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Remarks of

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**PRIVATE SECTOR ACCOUNTING STANDARDS:  
THE SEC'S OVERSIGHT ROLE**

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The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

PRIVATE SECTOR ACCOUNTING STANDARDS:  
THE SEC'S OVERSIGHT ROLE

I. INTRODUCTION

It is a great pleasure for me to appear at this National Conference on Current SEC Developments, sponsored by the American Institute of Certified Public Accountants. As accountants, you know that meaningful financial information is the key element of disclosure required by the federal securities laws. You also know that the profession plays a vital role in the disclosure process. I want to speak to you today about an essential aspect of that process, the interaction between the accounting profession, particularly the Financial Accounting Standards Board, the Securities and Exchange Commission, and the business community in prescribing accounting standards.

The Securities Act of 1933 gave the Commission the authority to prescribe accounting standards to be followed by companies for purposes of complying with the federal securities laws. 1/ The Commission has historically looked to the private sector to help establish those standards, creating an important joint responsibility.

This joint responsibility has recently been the subject of concern and comment, from both Congress and the business community. The Commission exercises strong oversight in the standard setting process and must do so in the context of complex and challenging accounting issues, some of which are

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1/ Sections 7, 19(a), and Schedule A of the Securities Act of 1933, 15 U.S.C. 77g, 77s(a), 77aa(25) and (26).

viewed as extremely important in today's national and international business environment.

## II. RECENT CRITICISM OF THE PRIVATE SECTOR STANDARD SETTING PROCESS

Despite the fact that the accounting profession and the Commission have worked together to establish the best accounting system in the world, criticism still exists. No system is perfect and both the FASB and the Commission are continually attempting to improve both accounting standards and the manner in which those standards are established. Nevertheless, the Accounting Principles Task Force of The Business Roundtable recently has voiced concern over the pace of issuance and complexity of recent accounting standards. Both the Commission and the FASB take these criticisms seriously and believe they merit consideration and response.

The business community's concern with recent standards issued by the FASB is well illustrated by a comment from the Chairman of the Business Roundtable's Accounting Principles Task Force. He states that:

We believe that . . . the FASB has produced too much change in too short a timeframe. They have made significant changes to a set of accounting rules that already work well, and the changes themselves have often been too theoretical or insufficiently practical, with the major effect being that companies are incurring significant implementation costs without providing much in the way of improved information.

Examples of the business community's concerns with recent FASB projects are not hard to find. One recent FASB project

culminated in the issuance of the Statement of Financial Accounting Standards No. 96 which relates to accounting for income taxes. The Statement requires the amount of income taxes recorded on financial statements to be determined by applying the provisions of the tax laws to all events that have been recorded on the financial statements. Critics argue that the calculations prescribed by the new standard are too complex and do not appropriately reflect the economic reality of the company's tax posture.

The Roundtable and business community have also expressed dissatisfaction with the direction and scope of several other FASB projects that are on the current agenda. These projects include financial instruments, post retirement benefits, and stock options.

In 1985 the SEC requested that the FASB address accounting for complicated new financial instruments. The Commission was concerned that the value of these instruments may not be sufficiently disclosed. In response, the FASB is considering whether to reflect financial instruments at historical cost or at fair market values. Critics argue that disclosures suggested by the FASB in the first phase of this project are too complex, too difficult to prepare, and of questionable use.

Another area of concern is the valuation of post retirement benefits. This problem has captured national attention because of the magnitude of the potential liabilities involved. The FASB is focusing on the appropriate

valuation of, and accounting for, potential liabilities regarding these post employment benefits which might be appropriately included on the balance sheet. Critics have raised concerns about potential measurement problems resulting from the uncertainties regarding the timing and amount of potential benefit payments.

A third project, on stock options, centers around the accounting for the potential compensation element of stock options issued to employees. The FASB has spent much time and effort studying complex valuation models for stock options, without reaching a conclusion. Critics argue that the compensation element, if any, cannot be adequately measured and should be ignored.

The Roundtable's principal focus, however, is not with individual standards or projects. Instead, the Roundtable believes there is a broad, pervasive problem with the process of standard setting at the FASB. The Roundtable believes that the current problems stem from:

- a lack of accountability by the FASB for its accounting standard setting activities;

- an outdated FASB agenda; and

- a lack of appropriate FASB project review procedures.

In order to improve these areas, the Roundtable has suggested that a new private sector committee be established to oversee FASB agenda decisions and standard setting activities.

I have not been able to agree with this recommendation. In order to understand why, it is useful to review the history of the Commission's relationship with the accounting profession and our current involvement with the FASB.

### III. HISTORY OF DEVELOPMENT

The Commission and the accounting profession have long supported the elimination of accounting options for similar facts and circumstances. Accounting Series Release No. 1 ("ASR No. 1"), issued in 1937, announced that opinions on accounting principles would be published periodically "for the purpose of contributing to the development of uniform standards and practices on major accounting questions." 2/ The Staff of the Commission looked to the accounting profession for the development of accounting principles that eliminated areas of differences.

In 1938, the Commission issued Accounting Series Release No. 4 ("ASR No. 4") that stated the following:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material. 3/

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2/ Accounting Series Release ("ASR") No. 1 (April 1, 1937).

3/ Accounting Series Release ("ASR") No. 4 (April 25, 1938).

The following year, in order to provide the "substantial authoritative support" sought by the Commission, the accounting profession established the Committee on Accounting Procedure, whose purpose was to identify accepted accounting practices, including alternatives. While this Committee gradually eliminated some questionable practices, it did not firmly choose between "acceptable" methods of accounting for specific types of transactions.

In the late 1950's, the accounting profession was subjected to criticism for permitting the existence of widely divergent alternative accounting practices, leading to charges that financial statements lacked comparability, and therefore misled investors. This criticism led to the creation of the Accounting Principles Board (the "APB").

In the mid-1960's the APB began to issue opinions on accounting matters in which the divergence of acceptable practices was the widest. One goal of the APB was to reduce the use of differing accounting methods that were not justified by factual or circumstantial differences. The APB undertook to narrow areas of difference in accounting practice by dealing with critical issues on a problem-by-problem basis. Earnings per share and accounting for business combinations were two such areas in which the APB narrowed the range of acceptable choices.

In the early 1970's, critics of the APB began to point to its lack of representation from a broad constituency and to the

growing backlog of problems that needed to be addressed. As a result, a broadly-based study group known as the Wheat Committee was formed, resulting in a 1972 recommendation leading to the establishment of the FASB. The FASB is composed of seven full-time members chosen by the Financial Accounting Foundation. The board members have diverse backgrounds and are required to sever all connections with the firms or institutions they served prior to joining the Board.

In Accounting Series Release No. 150 ("ASR No. 150"), the Commission endorsed the establishment of the FASB in the belief that the FASB would provide an institutional framework which would permit prompt and responsible actions flowing from research and consideration of varying viewpoints. ASR No. 150 stated:

For purposes of this policy, principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support. 4/

While the formation of the FASB was a response to criticisms, it was not intended to end criticism. Because of the controversial nature of standard setting, ongoing criticism was to be expected. In the 1973 inaugural speech introducing the newly formed FASB, Reginald Jones, then Chairman of the Board of General Electric, anticipated this controversy when he

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4/ ASR No. 150 (December 20, 1973).

said, "We must recognize that with its first decision, the new board is going to gore somebody's ox." 5/

The Commission's decision to rely on the private sector has sometimes been criticized. A 1976 report issued by the House Subcommittee on Oversight and Investigations, chaired by Congressman John Moss, characterized the result of the Commission's 1938 decision to seek authoritative support from the private sector as "disappointing at best." 6/ However, through a series of congressional hearings involving testimony by members of the accounting profession and by the Commission, Congress seems to have accepted the Commission's position that private sector standard setting, with active oversight by the SEC, is in the best public interest. For instance, in 1977, a Congressional report cited several factors supporting private sector standard setting, including the accounting profession's desire for the task and its willingness to respond to criticisms and take initiatives for improvements. 7/

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5/ Address by Reginald Jones, then Chairman of General Electric, quoted in an address by M. Armstrong, Third Annual Securities Regulation Institute, January 16, 1976, reprinted in The Journal of Accountancy 76-79 (February 1977).

6/ Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, 94th Cong., 2d Sess., Report on Federal Regulation and Regulatory Reform at 31 (October 1976).

7/ See generally Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs, 95th Cong., 1st Sess., Report on Improving the Accountability of Publicly Owned Corporations and Their Auditors (November 1977).

Congress also emphasized, however, that a key feature to this arrangement is the SEC's active oversight of the private sector standard setting process.

#### IV. SEC INTERACTION WITH THE FASB

The Commission engages in active oversight of the FASB. It interacts daily with the FASB and thus is in an excellent position to evaluate the FASB's performance. The Commission monitors the development of new standards and then deals with subsequent implementation and interpretation of the standards through ongoing advisory, examination, and enforcement programs.

The SEC's oversight is extensive and covers all aspects of the FASB's activities. The Commission staff discusses issues with the FASB staff on a daily basis and the two staffs meet regularly to discuss the FASB's agenda, current problems, and other matters of mutual interest. The FASB also meets periodically with the Commission members in open meetings to discuss topical issues.

The Commission's staff also actively monitors the structure, activities, and decisions of the FASB. Each of the projects on the FASB's technical agenda is assigned to Commission staff members who follow the project developments, review comment letters submitted to the FASB, attend FASB meetings and public hearings, and confer with FASB staff. Senior staff members from the Commission's Office of the Chief Accountant and the Division of Corporation Finance serve on

FASB task forces. Additionally, the Chief Accountant participates in quarterly meetings of the Financial Accounting Standards Advisory Council ("FASAC"), which consults with the FASB on major policy questions, technical issues, and project priorities. Additionally, the Chief Accountant serves on the FASAC Agenda Advisory Committee -- which evaluates potential projects to be added to the FASB's Agenda -- and on the FASB's Emerging Issues Task Force -- which provides guidance on emerging accounting problems on a timely basis.

In the exercise of its oversight role, the Commission believes it is necessary to seek uniform standards for similar transactions and events. In recognition of the complexity involved in setting unified standards, Commission oversight is designed to see that a particular solution reached by the FASB falls within a range of solutions considered to be acceptable. By allowing the FASB to select one reasonable solution among several acceptable solutions, the Commission, of course, recognizes that others may criticize the results as being second or third best among available reasonable choices. This approach does not seek the only acceptable answer to all accounting issues, but seeks to promote uniformity by selecting one reasonable answer for the vast majority of accounting issues.

The goal of uniformity also seems to have Congressional support. In a 1976 Report by the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign

Commerce, the Subcommittee recommended that: "the SEC should require to the maximum extent practicable uniform accounting principles." 8/

On occasion, the Commission has found it necessary to supplement or amend existing standards and has done so through Regulation S-X, Financial Reporting Releases, and Staff Accounting Bulletins. However, overall the Commission has consistently concluded that the FASB performs its tasks well. The SEC has continuously analyzed the accounting standards established by the FASB and has supported the results as necessary and appropriate.

V. SEC RESPONSE TO THE BUSINESS ROUNDTABLE

With this discussion of the Commission's oversight role as background, it may be easier to understand my reaction and that of the FASB to the Business Roundtable's criticism. In my view the FASB, and its parent organization, the Financial Accounting Foundation, have reacted to the Roundtable's concerns in a responsible manner.

The FASB has indicated a willingness to consider recommendations for improving the standard setting process. A healthy dialogue has ensued and a Financial Accounting Foundation Advisory Group, chaired by Ray Groves, 9/ has been

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8/ See note 6, supra, at 18.

9/ The FAF Advisory Group was formed by the Financial Accounting Foundation (FAF) to recommend ways to improve the FAF and FASB processes in response to concerns raised by the business community and others. The Advisory Group  
(continued...)

established to consider potential constructive changes. The FASB has also agreed to seek more field testing and to take other steps to seek the input of the business community.

You may be assured that the Commission is and will be an active participant in the continuing dialogue between the FASB and the business community. As early as April of last year, when the criticisms of the FASB were first expressed, the Commission's Chief Accountant, Ed Coulson, wrote to Rholan Larson who is President of the Board of Trustees for the FAF. Mr. Coulson voiced his continuing support for independent private sector standard setting and sought to open lines of communication between the profession and the Commission regarding any possible suggestions for reforming this process.

The Business Roundtable also communicated with the FAF, and, in a letter to the FAF Advisory Group, the Roundtable described its proposal for a FASB oversight committee. That proposal suggested that the oversight committee would have the power to overrule proposed agenda items, cause re-examination of existing rules, and delete what are considered to be unproductive projects from the agenda. Under this proposal, decisions of the oversight committee would be binding on both the FASB and the Commission.

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9/(...continued)

is chaired by Ray Groves (Chairman and Chief Executive, Ernst & Whinney). Other members include Philip Chenok (President, AICPA), John Quindlen (Senior Vice President - Finance and Chief Financial Officer, DuPont), Thomas Pryor (Yeager, Wood and Marshall, Inc.) and John Ruffle (Vice Chairman, J.P. Morgan).

After reviewing this proposal, I met with representatives of the FASB and the Roundtable. At the meeting, I described the close working relationship between the FASB and the Commission, and raised two principal concerns with the proposal.

First, the Commission's willingness to look to the private sector for leadership in establishing accounting principles has been with the understanding that the Commission may exercise its authority and either override, supplement, or otherwise amend the standards established by the private sector standard setting body or adopt rules in areas where private sector standards are silent. In order to fulfill its statutory obligations to set accounting standards for registrants, the Commission should not be restrained by a private sector body. The Commission therefore cannot support placing authority in a private sector oversight committee which could overrule proposed agenda items in a manner that would be "binding" on the Commission.

Second, the proposal would have a troubling impact on the FASB's independence. If established, the oversight committee could control the addition of items to the FASB's agenda, require the FASB to drop projects, cause the FASB to re-examine existing rules, provide guidance during any ongoing project, and openly criticize whether the FASB has "given appropriate weight to the views of those commenting." Such authority would create the appearance that the committee was the standard

setting body, and apparently relegate the FASB to the role of technical advisor. The process would no longer be perceived as standard setting by an independent body within the accounting profession.

Although I was unable to support the Roundtable proposal, it must be stressed that some Roundtable suggestions, such as the increased use of field tests and advisory task forces, are desirable steps toward increasing cooperation between the FASB and the business community. An increased advisory role for the FAF in the standard setting process also is under review.

Conversations between the Business Roundtable and the Commission are continuing. One alternative under consideration is the establishment of contact on a regular basis between senior business officials, senior partners of accounting firms, and the Commission. This interchange could provide the Commission with continued input and views on the FASB's performance and accounting issues in general.

In sum, communications among the Commission, the FAF, the FASB, and the Roundtable have been open and helpful to us all, and we are continuing to explore avenues that maintain the effectiveness and independence of the Board, but that also recognize the concerns of the business community about the standard setting process.

VI. INTERNATIONALIZATION

The concerns about standard setting in the United States are interrelated with current initiatives to develop mutually acceptable international accounting standards.

As noted in the Commission's November 1988 Policy Statement on Regulation of International Securities Markets, "[I]nternational markets for securities have grown tremendously in recent years. The world's markets for equity and debt securities have become increasingly automated and linked. Driven by new technology, investors' desires to enter foreign markets, and issuers' efforts to obtain low cost capital, the trend toward internationalization of the securities markets undoubtedly will continue." 10/

The continuing trend toward internationalization will increase the need for, and the benefits to be derived from, mutually agreeable international accounting principles. Such standards will reduce the regulatory burdens resulting from current disparities between the various national accounting standards. Accordingly, securities regulators and members of the accounting profession throughout the world should continue efforts to revise and adjust international accounting standards with the aim of increasing comparability and reducing costs.

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10/ See Policy Statement of the United States Securities and Exchange Commission: Regulation of International Securities Markets, Securities Act Release No. 6807, 53 Fed. Reg. 46963 (November 14, 1988).

In an effort to address accounting differences, the SEC's staff is working with international organizations such as the International Organization of Securities Commissions (IOSCO) and the International Accounting Standards Committee (IASC) to revise international accounting standards. IASC is addressing problems of completeness and lack of specificity in some of the international accounting standards and hopes to reduce the number of free choice accounting options permitted under some of the standards. Where options cannot be eliminated, the group seeks to specify one method as the benchmark (or "preferred" method) for international filings.

At its November 1988 meeting in Copenhagen, the IASC board approved publication of an Exposure Draft for public comment. This draft was released on January 1, 1989, and represents the first phase of the project -- proposed changes to deal with the question of accounting options in existing international standards. The Exposure Draft, which will have an exposure period of nine months, deserves careful consideration and comment since it represents an important first step in assessing the feasibility of the IASC project. I have previously mentioned the importance of eliminating accounting choices, and the Exposure Draft, if adopted, may provide a meaningful approach to this problem.

The FASB has also indicated an increased desire to participate more in the development and harmonization of international accounting standards. In his June 23, 1988

presentation to IASC, Dennis Beresford, Chairman of the FASB, spoke of several possible international initiatives to be undertaken by the FASB. 11/ One FASB Board member has been designated as liaison representative to the IASC, and is a member of the IASC consultive group, which meets regularly with the IASC Board to discuss projects.

I believe the SEC, FASB, and accounting profession, as well as our counterparts in other countries, along with the worldwide business and financial community, will have to devote increasing attention to international accounting issues in the years to come. As economic pressures continue to drive the internationalization of the securities markets, so will the need to minimize differences in accounting principles in order to facilitate transnational capital formation, while ensuring adequate disclosure for the protection of investors.

#### VII. CONCLUSION

These remarks are intended to offer a future involving continued responsiveness to criticisms and a willingness to take initiatives toward improvements. A continued spirit of proactive cooperation and improvement will become increasingly important as the FASB deals with increasingly important and complex issues.

The task of setting accounting standards demands our utmost attention. As accounting issues continue to increase in

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11/ Address by Dennis R. Beresford, Chairman of the Financial Accounting Standards Board, Meeting of the International Accounting Standards Committee, June 23, 1988.

complexity, the tasks of standard setting and active oversight will also become more complex. It is extremely important to the standard setting process that all concerned parties continue their active dialogue in seeking responses to these challenges.