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## Testimony... before the U.S. Securities and Exchange Commission on SEC concept release S7-29-94, Safe harbor for forward-looking statements, February 13, 1995

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American Institute of Certified Public Accountants (AICPA)

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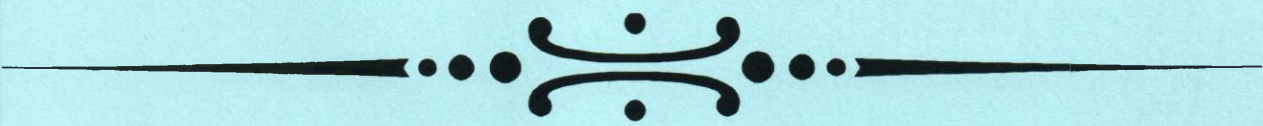
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AICPA. *Testimony... before the U.S. Securities and Exchange Commission on SEC concept release S7-29-94, Safe harbor for forward-looking statements, February 13, 1995*, by Philip B. Chenok.



**Testimony of Philip B. Chenok  
President  
American Institute of Certified Public Accountants**

**before the**

**U.S. Securities and Exchange Commission**

**on**

**SEC Concept Release S7-29-94  
Safe Harbor For Forward-Looking Statements**

**February 13, 1995**

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My name is Philip B. Chenok, President of the American Institute of Certified Public Accountants. With me is Richard I. Miller, AICPA General Counsel. We appreciate the opportunity to appear before the Commission to present our comments on current practices relating to disclosure of forward-looking information, with a focus on whether current safe harbor provisions are effective in encouraging voluntary disclosure of forward-looking information while providing appropriate protection for investors.

The AICPA is the national professional association of CPAs with more than 320,000 members in public practice, industry, government, and education. The AICPA, through the efforts of volunteer members, is devoted to developing standards for audits and other services by CPAs, providing educational guidance materials to its members, administering the Uniform CPA Examination, and monitoring and enforcing compliance with the profession's technical and ethical standards. All of these activities are undertaken with the objective of assisting our members in their efforts to serve the public interest.

The AICPA believes that the current safe harbor provisions for forward-looking statements are not effective and do not adequately protect issuers, their independent accountants, and other professional advisors from unwarranted litigation. Accordingly, issuers are unwilling to provide such information, independent accountants and others are reluctant to be associated with it, and investors are ill-served by this situation. As I will discuss later, under the caption "Scope of the Safe Harbor," strengthening the current safe harbor provisions is, therefore, important, and we encourage the Commission to do so.

However, in today's litigious society, a regulatory safe harbor for forward-looking statements in and of itself does not afford sufficient protection from the meritless litigation that currently plagues issuers, accountants, and other professional advisors. Those who abuse our legal system for self-serving ends that have little, if anything, to do with investor protection will be deterred only by legislative action, and we urge the Commission to lend its support and its unquestioned prestige to current legislative efforts

to achieve such action. While we appreciate the Commission's willingness to reconsider its safe harbor provisions, in today's environment we believe those efforts will not prove successful absent effective legislation. We are not in a position to respond to all of the questions posed in the release, but we hope these comments will be useful to the Commission as it deliberates these important issues.

### Disclosure of Forward-Looking Information

Users have recognized the problems in the present system as documented in the brochure, *Improving Business Reporting – A Customer Focus*, issued by the AICPA's Special Committee on Financial Reporting (Special Committee) in November 1994. The brochure summarized the Special Committee's recommendations and was widely distributed. Those recommendations were based on an unprecedented in-depth study to learn directly from users their information needs. The Special Committee has also published a comprehensive report that includes the results of that research, the basis for its conclusions, and details about its recommendations. (A copy of the report has been submitted for the record.) The Special Committee has observed that "managements see disclosure of forward-looking information, even though helpful to users, as providing ammunition for future groundless lawsuits that negatively affect the dissemination of forward-looking information." Worse, in terms of the credibility and relevance of our financial reporting system, the Special Committee reported that "[m]any users also are concerned that unwarranted litigation is discouraging companies from disclosing useful information."

### Types of Information Covered by a Safe Harbor

Both the Commission and the profession have a desire to provide useful forward-looking information to the public. Financial statements already include such amounts and disclosures that require estimates and judgements about future events. Such "soft" information cannot be subjected to the same degree of verifiability as historical information. Yet, we all agree that it is in the public interest to encourage the expanded

use of this information, and, therefore, an effective safe harbor is necessary. However, an incongruity exists if a safe harbor only applies to information outside the financial statements. Accordingly, it is entirely appropriate to provide the same safe-harbor protection for forward-looking information regardless of whether that information is inside or outside the financial statements.

The Special Committee found from its research into user needs that users are interested in management's perspective about opportunities and risks and about management's plans for the future. The Special Committee also found that users generally believe that management should not include forecasted financial and operating data in business reporting, although some users, particularly lenders to smaller companies, seek such information. Following are excerpts from the Special Committee's report:<sup>1</sup>

#### *Opportunities and Risks*

Opportunities and risks result from changes in a company's industry conditions, such as a threat from substitute products or services, changes in the bargaining power of customers or suppliers, including employees, and changes in the nature of competition with competitors. Opportunities and risks also result from concentrations in a company's assets, customers, or suppliers. Users also are concerned about illiquidity risks, and contingent gains and losses related to a company's rights and obligations. (Page 29)

#### *Management's Plans, Including Critical Success Factors*

Understanding management's plans is important for users. Management is the best source of information about the direction it intends to lead the company, and its plans are an important leading indicator of the company's future. Even though a company may not achieve its plans, understanding the general direction of the company is helpful. Also, management's plans are an important driver of the opportunities and risks a company will face. (Page 30)

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<sup>1</sup>Comprehensive Report of the Special Committee on Financial Reporting, American Institute of Certified Public Accountants, *Improving Business Reporting – A Customer Focus: Meeting the Information Needs of Investors and Creditors*.

### *Forecasted Operating and Financial Data*

Despite the relevance of forecasted data, except in the circumstances described below, users generally do not need forecasted data from management in business reporting, for the following reasons:

- Users generally prefer to make their own forecasts. Many users consider themselves experts in forecasting, valuing companies or assessing credit risk, and consider forecasting as an integral part of their role. Further, users believe they are more objective.
- Point estimates of future financial performance are inherently imprecise. Further, users' experience with those forecasts leads them to believe that management forecasts tend to be overly optimistic.
- Forecasts would increase litigation against the company. Forecasts that, with the benefit of hindsight, failed to foretell the future accurately would be easy targets for lawsuits filed routinely against companies whose stock prices have fallen.

Although users generally do not need forecasted data from management, some users, particularly lenders to smaller companies, seek management's forecast for the following reasons:

- A forecast helps the user understand management's view of the future and its plans for the company.
- Preparing forecasted data disciplines management to develop plans and think through the financial implications of those plans, an exercise that benefits both management and reduces credit risk for the lender. (Pages 30-31)

### Voluntary Disclosure

As noted, the Special Committee also concluded that companies are unwilling to voluntarily disclose additional forward-looking information because of their concern about the high risk and costs associated with unwarranted litigation, a concern understood and shared by many investors. Those concerns are sadly real. On the other hand, companies would be encouraged to expand reporting of forward-looking information once effective deterrents to meritless and unwarranted litigation are in place, including preemptive legislation relating specifically to such information. Only legislation



can achieve the results needed. Regulatory safe harbors are desirable and important but, in today's environment, are not a substitute for legislation. We believe that legislation introduced in the 103rd Congress, if enacted, would provide meaningful reform while continuing to protect investors. We again urge the Commission to support similar efforts in the 104th Congress.

We do not advocate closing the courthouse door to those investors who have been defrauded. The right to sue for recovery for legitimate claims must be preserved, but the current legal system is out of balance and is depriving users of useful information including forward-looking information. Until effective legislation is enacted, investors and other users of financial reports will and unfortunately must be deprived of valuable information because companies will not provide forward-looking information.

#### Scope of the Safe Harbor

The AICPA recommends that any amendment to or modification of the safe harbor for forward-looking information must also provide specific protection for third party reviewers. (Current Rule 175 protects statements "made by or on behalf of an issuer or by an outside reviewer retained by the issuer." A literal reading of this provision might lead to the conclusion that reports by third party reviewers on forward-looking information are not covered unless the third party reviewer itself publishes the forward-looking information.) At a minimum, third party reviewers should be shielded from liability to the same extent as issuers.

As discussed above, forward-looking information plays a vital role in the financial markets. However, because the potential for liability is great, it is unlikely that voluntary disclosures of forward-looking information will be routinely provided unless there exists a safe harbor that truly protects the parties associated with the dissemination of such information from liability when, inevitably, actual results vary from the information as presented. Ideally, this can only be accomplished when the protection of a safe harbor is extended to provide relief from both federal and state causes of action.



Any safe harbor legislation must be specific and absolute. There should be no liability for forward-looking statements involving qualified issuers. "Forward-looking statement" would be broadly defined as it currently exists in Rule 175. The issuers' qualifiers for inclusion in the scope of the safe harbor can be determined by rule-making by the Commission. Once an issuer qualifies for inclusion in the safe harbor under criteria established by rule by the Commission, private actions both at law and equity that are based upon forward-looking statements contained in documents filed with the Commission would be precluded simply because the actual results differ from the information as presented. The forward-looking statements would be protected whether they were made by or on behalf of a qualified issuer, or reviewed or reported upon by third party reviewers. There would be no liability to private plaintiffs under state or federal law unless such liability was explicitly provided for by a subsequent act of Congress. Of course, that safe harbor protection should not be available to any person or company found to have committed a fraud in connection with the issuance of any forward-looking information. In addition, the Commission's ability to bring enforcement actions seeking civil or criminal fines should not be disturbed.

As implemented, the safe harbor should provide that forward-looking statements concerning a qualified issuer would be protected from private actions if it is identified in a report filed under the Securities Exchange Act of 1934 or a registration statement filed under the Securities Act of 1933. The forward-looking statements, as contained in such documents, must be accompanied by a legend prominently presented in bold-face capital letters that contains detailed warnings about the nature of the forward-looking statements. The legend itself would be prescribed by rule by the Commission and be based on the "bespeaks caution" doctrine. It would forewarn readers that state and federal liability for the forward-looking statements is precluded by statute. It must specifically contain language cautioning readers that the forward-looking statements consist of estimates of future results, do not represent historical information, and most importantly, it must contain a caveat that the future actual results will inevitably differ from the forecasted or projected results. Thus, under this approach, forward-looking

statements would be protected so long as they were properly qualified and accompanied by clear and specific cautionary language that adequately discloses the risks involved.

### Summary

The AICPA believes that users need additional disclosures of forward-looking information, but such disclosures are unlikely to occur on a voluntary basis until effective regulatory safe harbors are in place and appropriate legislative remedies are enacted to reduce to acceptable levels the legal risk and thereby create a climate conducive to such disclosures. Full and fair disclosures are the foundation of our financial reporting system, but our current legal system is thwarting that goal. The Commission can and should provide appropriate safe harbors that encourage companies to provide useful forward-looking information to investors without the risk of being sued if their good faith projections are later proven wrong.