecasts include results shown by unaudited interim accounts for the period. . . . In our opinion the forecasts, so far as the accounting bases and calculations are concerned, have been properly compiled on the footing of the assumptions made by the Board set out on page . . . of this circular and are presented on a basis consistent with the accounting practices normally adopted by the company.

See ACCOUNTANTS' REPORT ON PROFIT FORECASTS, *supra* note 12, at 64. *See also* Appendix, *infra*. An Example of a British Profit Forecast is exhibited in Damant, *A Note on Practice in the United Kingdom Financial Forecasting by Companies*, FINANCIAL ANALYSTS JOURNAL 44, 45 (Sept.-Oct. 1972).

24. Carmichael, REPORTING ON FORECASTS, A U.K. PERSPECTIVE 4 (1972). This was a paper presented by Douglas Carmichael, Director of Technical Research of the American Institute of Certified Public Accountants at the Colloquim on Accounting and Information Systems, Graduate School of Management, University of California, Los Angeles, August, 1972 [hereinafter cited as REPORTING ON FORECASTS]. Copy on file at CALIF. W. INT'L L.J. offices.

25. One reason why a circular must be sent to shareholders is:

> When a quoted company acquires an unquoted company and the size of the latter is significant in relation to the former—broadly speaking 15 percent or more of related figures—a circular must be sent to shareholders giving particulars of the transaction. This will include an accountants' report on the profits and net assets of the company being acquired, together with a statement by the directors as to trading prospects. The accountants' consent to the inclusion of their report in the circular must be given so that in effect the same considerations apply as in the case of a prospectus.

See Accountants' Reports, supra note 6, at 48.

26. *See* REPORTING ON FORECASTS, *supra* note 24, at 5.

27. *See Accountants' Reports, supra* note 6, at 48. The author points out that the comfort letter is not to be quoted or referred to in whole or in part in any literature connected with the sale of the securities.

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sole responsibility of the directors of that company.[28] The letter contains comments, reservations, or both, as deemed pertinent by the accountant. The conclusions, if any, are invariably couched in the form of a negative assurance, such as "[I]ncreases in the level of manufacturing costs for the remainder of the year will be kept within the margin of 2 percent allowed for in the estimates."[29]

The prospectus forecast traditionally has been quite conservative. This makes it possible for a new issue to achieve its forecast without much difficultly and to establish a credible record from the outset.[30] However, the penalty for failing to reach the projected forecast is a loss of status which adversely affects the reputation of the company and its advisors.[31] An inaccurate forecast could have a pejorative effect on both the market value of the shares and on the cost of raising additional capital. Consequently, companies make a diligent effort to ensure achievement of the forecast. Reported profits are often adjusted upward to avoid falling short of the forecast, but they are rarely adjusted downward. This practice manifests the English financial philosophy of ensuring that fledgling companies have a successful ingress into the market place.

One authority reports that merchant bankers have been known to voluntarily refund the purchase price of stock when one of the new companies fails.[32] This same author concludes that forecasting accuracy deteriorates rapidly as forecast intervals are extended.[33] The accuracy of profit forecasts in prospectus situations varies insignificantly despite the passing of portions of the year for which the forecast was prepared. Apparently, the reason is that the internal adjustment of the projected figures achieves the desired result.[34] Therefore, a profit forecast in a prospectus is inherently unreliable because it is designed to be

28. *Id.*

29. Hull Address, *supra* note 1.

30. Goldston Address, *supra* note 15.

31. Dev and Webb, *supra* note 18, at 29.

32. Address by Douglas Carmichael, Director of Technical Research of the American Institute of Certified Public Accountants before the Securities and Exchange Commission *Public Hearings on Estimates, Forecasts and Projections of Economic Performance*, Washington, D.C., Nov. 28, 1972 (copy provided by Douglas Carmichael and is on file with the CALIF. W. INT'L L.J. office).

33. Dev and Webb, *supra* note 18, at 37.

34. *Id.*

easily met or exceeded.[35]

In the past two decades the British have experienced increased activity in the field of take-over bids and mergers.[36] An unwelcome bid is opposed with financial manuevers rather than legal proceedings. One such financial tactic is the inclusion of statements regarding future prospects and profits distributed to the shareholders by the board of directors of each company involved in the take-over attempt.[37]

During the late 1950's, many contested bids led to embittered corporate factions and harsh criticism from the financial community. As a result, the "City"—the geographically compact financial community of London[38]—recognized two alternatives: implementing legal constraints or developing a system based on a code of self-discipline.[39] The "City" selected the latter course of action and in September, 1967, the Governor of the Bank of England established the Panel on Take-Overs and Mergers.[40]

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35. *Id.*, at 29. Sometimes a profit forecast is adjusted in the following manner:

> Having arrived at a forecast that is as realistic as possible and that is approved by all concerned, a contingency discount is then applied to this realistic forecast to produce the figure that will actually be used in the prospectus. The size of the discount will be governed by how much uncertainty there is over the achievement of the profit forecast (which in turn is primarily determined by the nature of the company's business and how much of the financial year has elapsed by the time of the flotation) and by the caution of the directors and the sponsors of the issue; the normal range is 7½-10%.

Harford, *Pricing a Flotation*, 1 J. BUS. FINANCE 17 (1969).

36. *See Accountants' Reports, supra* note 6, at 49. For example:

Table 1

Year	*Number of Companies Acquired*
1964	71
1965	75
1966	78
1967	84
1968	140

37. *See* REPORTING ON FORECASTS, *supra* note 24, at 5.

38. *See* Goldston Address, *supra* note 15, at 2.

39. *See Accountants' Reports, supra* note 6, at 49.

40. The basic tenets of the City Code are set forth below:

> The City Code on Take-overs and Mergers . . . is issued on the authority of the City Working Party, a body originally set up by the Governor of the Bank of England in 1959 for the purpose of considering good business practice in the conduct of take-overs and mergers. The City Working Party consists of representatives of the bodies named below.
>
> The City Code has not and does not seek to have the force of law. It represents the collective opinion of those professionally concerned in the field of take-overs and mergers on a range of business standards. Those who wish to have the facilities of the securities markets in the United Kingdom available to them should conduct themselves in matters relating to take-overs and mergers according to the City Code; those

In March, 1968, the City Code of Take-Overs and Mergers first appeared as the definitive guideline for take-overs and merg-

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who do not so conduct themselves cannot expect to enjoy those facilities and will find that they are withheld. The privileges and disciplines described herein apply in the first place to those who are actively engaged in the securities market in all its aspects but they will also apply to Directors of public companies and their professional advisers (in so far as they advise on the transactions in question), even where they are not directly affiliated to the bodies who are responsible for this document.

The authors of the City Code are satisfied that sufficient advertisement has been given to previous editions and will be given to this edition to make it difficult to plead ignorance as an excuse for non-compliance. The provisions of the City Code fall into two categories. On the one hand, it enunciates general principles of conduct to be observed in take-over and merger transactions; these general principles are a codification of good standards of commercial behaviour and should have an obvious and universal application. On the other hand, the City Code lays down a series of rules, some of which are no more than examples of the application of the general principles and others are rules of procedure designed to govern specific forms of take-over and merger transactions practiced in the United Kingdom.

The City Working Party points out that some of these general principles, based as they are upon a concept of equity between one shareholder and another, while readily understandable in the City and by those concerned with the securities markets generally would not easily lend themselves to legislation. The City Code is therefore framed in non-technical language and is, as a measure of self-discipline, administered and enforced by the Panel on Take-overs and Mergers, a body representative of the City itself. The duty of the Panel is the enforcement of good business standards, not the enforcement of law.

The Panel, as the administering body, works on a day-to-day basis through its executive, headed by the Director General. The Director General or his Deputy are available at all times to give rulings on points of interpretation of the City Code. Companies and their advisers are invited to make full use of this service. Consultations are confidential.

In the event of disagreement, companies or their advisers may appeal to the full Panel, which can be convened in a matter of hours to review the executive decision. The findings of the full Panel on a matter of interpretation of the City Code will be final.

If there appears to be a breach of the City Code, the Director General will invite the alleged offender to appear before the full Panel for a hearing. If the full Panel finds that there has been a breach it may have recourse to private reprimand or public censure or, in a more flagrant case, to further action designed to deprive the offender temporarily or permanently of his ability to enjoy the facilities of the securities markets. No finding of a breach of the Code nor any reprimand, censure or further action will take place without the alleged offender having the opportunity to answer the allegation and to bring witnesses and the right of appeal to the Appeal Committee of the Panel. Proceedings are, however, always informal and no legal representation is permitted.

The permanent Chairman of the Appeal Committee is Lord Pearce and for each individual case the Appeal Committee will have three further members, one of whom so far as is possible will be a representative of the body to which the alleged offender is affiliated. Upon the full Panel arriving at an adverse decision in a disciplinary matter the offender will have two days in which to consider whether he wishes to appeal (during which time no public statement of the findings will be made). If he decides not to appeal, publication (if that is so decided) will take place. If he decides to make use of the appeal procedure, no publication will take place until the procedure is completed and, in the case of a successful appeal, only if the appellant so desires.

The City Code was drafted with quoted public companies particu-

ers.[41] This document outlined the various problems associated with profit forecasting and the related limits to which the accountants could report their findings. Within this particular draft, it was recommended that the accountants should not permit their names to become "associated" with published forecasts. The rationale of this conservative approach was that associating a well-known name with a forecast, however remotely, might lend an undue aura of credibility to that company in the eyes of the general investing public.[42]

In effect the accountants were allowed to analyze the profit forecasts but the investors were not allowed access to those analyses.[43] This restriction on the disclosure of profit projections created unrest in the British financial community. The Panel recognized the problem and realized that if this concept of profit forecasting were to succeed, drastic revisions would be necessary. In 1969 the original Code was redrafted and the prevailing spirit of this revised Code is best exemplified by the first general principle stated in bold print:

> [P]ersons engaged in such transactions should be aware that the spirit as well as the precise wording of these General

larly in mind. Nevertheless, since unquoted public companies make use of the facilities of the securities markets, these too will be expected to observe the spirit of the City Code and where appropriate the letter. The general principles may also be relevant to transactions in the shares of private companies but the Panel will not claim any authority in such cases.

Neither the City Code nor the Panel is concerned with the evaluation of the financial or commercial advantages or disadvantages of a take-over or merger proposition which must be decided by the company and its shareholders.

The Panel is available for consultation at any time before or during a take-over or merger transaction.

. . . .

Issued on the authority of—
The Accepting Houses Committee
The Association of Investment Trust Companies
The Association of Unit Trust Companies
The British Insurance Association
The Committee of London Clearing Bankers
The Confederation of British Industry
The Issuing Houses Association
The National Association of Pension Funds
The Stock Exchange, London

CITY WORKING PARTY, THE CITY CODE ON TAKE-OVERS AND MERGERS 3-5 (London 1972). [Hereinafter cited as CITY CODE].

41. *Id.* A revised Code appeared in April 1969 followed by the most recent revision in February 1972. From time to time the Panel issues "practice notes" as supplements to the Code.

42. *See Accountants' Reports, supra* note 6, at 50.

43. *Id.*

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> Principles and of the ensuing Rules must be observed.[44]

Under the revised rules, persons accused of violating the Code are brought before an appeals tribunal which is empowered to privately or publicly censure misconduct.[45]

Another important facet of this edition of the Code is the requirement that the accountants' report be published in the take-over document.[46] Rule 16, dealing with the individual responsibilities of both the accountants and the directors, in effect, preempts the negative assurance doctrine discussed above.[47] From this point on the responsibility of approving the profit forecast is placed squarely on the shoulders of the accountants. If for any reason they are dissatisfied with the reasonableness of the forecast or the assumptions contained therein, they are free to qualify their report or withhold their consent.[48]

Thus, the English Institute acknowledges that within speci-

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44. CITY CODE, *supra* note 40 at 9.

45. *Id.*

46. *Id.*, at 14. This requirement is contrary to the first technical release of the City Working Party which specified that the accountants' report had to be submitted in writing to the directors and the Panel, but that it would not be published in the take-over document.

47. Rule 16 states:

> Without in any way detracting from the imperative necessity of maintaining the highest standards of accuracy and fair representation in all communications to shareholders in a take-over or merger transaction, attention is particularly drawn in this connection to profit forecasts and asset valuations.
>
> Notwithstanding the obvious hazard attached to the forecasting of profits, any profit forecasts must be compiled with the greatest possible care by the Directors whose sole responsibility they are.
>
> When profit forecasts appear in any document addressed to shareholders in connection with an offer, the assumptions, including the commercial assumptions, upon which the Directors have based their profit forecasts, must be stated in the document.
>
> The accounting bases and calculations for the forecasts must be examined and reported on by the auditors or consultant accountants. Any financial adviser mentioned in the document must also report on the forecasts. The accountants' report and, if there is an adviser, his report, must be contained in such document and be accompanied by a statement that the accountants and, where relevant, the adviser, have given and not withdrawn their consent to publication.
>
> Wherever profit forecasts appear in relation to a period in which trading has already commenced, the latest unaudited profit figures which are available in respect of the expired portion of that trading period together with comparable figures for the preceding year must be stated. Alternatively, if no figures are available, that fact must be stated.
>
> When revaluations of assets are given in connection with an offer the Board should be supported by the opinion of a named independent professional expert and the basis of valuation clearly stated. The document should also state that the expert has given and not withdrawn his consent to the publication of his name therein.

Id.

48. *See Accountants' Reports, supra* note 6, at 51.

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fied limits accountants may assume responsibility for an objective review of the accounting bases and of the calculations for profit forecasts. They may also form an opinion[49] as to whether the forecasts have been properly compiled from the underlying assumptions and data, and as to whether they have been presented on a basis consistent with the accounting principles used in the previous financial statements of the company.[50]

Other provisions of the Code[51] define precisely the intended role of the reporting accountant. That responsibility encompasses an analysis of the assumptions contained within the profit forecast. However, it must not create any impression that he has accepted the responsibility for the ultimate accuracy or realization of the forecast.[52] The Code offers little assistance as to what is meant by the phrase "assumptions, including the commercial assumptions, upon which the Directors [of the particular company involved] have based their profit forecasts".[53] As would be expected, it has been

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49. *See* note 23 *supra.*
50. *See Accountants' Reports, supra* note 6, at 51.
51. *See* CITY CODE, *supra* note 40, at 43.
52. *Accountants' Reports, supra* note 6, at 51.
53. *See* CITY CODE, *supra* note 40, at 43. The City Code states that:

> Any document or advertisement addressed to shareholders under these headings must be treated with the same standards of care with regard to the statements made therein as if it were a prospectus within the meaning of the Companies Act of 1948. This applies whether the document or advertisement is issued by the company direct or by an adviser on its behalf. Each document or advertisement addressed to shareholders of the offeree company must state that the Directors of the offeror and/or, where appropriate, the offeree company, have taken all reasonable care to ensure that the facts stated and opinions expressed therein are fair and accurate and, where appropriate, that no material factors or considerations have been omitted. It must also be stated that all Directors (including any who may have delegated detailed supervision of the document) jointly and severally accept responsibility accordingly. If any Director does not so do, this must be formally stated in the document or advertisement.
>
> A copy of the authority on behalf of the Board of the company for the issue of such document must be lodged with the Panel.

Id., at 13. *See also* note 47 *supra.* Nevertheless, there is a certain degree of flexibility built in to the Code. For example:

> From the standpoint of the Directors making the forecast and of their advisers it is also right that they should be able to explain the uncertainties and so protect themselves from subsequent unjustified criticism if the forecast is not achieved.
>
> The forecast and the assumptions on which it is based are the sole responsibility of the Directors. However, a duty is placed on the financial advisers to discuss the assumptions with their client and to satisfy themselves that the forecast has been made with due care and consideration. One of the duties placed on the auditors or consultant accountants is to satisfy themselves that the forecasts, so far as the accounting bases and calculations are concerned, have been properly compiled on the footing of the assumptions made.
>
> Although the accountants have no responsibility for the assumptions, they will as a result of their review be in a position to advise the com-

interpreted in a variety of ways.[54] Why the Code refused to define "assumptions" is best explained by emphasizing that profit forecasts necessarily depend on subjective judgments. These judgments are subject to a substantial number of uncertainties which increase dramatically as more time is included within the forecasting period.[55] Profit forecasts are not capable of confirmation and verification as are the financial statements which represent the results of a completed accounting period.

The critical nature of the work performed in detailing a forecast cannot be equated properly with a year-end financial audit. Such work may be described as taking an "audit approach", for an audit is an error-oriented critical investigation. In his work on the year-end audit, the accountant focuses his attention on specific areas which he feels could invalidate it. He applies a similar analytic approach as he reviews the profit forecast in his search for factors that could vitiate the validity of the forecast.

It is inherent in the nature of forecasts that only in the most unusual situations will they be completely accurate. If users are to maintain confidence in them, however, they must be reasonably accurate in a majority of cases. The results of a recent

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> pany on what assumptions should be listed in the circular and the way in which they should be described. The financial advisers and accountants obviously have substantial influence on the information given in a circular about assumptions. Neither should allow an assumption to be published which appears to them to be unrealistic (or one to be omitted which appears to them to be important) without commenting on it in their reports.

Id., at 42-43.

54. *Id.*, at 43. The City Code provides limited guidance for purposes of drafting assumptions:

> It is suggested that the following general rules should apply to the selection and drafting of assumptions:—
> (a) the reader should be able to understand their implications and so be helped in forming a judgement as to the reasonableness of the forecast and to the main uncertainties attaching to it;
> (b) the assumptions should be, wherever possible, specific rather than general, definite rather than vague;
> (c) all-embracing assumptions and those relating to the general accuracy of the estimates should be avoided;
> (d) the assumptions should relate only to matters which may have a material bearing on the forecast.
>
> There is however a need for brevity and simplicity which may restrict adherence to the foregoing in every detail. There may be occasions, particularly when the forecast relates to a period already ended, when no assumptions are required.

Id. at 45.

55. *See also Accountants' Reports, supra* note 6, at 51. *See* ACCOUNTANTS' REPORTS ON PROFIT FORECASTS, *supra* note 12.

study[56] indicate that of 245 forecasts made during the period,[57] 226 were reviewed for possible participation in the study. Sixteen were discarded, leaving a sample of 210 forecasts of which 170 (eighty-one percent) achieved their goals within a margin of plus or minus ten percent. Of the forty failures, to date nineteen of them have been investigated and only three (sixteen percent) have failed to provide a satisfactory explanation.[58] Additional research of the sample revealed that twenty-three percent of the forecasts were "spot on" (within a plus or minus two percent).[59] There was a tendency for forecasts to be conservative; more forecasts were exceeded (fifty-three percent) than not (twenty-four percent).[60] Perhaps one explanation of these results is that a forecast is more likely to be exaggerated in a bid situation in an effort to fend off an unwelcome bid. As a result, the Panel applied considerable pressure on directors to project the best possible results of future operations to prevent a built-in "cushion" in future forecasts.[61]

This informal sanction by the Panel apparently achieved a certain degree of success. One who fails to adhere to the recognized norms may be ostracized from the investment community. In such a closely-knit financial community as the "City" banishment spells certain disaster; thus, the necessity for stringent legal enforcement is lessened considerably.

One of the most striking differences between the investment communities of the United States and the United Kingdom is the varying degree of legal liability and the necessity for legal sanctions.[62] In the United Kingdom accountants are given broad discretionary power in that they are self-enforcers of the policy of expanded financial disclosure. However, their possible legal exposure is minimized as a result of two factors: British attorneys cannot be retained on a contingent fee basis; and, class actions and derivative suits are not possible.[63] Accordingly, there is gen-

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56. WESTWICK, THE ACCURACY OF PROFIT FORECASTS IN BID SITUATIONS (London 1972). [Hereinafter cited as ACCURACY OF PROFIT FORECASTS].

57. *Id.*, at 1. The forecasting period extended from May 1, 1969 to on or before September 30, 1970.

58. *Id.*

59. *Id.*, at 3, Table 3.

60. *Id.*, at 3. See also Table 2, at 2.

61. *See* REPORTING ON FORECASTS, *supra* note 24, at 7.

62. *Id.*, at 20.

63. *Id.*

erally a lesser propensity to litigate in the United Kingdom. In addition, in litigation English barristers are not hampered by the burden of proof concept present in the Securities Act of 1933.[64] Moreover, "[t]hird party allegations against accountants come under the list of things which are 'just not done' in the 'City' ".[65]

The English system has recognized the importance of the accounting profession and its vital role in preparing a document which will assist the investigating public at large. By their efforts, the accountants (rather than attorneys) ensure the accuracy and fairness of the assumptions and financial data projected by the directors of the reporting companies to all interested parties. Theoretically, this system approaches the extensive, unbiased disclosure of financial data desired by American investors. Therefore, in light of the possible adaptation of this British program to the United States, an analysis of current American forecasting disclosure practices is appropriate.

II. ADAPTABILITY OF THE PROFIT FORECAST IN THE UNITED STATES

A. Manager, Accountant and S.E.C.: Varied Standpoints

The British profit forecasting system has no direct counterpart on the American financial scene. This makes a comparative study difficult. The Kearney study,[66] which was prepared for the

64. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970).

65. REPORTING ON FORECASTS, *supra* note 24, at 20.

66. *See* A.T. KEARNEY, INC. AND SIDLEY & AUSTIN, PUBLIC DISCLOSURE OF BUSINESS FORECASTS (1972) [hereinafter cited as DISCLOSURE OF BUSINESS FORECASTS]. The purposes of the study are set forth in its introductory paragraphs:

> Some spokesmen of the investing public are demanding both more and better information, not only concerning the historical results of corporations, but also as to their future prospects. One of these demands is that United States corporations publish their internal forecasts. In the ideal form, this statement would be prepared in sufficient detail to allow a party external to the organization to develop a reasonably accurate independent projection of the company's profit prospects for the period covered by the forecast. The spokesmen argue that investors should not have to rely on security analysts to project earnings, but should be informed directly by management of the qualified expectations of the company.
>
> The United Kingdom's experience with this type of disclosure is submitted as proof of the practicality of this proposal. However, this has little or no relevance to the situation in the U.S., since the U.K. experience is limited to the inclusion of a profit forecast in prospectuses prepared only in connection with the physical sale of securities or documents prepared in connection with a takeover bid. The auditors are required to comment only on the forecast data included in takeover and merger circulars: their duties are limited to seeing that the forecast is properly prepared on the basis of the assumptions given and that the mathematical calculations are correct. Even with this limited experience in the publication of profit forecasts, among those actually

Financial Executives Institute on the use of profit forecasts by American companies and the extent of their disclosure to the investing public, has recently been completed. This analysis[67] serves as the focal point for a discussion regarding business forecasts[68] from the American corporate manager's standpoint. Em-

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familiar with the situation there is a divergence of opinion as to whether the results in England are satisfactory.

Corporate managers are concerned with maintaining a proper balance of information that is disclosed to the public. They recognize that investors require information concerning the corporation in order to make their investment decisions. However, they are deeply concerned that disclosure of excessive information will be misleading.

Further, most executives are concerned with the problem of communicating intelligently with the public. Some feel that confusion over technicalities of historical financial reporting has resulted in a credibility gap between corporations and the investing public. They fear that internal forecast publication might enlarge this gap.

On the other hand, a few managers feel that the investing public has a right to management's internal forecasts. They feel that this data should be disclosed in as great detail as possible for reasons that are often unique to their particular organizations.

The Financial Executives Research Foundation wanted to determine corporate management's viewpoint. They felt that prior to any decisions by regulatory bodies as to the desirability and feasibility of publishing forecasts there must be a weighing of the advantages and disadvantages as seen by the financial managers. In addition, the Foundation was concerned with documenting the availability and use of internal company forecasts. In this regard it commissioned the management consulting firm of A.T. Kearney, Inc. to undertake this research project.

Id., at 1-3.

67. The objectives of the Kearney Study are illustrated as follows:

In determining the feasibility of public disclosure of internal forecasts it is essential to take into consideration the interests of both the suppliers and the users of the information. Accordingly, the purpose of this study was to concentrate on the proprietary interests with regard to these issues. These interests were translated into three specific study objectives:

1. To determine the availability and the nature of forecast data currently used in companies.

2. To define the internal uses for which management develops forecasts and the extent to which forecasts for use by other groups might need to be constructed differently.

3. To ascertain corporate management's views of the advantages and the disadvantages of furnishing forecasts in a public presentation.

This research effort did not attempt to include a study of either the validity of the demand for forecast information or the utility value of this information to the investing public. It was felt that the documentation of forecast availability and management's appraisal of the practical implications of forecast disclosure were a manageable portion of the total problem.

Id., at 5.

68. Various terms of art were defined in the Kearney Study:

Recognizing that the terms "forecast," "budget," and "profit planning" are used differently from company to company, arbitrary definitions (solely for the purpose of filling out the questionnaire, [sic] were developed as follows:

Budgets: Financial planning information applicable to both the current fiscal year and to the next complete fiscal year.

Forecasts: Financial planning information applicable to any fiscal year beyond the current and to the next complete fiscal year.

Id., at 6.

phasis was placed on comparing the similarities between the British and American approaches,[69] to discern the feasibility of adapting the former to meet the requirements and needs of the latter's investing public.[70]

The study revealed[71] that today's managers utilize forecasts to assist them in identifying the internal company variances[72] that

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69. In order to achieve this desired result, specific forecasts were requested:

> The development of the questionnaire required the identification of the types of forecasts to be included. From the wide range of possibilities, nine types of forecasts were selected for inclusion in the first section of the questionnaire.
> 1. Corporate Earnings
> 2. Earnings by Division
> 3. Corporate Sales (Units or Dollar Values)
> 4. Sales (Units or Dollar Value) by Division
> 5. Corporate Expenses
> 6. Expenses by Division
> 7. Expenses by Corporate Chart of Accounts
> 8. Changes in Capital Structure
> 9. Changes in Productivity

Id., at 4-5.

70. The researchers sought answers to the following questions as to how management utilized its present internal forecasts:

> 1. What forecasts are being prepared by companies at present, whether for internal planning and control purposes only or for public dissemination?
> 2. What are the typical periods of time covered by the various forms of forecasts?
> 3. How often are the forecasts revised?
> 4. In what form are the forecasts usually presented?
> 5. To what extent is external assistance employed in preparing forecasts?
> 6. To what extent is there documentation of the assumptions that typically underlie forecasts?

Id., at 9-10. *See also* note 66 *supra*, Table II, at 11.

71. The consulting firm also discovered that:

> If a publication of forecasts using a range format were made a requirement, it appears as through [sic] over 90 percent of the companies would have to alter their existing procedures.

Id., at 16.

72. The research team qualified the yearly variance in each one of the forecasts presented to the companies:

Rank(1)	Type of Forecast	Cumulative Percent Variance(2)				
		5%	10%	15%	20%	21%+
1	Corporate Expense	65%	90%	97%	98%	2%
2	Expenses by Corporate Chart of Accounts	55%	84%	92%	98%	2%
3	Corporate Sales	53%	84%	93%	95%	5%
4	Changes in Capital Structure	53%	84%	92%	95%	5%
5	Expenses by Division	53%	82%	95%	97%	2%
6	Changes in Productivity	47%	77%	92%	97%	3%
7	Sales by Division	36%	74%	88%	94%	6%
8	Corporate Earnings	37%	70%	80%	87%	13%

occur as a result of changing external business conditions which affect anticipated corporate goals.[73] Once these variances are recognized, management adjusts the forecast to more accurately reflect the short term planning and strategy of the company.[74] In order to effectively revise the forecasts, essentially all levels of management must become involved; the forecast is but another tool used by management for motivational purposes.[75]

The current disclosure practice of the American financial community indicated from this survey can be succinctly stated: internal company forecasts are not released for public scrutiny. In fact, many companies have established guidelines regarding informational disclosure.[76] For example, the study reveals an extremely negative attitude on the part of the financial managers toward the release of any forecast.[77] There was no correlation between sales volume, industry classification, the assessment of

9	Earnings by Division	22%	58%	73%	82%	18%

(1) Based upon cumulative variance at 10%.
(2) Percent variances represent plus or minus difference.

Id., at 28.

73. *Id.*, at 22.

74. It is significant to note the absence of external auditor assistance in the preparation of forecasts:

> The companies surveyed do not utilize external auditor assistance in the preparation of budgets or forecasts.
>
> During the interviews most companies questioned the ability of auditors to certify their forecasts. They stated that the forecasts are based on numerous assumptions which emanate from all lower levels of management. In order to certify these forecasts, the auditors would have to reconstruct the basic figures with all the people involved in the forecasting process. This procedure would require more auditors than are presently used for auditing purposes and would be costly.

See DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 17.

75. All managers stated that forecasts are one of their most essential management tools. Forecasts were described as "energizers of people." They viewed the forecast as a means of insuring that all management levels become invoved in forward planning for their particular spheres of activity.. In addition, this anticipation of internal and external changes facilitates the efficient allocation of a company's resources in terms of finances and manpower.

Id., at 22.

76. The Kearney Study promulgates interesting statistics:

> The publication of written guidelines is a function of the size of the company. While 57 percent of the large companies publish guidelines, only 22 percent of the smaller companies do. The majority of the companies who have guidelines specifically mentioned profit forecasts in them.

Id., at 32.

77. The analysis showed that:

> The reasons for the opposition tend to fall into five major categories: competitive implications, the use of the forecast, the credibility of the forecast, the legal problems with regard to release, and the "gamesmanship" involved in the release itself.

Id., at 41.

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the financial community's earnings per share projections, or the reliability of their internal forecasts and this negative attitude.[78] Rather all companies, regardless of classification, expressed considerable concern over the possible legal consequences of the release of their internal forecasts.

Perhaps the overriding concern of these companies is that increased dissemination of forecasts will develop a lack of credibility[79] by the investing public. To avoid this possibility, many companies indicated they would alter their managerial pattern to negate the usefulness of the forecast. The forecast would be extremely conservative to insure successful achievement of the projected goals. This is the same philosophy employed by the English companies. This conservative concept would not be favored by the members of the American financial community since it would reduce the community's analysts to the role of second-guessing the internal forecasts of management.[80]

The employment of subterfuge with respect to public forecasts would assume a dominant role in this area, with more emphasis being placed upon the actual date of publication than on the contents of the document itself. If this approach were adopted, the forecasts themselves would tend to be completely discounted and a greater effort would have to be exerted in extracting "secret" information from the reporting companies. Therefore, without a gradual educational involvement by both management and the investing public as to the strengths and weaknesses of profit forecasting, the existence of a credibility gap is assured.

The accountant maintains a similar viewpoint regarding the necessity of profit forecasts.[81] All investors would benefit if

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78. *Id.*

79. The companies surveyed:

> [C]ited as factors the difficulty in presenting intelligible audited historical operating statements, the amount of time required by the investor to truly understand the factors accurately, and the myriad of internal and external developments which would necessitate frequent changes to the forecast. If the public disclosure of internal forecasts results in a loss of confidence in management by the investing public, the costs to the company and the security industry are incalculable. In order to prevent this from occurring and to minimize the harmful effects on their present shareowners, companies would adopt a management style or pattern of behavior which would negate the usefulness of the forecast.

Id., at 56.

80. *Id.*, at 57.

81. Address by Leonard Spacek, Senior Partner Arthur Andersen & Co., *No Benefits Flow to Public Stockholders from One-Year Earnings Forecasts*, before the Financial Executives Institute, Milwaukee, Wisconsin, Dec. 12, 1972.

some accurate analysis of future growth could be designed, but to suggest a one-year forecast as the financial panacea does nothing more than create an atmosphere of false security.[82]

An argument has been proposed that the one-year's earnings forecast only serves the salesman and the short term "in and out" speculator because they will examine the forecast based on their interpretations of the assumptions and gamble on the conservatism or optimism of management.[83] If this "in and out" approach is widely adopted it can only have adverse effects on the market. It will also have the negative effect of reducing the long term investor to a short term gambler and markedly increase the volatility of the markets.

From the accountant's viewpoint, a second argument against requiring one-year forecasts is: if an optimistic forecast is published and not achieved, the public stockholder will claim that he was misled. If, on the other hand, a conservative forecast is published, such a goal is an invitation to operating personnel for mediocre performance with the consequent result of a low return to stockholders and a disgruntled investing public.[84] Thus, any attempt to burden management with a requirement to publish a specific forecast of earnings will result in the existing shareholders having every opportunity to lose and little opportunity to gain.[85] Additionally, an aura of accuracy may be attached to any formal document executed by an accountant. In other words, the adverse effect on the market would be greater if the forecast goals were not achieved. Also, this report and its assumptions could possibly create a new branch of fiduciary duties to the public, in effect, another burden placed on the corporation and the accountant.

A third argument as to why one-year earnings forecasts are not beneficial to the investing public is that the public accountant could not corroborate the forecast without violating Rule 2-04[86]

82. *Id.*, at 4.
83. *Id.*, at 6.
84. *Id.*, at 8.
85. *Id.*, at 9.
86. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66. As indicated by the research study, Rule 2-04 of the Code of Professional Ethics of the American Institute of Certified Public Accountants states that:

> A member or associate shall not permit his name to be used in conjunction with an estimate of earnings based upon future transactions in a manner which may lead to the belief that the member or associate vouches for the accuracy of the forecast.

Id., at 92.

of the Code of Professional Ethics of the American Institute of Certified Public Accountants. Strict adherence to this rule requires an attestation by an independent third party to the earnings forecast. Even if this rule were not observed closely, it has been noted[87] that third party attestation of the assumptions used in developing forecasts would be misleading. There is no basis on which the third party can challenge the assumptions made by sincere management; to do so would mean that the attestor and not the preparer had selected the assumptions.[88]

Independence of the public auditor is another issue raised by adherence to this rule. One who attests to the assumptions used in a forecast could not, under any circumstances, be deemed independent with respect to the actual financial statements covering the same period. As a result, the company's independent auditor must be disqualified from attesting to the assumptions made in the forecast.[89]

If the investing public is to benefit from earnings forecasts attested to by third parties, new standards for their presentation must be established. Third party attestation[90] cannot be based on an assumption that the work will be done with due care and in an objective manner, nor can there be an assumption that those attesting have the ability to accept responsibility for the work.[91]

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87. Address by Harvey Kapnick, Chairman and Chief Executive, Arthur Andersen & Co., *In the Matter of Estimates, Forecasts or Projections of Economic Performance*, Securities and Exchange Commission, Dec. 1, 1972 [hereinafter cited as Kapnick Address].

88. *Id.*, at 3.

89. *Id. See also* W. PROSSER, TORTS 708 n.57 (4th ed. 1971).

90. *See* Annot., 46 A.L.R.3d 979 (1972).

91. *See* Kapnick Address, *supra* note 87, at 15. In his address before the S.E.C., Chairman Kapnick recommended:

> Keeping in mind the Commission's responsibilities to the investing public, and based on my statement today, I recommend that the Commission take the following action with respect to forecasted financial data:
>
> 1. Require that information as to goals and facts related to the future financial aspects of a company be made available to all stockholders and the public whenever such information is provided to anyone outside of the company.
> 2. Adopt regulations setting standards covering the preparation and dissemination of forecasts by investment advisers.
> 3. Insist that the accounting profession set as its first order of business the establishment of the objectives of financial statements.
> 4. Institute a study to determine what the investor needs to know in order to reach an investment decision.
> 5. Disqualify as not independent any independent accountant who attests to the assumptions in a forecast or reports that the assumptions have been chosen with due care from later reporting on the historical financial statements covering the same period.

Id.

In November, 1971, in a speech before the National Industrial Conference Board, William J. Casey, then Chairman of the Securities and Exchange Commission spelled out the interest of the Commission in profit forecasting by stating:

> [T]he time has come to take a broader view of what is pertinent to investment values and the obligation to convey economic reality as management knows it to stockholders and investors. I believe the time has come when we should re-examine the question of the inclusion of projections, forecasts and appraisals in our disclosure framework.[92]

In January, 1972, the Division of Corporate Finance of the Securities and Exchange Commission invited certain groups directly concerned with corporate financing to meet with members of the Commission's staff to discuss the availability of data necessary for an informed review of profit forecasting.[93] On June 28, 1972, representatives of the Commission met again to review the status of the studies under consideration.[94] Chairman Casey announced on June 29, 1972, that the Securities and Exchange Commission would await submission of reports by these groups before making a formal statement regarding the inclusion of earnings forecasts in registration statements or reports filed with the Commission.[95]

In a further update of the Commission's position, it was reported that the new proposals would require a company to disclose a description of the accounting principles it follows and, if they differ from prevailing industry principles, to estimate the dollar impact on net income on an annual basis.[96] Under these new proposals, a company would have to determine the impact on profits when it uses more than one accounting principle in reporting similar kinds of transactions.[97] This is intended to eliminate the technique used by corporations to select the set of accounting principles most likely to enhance profits in their reports to inves-

92. Address by William J. Casey, Chairman of Securities and Exchange Commission, *Responsibilities and Liabilities in Corporate Life,* before the National Industrial Conference Board, Nov. 18, 1971, as indicated in DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 81.

93. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 81.

94. *Id.*

95. *Id.*, at 81-82.

96. Wall Street Journal, Dec. 19, 1972, at 2, col. 2.

97. *Id.*, at col. 3.

tors.[98] Another proposal indicated that guidelines should be established to cover the contents and subsequent dissemination of company news releases and interim financial reports. A decision was reached by the Securities and Exchange Commission which permits disclosing companies to include profit projections in reports they file with the agency. But the Commission has decided against *requiring* projections, although it had been under serious consideration and was favored by many members of the Commission's staff.[99]

According to the new proposals, companies that decide to file forecasts in their Securities and Exchange Commission filings would include them in the annual 10-K forms presently filed with the agency. They would also be required to update the forecasts when necessary and to provide an annual analysis of their accuracy for consideration by the shareholders.[100] Recently the Securities and Exchange Commission, in its continuing effort to tighten the controls over projections made by companies to financial analysts and to the news media, announced that it was considering requiring companies to file with the Commission any earnings and sales projections made to securities analysts at analysts' meetings, or other similar forums, including the press.[101] The one step that the Securities and Exchange Commission has chosen not to take, however, is verification or certification of projections by a third party.[102] In effect, the Commission has chosen not to come in conflict with Rule 2-04.

From what has transpired to date, it would seem that the Securities and Exchange Commission has chosen a middle-of-the-road approach. Not wishing to incur the full wrath of the Amer-

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98. *The Impact of S.E.C.'s New Disclosure Rules,* BUS. WEEK 58, Jan. 6, 1973.

99. Wall Street Journal, Feb. 2, 1973, at 2, col. 2.

100. *Id.,* at col. 3.

101. Wall Street Journal, Feb. 5, 1973, at 16, col. 1. Former S.E.C. Chairman William Casey stated that the quality of earnings is under attack in BUS. WEEK 74, Dec. 23, 1972:

> Investors want an earnings figure, and they want one which they can rely on as a consistent measure of corporate performance and progress, one not subject to manipulation. They want to know how good the company is, how solid the earnings are, and how real the growth is . . . When the figures are elusive or too complicated to grasp, investors have to base their judgment on their confidence in management . . . Management has to tell it like it is . . . Credibility can only be maintained by spelling out the facts, whether the accountants require it or not.

102. Wall Street Journal, Feb. 5, 1973, at 16, col. 1.

ican business community, it has proposed voluntary disclosure without the obligation of employing external auditors to become associated with the forecast. More importantly, since the Securities and Exchange Commission's staff and the Commission members have been sharply divided on whether to allow or require these forecasts to be filed with the agency, the exit of Chairman Casey will most probably have some impact on the final version of these proposals.[103]

B. Legal Problems Associated with Disclosure of Business Forecasts[104]

The concern of the corporate managers regarding the legal ramifications of profit forecasting is not associated with those who would deliberately attempt to misguide the investing public. Rather, it derives its origin from the very nature of forecasting itself and the possibility of litigation arising from the compulsory disclosure of these estimates.[105] The emergence of increased litigation in this area is inevitable, given the inexactness of forecasting and the demand for precision by the law.

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103. *Id.*

104. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 98. In his discussion concerning corporate managers' apprehension with regard to public disclosure of corporate forecasts, Mr. Brown eloquently highlights the problem:

> With regard to legal liabilities of managements and board of directors the formal publication of projected financial statements cannot help but increase legal exposure. Financial performance significantly better or worse than that projected seems clearly to be a basis for action for damages. Where they were able to establish a deliberate attempt to mislead third parties would have the same avenues for redress as they do now. One gets into a gray area, however, when performance differs significantly from plan and there has been an honest attempt to (1) plan properly (2) make full disclosure (3) manage the company as efficiently as possible. The recognition of this potential new source of legal complications is one of the reasons why management is not particularly enthusiastic about publishing forecasts in the form of projected financial statements.

Brown, *Ethical and Other Problems in Publishing Financial Forecasts*, FINANCIAL ANALYSTS J. 38, 41 (March-April, 1972).

105. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 99. As reported by the researchers, one company executive stated:

> Forecasting earnings is certainly not a precise art, and rarely are such forecasts even *acceptably* accurate. If on the high side, a company can be accused of attempting to influence the market price of its stock; if on the low side, the forecast could have an unfortunate adverse effect on the market price. In either situation the company may become vulnerable to stockholders' suits by those who assert that they relied on the forecast in connection with the purchase or sale of stock. The company should not be placed in the position of having to expose itself to such suits. [Emphasis added].

Id., at 46.

Untrue statements of material facts or the failure to state a material fact is prohibited by the Federal securities laws, and civil liability is imposed for violations.[106] However, according to common law, corporate forecasts were mere expressions of opinion; they were not a basis upon which an action for fraud or deceit could be maintained if the prediction was not achieved.[107] Under present securities regulations, courts have found little difficulty in concluding that forecasts were statements of fact and, as such, were subject to the application of the anti-fraud or deceit sections of those regulations.[108] Once the courts recognized that forecasts disseminated to the investing public were subject to regulation by the securities laws, the next logical step was to define the test of materiality.

In *List v. Fashion Park, Inc.*, the court stated that the basic test of materiality is "whether 'a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question.' "[109] This included any fact "[W]hich in reasonable and objective contemplation might affect the value of the corporation's stock or securities."[110] The concept of materiality and the "reasonable man" theory was extended in the *Securities and Exchange Commission v. Texas Gulf Sulphur Company* case:

106. *See, e.g.*, §§ 11(a), 12(2), 17(a) of the Securities Act of 1933, 15 U.S.C. §§ 77k(a), 77(2), 77a(a); *See also* 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5.

107. *Id.*, at 100. *See* Heller, *Disclosure Requirements Under Federal Securities Regulations*, 16 THE BUS. LAWYER 300, 307 n.18 (1961).

108. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 100. *See, e.g.*, Sprayregan v. Livingston Oil Co., 295 F. Supp. 1376 (S.D.N.Y. 1966), in which the court found that for the first six months of the fiscal year 1964-65 that the company showed greatly reduced rather than greatly increased net profits, as had been predicted, and the cash flow was significantly reduced rather than improved; Janigan v. Taylor, 212 F. Supp. 794 (D. Mass. 1962), *aff'd* 344 F.2d 781 (1st Cir. 1965), *cert. denied*, 382 U.S. 879 (1965) where the prediction of future profitability by the owner and his subsequent purchase of shares of stock for $20.00 per share based on his forecasts and then his sale of the corporation two to three years later for $300.00 per share; S.E.C. v. F.S. Johns & Co., 207 F. Supp. 566, 573 (D.N.J. 1962), where the court held that the element of speculation is inherent in stock investments but the investor is entitled to have the opportunity to evaluate the risk of loss, as against the hope of a lucrative return, from true statements of the financial status of the corporate enterprise in which he is acquiring an interest.

109. 340 F.2d 457, 462 (2d Cir. 1965), *cert. denied*, 382 U.S. 811 (1965). *See also* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 101.

110. Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963). *See also* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 101.

> [M]aterial facts include not only information disclosing the earnings and distributions of a company, but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.[111]

The plethora of cases dealing with corporate forecasts combined with the demand for more complete disclosure, clearly indicate that business forecasts have been deemed "material facts" and as such will be examined in the light of the Federal securities laws and regulations.[112]

There are no established standards against which one can measure the accuracy of a forecast to determine whether its public disclosure is misleading.[113] The British system allows for a plus or minus ten percent variance before action is taken. In the Kearney Study[114] it was noted that thirteen percent of the responding companies' annual corporate earnings forecasts varied by more than twenty-one percent.[115]

If a forecast is inaccurate in its predictions by twenty-one percent, does this justify labeling it as misleading? Prior to the commencement of any litigation, the factors affecting that error must be scrutinized. In *Texas Gulf Sulphur,* the court stated that:

> [I]f corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.[116]

However:

> The requirement that a statement may not be found misleading unless its issuance is actuated by a "wrongful purpose" for this might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.[117]

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111. 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied, sub. nom.,* Coates v. S.E.C., 394 U.S. 976 (1969). *See also* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 102.

112. DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 103.

113. *Id.,* at 109.

114. *See* note 66 *supra.*

115. *See* note 72 *supra.*

116. *See* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 862 (1968). *See also* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 109-10.

117. S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 861 (1968).

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In a recent case, *Dolgow v. Anderson*,[118] the Court quantitatively analyzed the reasons behind the missed projection and set forth a qualitative decision stating that:

> Monsanto's management demanded that the internal documents and estimates be honest. The divisions of the corporation made every effort to be accurate and honest in their forecast. The internal estimates were made honestly, were reasonable, and were the best estimates of the people in Monsanto most qualified to make them.[119]

Recognizing the present pressure for more detailed corporate disclosure and the public clamor for a remedy for damages caused by misleading forecasts, this approach would seem to fall far short of a desired solution given the present state of the art of forecasting.[120]

The Securities and Exchange Commission has proposed that forecasts be filed on a voluntary basis. What happens if these forecasts are submitted in good faith but are not updated by corporations as business and economic conditions dictate? A corporation's failure to issue a public statement indicating prior information disseminated to the public has become inaccurate, can give rise to a cause of action under the Securities and Exchange Rule 10b-5.[121] Although the Court in *Dolgow* did not address itself to the specific requirements which would remove the burden of the corporation to report the necessary changes and revisions of their forecasts, it did analyze Monsanto's performance in light of the altered business and economic conditions. It held that Monsanto avoided liability by exerting a good faith effort to update their estimates and projections when economic conditions so warranted.[122]

The issue is: At what juncture does a forecast become material and therefore in need of disclosure to the investing public? The Court in *Texas Gulf Sulphur* stated that:

> We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the

118. 53 F.R.D. 661 (E.D.N.Y. 1971). *See also* Wall Street Journal, Dec. 11, 1972, at 12, col. 5.

119. *Id.*, at 676.

120. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 112.

121. *Id. See, e.g.*, S.E.C. v. Shattuck Denn Mining Corp., 297 F. Supp. 470 (S.D.N.Y. 1968); Fischer v. Kletz, 266 F. Supp. 180 (S.D.N.Y. 1967).

122. 53 F.R.D. 661 (E.D.N.Y. 1971).

> management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and the SEC.[123]

Under the materiality test of *Texas Gulf Sulphur*:

> [I]t may well be that certain of the assumptions arrived at in the preparation of a forecast may reflect events which are material and must be disclosed because of the 'indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company's activity.' This does not, however, dictate disclosure of the forecast, but merely of the event.[124]

Corporations are therefore faced with a balancing effort to define what is material and what is part of the ordinary day-to-day conduct of the business.[125] It is not as important to establish the quantitative requirements of materiality as it is to understand the qualitative nature of the problem with which one is faced.

III. CONCLUSION

> Our American prospectus has evolved from a selling document into a boiler-plated liability-avoiding document. The original purpose of the prospectus was as a selling tool, a description of the company needed in the process of raising the required capital and in presenting the story of the company fairly and accurately. As a result of the concentration over the years on avoiding liability rather than sales, we have left out the most important pieces of information from the standpoint of both the buyer and the seller of securities . . . and the vacuum between supply and demand is being filled, as it always is, by "boot-legged" information.[126]

The comparison of the British and the American systems discloses some striking differences between the two which must be resolved prior to any meaningful discussion regarding the introduction of even a modified version of the British example in the United States.

The basic structure of the British legal system, with the absence of class action suits and contingency fees, lends itself per-

123. *See* S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (1968). *See also* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 114.

124. DISCLOSURE OF BUSINESS FORECASTS, *supra* Note 66, at 114. *See* S.E.C. v. TEXAS GULF SULPHUR CO., 401 F.2d 833, 850 n.12 (1968).

125. *See* DISCLOSURE OF BUSINESS FORECASTS, *supra* note 66, at 114.

126. Goldston Address, *supra* note 15, at 6.

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fectly to the implementation of such a forecasting system, without the fear of litigation that is prevalent in the United States. The British accountants are able to concentrate their efforts on providing a vital service to the investing public by reviewing the forecasts and discussing the assumptions contained therein with the boards of directors, all within the framework of their Code of Ethics. If restrictions are required, the British financial community can itself apply and enforce informal sanctions. The success of this approach is due in large measure to the closely-knit nature of the financial community and the concomitant fear of embarrassment attributable to the possibility of expulsion for serious wrongdoings.

The American financial community may be characterized by its expansiveness and considerable reliance upon a constant supply of "hot issues" to motivate investors. In contrast, the recognition of director liability has played an integral part in the development of the British system. The responsibility and liability of the director and the external auditor has been clearly defined. If the forecasting system were adopted by the American financial community, the directors of United States corporations could expect to operate under a similar liability. The refusal of the Securities and Exchange Commission to allow third party attestation of the voluntarily tendered business forecasts presents another stumbling block. It appears that the only parties attesting to the submitted forecast would be the company and its board of directors, unless of course the company hired (at its own expense) external auditors to reconstruct the forecast and comment on it. This technique, without independent third party attestation, would seem to lack purpose and would therefore lose credibility with the investing public.

Even if the above items could be resolved successfully, there would still exist a lack of precise forecasting in the future. The demand for accurate figures in the financial community is of paramount importance. At the same time, the analytical value of a one-year business forecast with a plus or minus fifteen or twenty percent variance must be questioned seriously. The profit forecast as now employed in the British system, given the present state of the art of profit forecasting, would not significantly clarify nor materially add to the financial data already presented to the American investor. Moreover, it would constitute an increased

financial burden with the attendant possibility of expanded legal liability. Therefore, introduction of a similar system in the United States does not seem advisable at this time.

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APPENDIX:

AN EXAMPLE OF A BRITISH PROFIT FORECAST

The following is an extract from the report submitted by Pilkington Brothers Ltd. to J. Henry Schroeder Wagg & Co. Ltd., the issuing bankers, on the occasion of the issue of § 56,287,260 ordinary shares in Pilkington in November 1970; and forming part of the relevant prospectus:

"Based on the unaudited profits for the 179 days ended 26th September 1970 and on revised budgets for the 186 days to 31st March, 1971, taking into account the effect of the General Motors Corporation strike up to the end of November, 1970 and, in the absence of further unforeseen circumstances, the Board estimates that the profits before taxation of the Group for the year ending 31st March, 1971, arrived at on the same basis as those set out in the Accountants' Report will be approximately £ 10,400,000.

"The following table summarises the estimated profits for the year ending 31st March 1971:

	£ '000	£ '000
Trading profits before taxation but after all other charges, including amounts set aside for depreciation, replacement and obsolescence, and after deducting gross minority interests		1,900
Licensing income and technical fees less related expenditures		8,000
Share of profit attributable to the Group's holding in associated companies		500
Profits before taxation		10,400
Deduct: Taxation, including corporation tax on United Kingdom profits at 42½ percent	4,250	
Transfer to deferred taxation account	1,000	5,250
Profits after taxation		5,150

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Note: The trading profits are stated before deducting estimated exceptional costs of £ 500,000 in connection with the closing of a factory in Glasgow.

"Whilst recognizing the great difficulties involved in arriving at such an estimate, the Board considers that the unofficial strike in the United Kingdom caused a loss of profits of some £ 5,000,000. Taking this into account, the adjusted estimate of the profits of the Group for the year ending 31st March 1971 would be some £ 15,400,000 before taxation and some £ 8,000,000 after taxation."