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SEC Integrated Disclosure

The Pervasive Effect

By Wesley T. Andrews, Jr. and Jane Dodd

Over the past three years, the Securities and Exchange Commission (SEC) has been moving steadily to implement what are commonly called "Integrated Disclosure Rules" for registrants. There seem to be three purposes in this effort: first, to standardize reporting and disclosure requirements across all types of filings with the Commission, second, to require additional desirable disclosure and, third, to secure uniformity of required disclosures between annual reports to stockholders and filings with the Commission.

The impact of this effort is likely to be more pervasive than its effect on the annual reports of registrants—indeed, the additional disclosure requirements imposed on SEC registrants may be reflected in generally accepted accounting principles and therefore affect reporting requirements for non-registrants as well as registrants. Hence, these developments are of interest to practitioners who serve non-public clients as well as those directly involved in practice before the SEC.

This article summarizes recent changes in SEC regulations regarding financial statement reporting requirements under Regulation S-X, as well as recent changes in disclosure requirements under Regulation S-K.

INTEGRATED DISCLOSURE Changes in Form and Content of Financial Statements.

Regulation S-X, originally adopted in 1940, is the principal regulation governing reporting for financial statements, footnotes and schedules. It integrates all accounting requirements into a single codification, and the requirements are applicable to filings under all securities acts. The last major revision of Regulation S-X was in 1972—prior to the issuance of several APB Opinions and the establishment of the FASB.

On September 16, 1980, the SEC issued Accounting Series Release (ASR) Nos. 280 and 281, which significantly change the original provisions of Regulation S-X. The majority of the text of ASR No. 280 consists of very specific rule changes and tables of conversion from the old Regulation S-X. Of more general interest is the Commission's view of the role of the Financial Accounting Standards Board (FASB) in which it specifically supports the FASB and states its intention to continue relying on the FASB for leadership in establishing accounting and reporting standards. The SEC denies

undermining the authority of the FASB by requirements in Regulation S-X which are not generally accepted accounting principles but rather is providing an "authoritative source" in some areas where GAAP standards are not explicit. Also stated is the intention to eliminate rules in Regulation S-X as the accounting profession and the FASB develop related standards.

ASR No. 281 was intended to simplify registration and reporting requirements by providing uniform instructions, centralized within Regulation S-X, as to the periods to be covered by audited financial statements in most registration statements and in annual reports to stockholders. Also modified were form and content requirements of unaudited interim financial information in registration statements to parallel the requirements of quarterly reporting in the condensed Form 10-Q format. This eliminates the need for filing complete financial statements and schedules for interim periods in registration statements.

Prior to the development of these amendments, each different type of registration and reporting form had its own instructions and, in most cases, the years of financial statements required by each were different. This release provides uniform requirements for all forms—audited statements of income and changes in financial position for the three most recent fiscal years and audited balance sheets as of the end of the two most recent years as well as the five-year summary of selected financial data.

Required Disclosures In Addition To Information Contained in Financial Statements.

The adoption of Regulation S-K, "Integrated Disclosure Rules," effective for fiscal years after March 15, 1978, was the Commission's initial step toward integrated disclosure. Regulation S-K was designed to achieve standard disclosure under both the Securities Act of 1933 and the Securities Exchange Act of 1934 by prescribing requirements of disclosure for financial information not presented in the financial statements. Prior to adoption of the new rules, the Regulation S-K items in effect were disclosures regarding an issuer's business, property, directors and executive officers, their remuneration and security ownership, and legal

Revisions were proposed by the SEC to eliminate duplication, update rulings, and clarify requirements.

proceedings. With Accounting Series Releases Nos. 279 and 280, the Commission adopted six more S-K item requirements, stating:

These new items will ensure uniform disclosure under both Acts of information regarding market price of the issuer's common stock, selected financial data, management's discussion and analysis of the issuer's financial condition, supplementary financial information, and exhibits. It is anticipated that Regulation S-K will develop in time to encompass further disclosure requirements.

ASR No. 279 consists of amendments to the annual report form, Form 10-K, and to related forms, rules, regulations and guides under the Securities Act of 1933 and the Securities Exchange Act of 1934. These changes, along with the changes brought about by ASR No. 280, result in substantial changes in the basic annual reporting and disclosure requirements of Form 10-K. Form 10-K has been restructured by deletion of some items, simplification, and shifting some disclosures of a technical or supplementary nature to separate schedules or exhibits which could be available to users upon request. The result is a "basic information package" that is presumably useful to investors by providing information concerning the registration and sale of new shares. Generally, this "basic information package" includes audited financial statements, a summary of selected financial data for analysis, and a description of the business. See Appendix.

The January 15, 1980 proposal for these changes proposed mandatory incorporation of portions of the annual report into Form 10-K and optional incorporation of portions into certain registration filings. As mentioned earlier the mandatory feature was eliminated. Instead, the four-part Form 10-K was

designed to *encourage* combination of annual reports and Form 10-K's. The Commission indicated that the communicative style of annual reports is excellent and that attention to style should continue whether or not the information is also part of the Form 10-K.

Paralleling these changes in annual reporting requirements, the SEC issued on February 9, 1981 final rules to make disclosure requirements for interim financial information in quarterly reports and in registration statements consistent with those for annual reporting. ASR No. 286 established standard requirements for both interim financial statements and management's discussion and analysis for interim periods. These Form 10-Q, Regulation S-K and Regulation S-X revisions are intended to provide for meaningful disclosure on a continuous basis by making quarterly reporting a mechanism of updating the annual report.

Of particular interest to auditors is the change in reporting under SAS No. 24, Review of Interim Data by an Independent Accountant. Under the new rules, if a review of interim data is made in accordance with SAS No. 24 and the Form 10-Q refers to the review, only the report of the accountant must accompany the interim information, rather than the narrative, letters, and other disclosures previously required.

Reasons for the Changes

Originally, the purposes of these revisions were to 1) eliminate rules which duplicate generally accepted accounting principles, 2) change rules to recognize current practice and changes in circumstance, 3) clarify and modify requirements which are subject to various interpretations, and 4) expand certain disclosure requirements to improve financial reporting. Because of the many objections from the private sector to the related requirement that financial statements in annual reports to shareholders be prepared in accordance with Regulation S-X, this fourth purpose and related requirement were withdrawn.

The FASB objected to the proposals to require financial statements in the annual reports to stockholders to conform to Regulation S-X, to require certain disclosures not required by GAAP to be included in such financial statements, and to require certain other disclosures presently made only in filings with the SEC to be included in the annual report to stockholders but not

necessarily in the financial statements (Regulation S-K items). The FASB objected to the proposals for several reasons: annual reports to stockholders and reports to the SEC serve different purpose and different audiences, reduced "readability" of the annual reports, possible de facto extension of SEC requirements to companies out of its jurisdiction but subject to GAAP. The principal objection in general was that of the likelihood of changing the nature of the annual report to stockholders from a communication device to a regulatory device.

Even though the SEC did agree to not formally require that financial statements in annual reports to stockholders be prepared in accordance with Regulation S-X, it did pursue its first three objectives in its quest for uniformity between financial statements for annual reports and those contained in filings with the Commission.

A RELATED ISSUE

Auditors' Opinions on Adequacy of Internal Accounting Control

On June 6, 1980 with Accounting Series Release No. 278, the SEC withdrew its April 30, 1979 rule proposal that would have required a statement by management and an auditor's opinion on internal accounting control in 10-K reports and annual reports to stockholders. The withdrawal of this proposal provides an example of the SEC's willingness to encourage the accounting profession in development of standards rather than to regulate through legislation.

ASR No. 278 stressed the importance of an effective system of internal accounting control to investors and management because it provides the basis for financial statements, unaudited financial information, and assurance to management that it is fulfilling its responsibilities of accountability to investors. In general, ASR No. 278 discusses factors concerning the design, implementation and monitoring of internal accounting control systems, including the need for documentation, the importance of a proper control environment, and the concept of reasonable assurance. The SEC stated its intention to gather more information and monitor voluntarily submitted management reports and auditors' involvement in reporting on systems of internal control through the Spring of 1982.

The AICPA subsequently issued SAS No. 30, "Reports on Internal Control," which provided guidelines for reporting on a client's internal accounting controls if the client so desires. Issuing an opinion on a system of internal control is not required but this encouragement to do so is certainly a departure from years of auditing practice in which auditors' opinions have been publicly issued only on financial statements. SAS No. 30 indicates that a study made in connection with an engagement to express an opinion on a system of internal accounting control need not be an isolated event, but rather such a study could also form the basis for reliance on internal accounting controls in determining the nature, timing, and extent of audit tests.

The timing of the issuance of SAS No. 30 and ASR No. 278 is such that it could appear as if the AICPA is merely "following suit," responding directly to the SEC's request for auditors' opinions on clients' systems of internal accounting control. Actually, these developments were preceded by several years of concern and activity on the subject of reporting on internal control by both the AICPA and the SEC. SAS No. 20, "Required Communication of Material Weaknesses in Internal Accounting Control," was adopted by the AICPA in 1977. In addition to requiring an auditor's report to management when material weaknesses in internal control were identified in the course of an audit, SAS No. 20 stated that the AICPA was considering the issue of reporting to the public on a system of internal accounting control. The Foreign Corrupt Practices Act (FCPA), a 1977 amendment to the Securities Exchange Act of 1934, required all public companies under SEC jurisdiction, not just those with foreign operations, to maintain an adequate system of internal control, imposing increased responsibility and potential civil liability for auditors.

Uncertainty over implementation of the Act has existed since 1977, with interpretations ranging from the view that no additional audit work is necessary to the recommendation of the Commission on Auditor's Responsibilities (Cohen Commission) in 1978 that an auditor expand his study to be able to judge whether controls over each significant part of the accounting system provide reasonable assurance of no material weakness.

SAS No. 30 does not provide guidance in complying with the internal control portions of the Foreign Corrupt Practices Act. In fact, SAS No. 30 states:

Whether a company is in compliance with those provisions of the Foreign Corrupt Practices Act is a legal determination. An independent accountant's opinion does not indicate whether the company is in compliance with those provisions but may be helpful to management in evaluating the company's compliance.

Instead, SAS No. 30 may provide auditors with an opportunity to gather experience in reporting on systems of internal accounting control and develop additional guidelines and standards for such reports. This experience may be very helpful, since it seems clear that either the profession will act or the SEC is likely to expand integrated disclosure requirements in the near future.

IMPLICATIONS FOR THE PRACTITIONER

At the beginning of this paper, three goals were identified for the SEC's Integrated Disclosure effort:

1. To standardize reporting and disclosure requirements across all types of filings with the Commission;
2. To require additional desirable disclosure in filings with the Commission, and;
3. To secure uniformity of required disclosure between annual reports to stockholders and filings with the Commission.

The revisions of Regulations S-X and S-K, discussed above, appear to have met the objective of goal No. 1 without much opposition from the accounting profession. Of course, the impact of goal No. 1 is largely confined to registrants and the goal may be described as being essentially "house-keeping." Hence, the achievement of this goal is not likely to have far-reaching implications for the development of future generally accepted accounting principles.

With respect to the second goal, the new rules now require disclosure of substantial information which was not previously required by the old SEC requirements or by generally accepted accounting principles. Of course, in the past, several filings with the SEC (Form 10-K, for example) have required disclosure of information not re-

The FASB maintains that annual reports to stockholders and reports to the SEC serve different purposes.

quired by generally accepted accounting principles; the new rules simply expand this additional disclosure. Even so, the private sector accounting standard setters apparently do not disagree with the SEC's requirements for additional disclosure in SEC filings. Consequently, the SEC appears well along towards achievement of goal No. 2.

This poses an interesting dilemma — the SEC's position that more disclosure is necessary to fulfill the needs of investors implies that the amount and types of disclosure now required in annual reports may not adequately meet investors' needs. This observation may account for the profession's (notably, the FASB's) reluctance to accept the SEC's proposals to achieve its goal No. 3 of integrated disclosure requirements between annual reports to stockholders and SEC filings. Thus, it appears that the accounting profession's resistance is not to the existence of a dual disclosure standard for public and non-public companies, but rather to the attempt by the SEC to impose its disclosure standards for public companies upon the entire business community — particularly upon non-public companies.

The SEC, in turn, has indicated a willingness to *defer* seeking achievement of goal No. 3 until late 1982 or 1983; it would be naive, however, to presume that the SEC has abandoned eventual achievement of goal No. 3. Thus, the stage appears set for the exercise of "friendly persuasion" on the accounting profession; indeed, one avenue for future development of generally accepted accounting principles might be to require additional disclosures such as those proposed by the SEC. Hence, it behooves all practitioners, whether or not actively practicing before the SEC, to be aware of the

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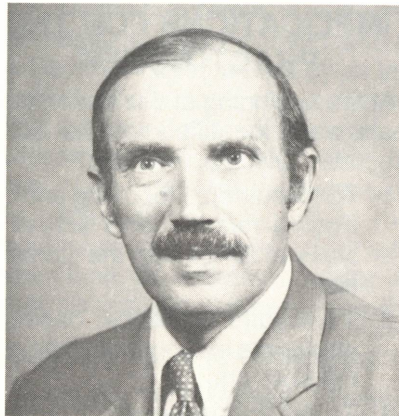
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expanded disclosure required by the SEC and to consider the impact of potential increased disclosure requirements on all engagements. Ω

APPENDIX

The following is an outline of the new four-part Form 10-K:

- I. Detailed disclosure requirements
 - Item 1.
Description of business—incorporates existing Regulation S-K Item #1 basically unchanged
 - Item 2.
Properties (unchanged)
 - Item 3.
Legal Proceedings (unchanged)
 - Item 4.
Security Ownership of Certain Beneficial Owners and Management (unchanged)



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- II. Basic disclosure package
 - “basic information package” for all SEC filings and annual reports
 - Item 5.
Market for the Registrant's Common Stock and Related Security Holder Matters (new Regulation S-K item)
 - requires information on markets for common stock, range of stock sales prices for past two years, dividends paid over past two years, dividend restrictions, number of holders of common stock;
 - encourages statement of intention regarding future dividends
 - Item 6.
Selected Financial Data (new Regulation S-K item)
 - to be presented in columnar form for at least past five years; includes operating revenues, income from continuing operations, total assets, long-term obligations (debt, capital leases, redeemable preferred stock), and cash dividends declared per common share; replaces old “summary of operations”
 - Item 7.
Management's Discussion and Analysis of Financial Condition and Results of Operations (new S-K item)
 - requires coverage of all financial statements and details regarding liquidity, capital resources, and the effects of inflation;
 - encourages “forward-looking information” which will be covered by the Commission's “safe harbor rule” for projections
 - Item 8.
Financial Statements and Supplementary Data
 - financial statements must comply with Regulation S-X requirements; requires audited statements of income and changes in financial position for the three most recent years and balance sheets as of the end of two years
 - supplementary financial information required: 1) selected quarterly data for registrants meeting certain criteria, 2) disagreements on accounting and financial disclosure matters and/or change of accountants (new S-K item)
- III. Proxy disclosure information
 - Item 9.
Directors and Executive Officers of the Registrant (unchanged)
 - Item 10.
Management Remuneration and Transactions (unchanged)
- IV. Exhibits, Supplemental Information and Signatures
 - Item 11.
Exhibits, Financial Statement Schedules and Reports on Form 8-K
 - Signatures
 - expanded requirement from one authorized signature to certain officers and at least a majority of the directors