

Arthur Young Professors' Roundtable  
at the University of Illinois  
Urbana, Illinois

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March 31, 1976

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## SETTING ACCOUNTING STANDARDS IN THE 1980'S

Response to a paper presented by Charles T. Horngren  
for the Arthur Young Professors' Roundtable  
March 30-31, 1976

It's encouraging that Chuck spoke only briefly, because I basically agree with much of what Chuck says and I also intend to speak only briefly.

Even in this friendly environment I should point out before I go any further that I do not speak for the Commission or for my colleagues on the staff of the Commission. We have many friendly discussions in Washington and my viewpoint is only one of many.

Basically I concur with Chuck's conclusions:

- 1) That the present method of establishing standards will survive into the 1980's, as it should.
- 2) That research does have a role to play. That researchers must contemplate the results of actions in a political arena, and cannot be confined to questions of technology and absolute truth.
- 3) That we will have a conceptual framework which will probably be rather general in nature. I believe that this framework will be modestly useful in standard setting and perhaps very useful in teaching and explaining the accounting model. However, I doubt that the Standards Board will be able to look at it and say, "Aha, this leads us inextricably to the answers for each of the various questions before us."

## THE POLITICAL FRAMEWORK OF THE ACCOUNTING STANDARDS SETTING PROCESS.

Let's consider for a few moments the political framework within which the accounting standard setting process exists. Chuck in effect culminated his paper with a recognition of the importance of this political framework, and I think what he has recognized is quite significant and warrants further comment.

The political process, as Chuck points out, does not necessarily mean counting the noses of those affected by the actions of the process. In a democracy, one must operate broadly within a consensus, but that does not mean that on every issue one must count the votes. Unanimity is not required for standard setting or policy making. Actions do have to be within the boundaries of a broad consensus, but that doesn't mean they can't be near the boundaries.

Leadership is always a critical element in the political process. This is particularly true when operating close to the boundaries of consensus. I believe that leadership means perceiving needs, perhaps in advance of the time that others see them, devising solutions and then selling the solution. If we are to have a dynamic process of financial reporting, we are going to have to anticipate problems rather than react to them. And we must also recognize the need not only to see the problem and to devise the solutions, but to sell these solutions as well. Chuck, of course, has written about that in the past.

In the process of selling ideas it may be both possible and desirable to shift the consensus from time to time. For example, if we look at the issue of illegal payments, which was touched upon yesterday, I think it can be argued that there was at one stage a recognized gray area plus some black and white. What has happened is that during the last year there has been a shift in the whole spectrum so that the gray area still exists but exists in a different location.

On a broader scale, in dealing with accounting standards and principles within the framework of consensus there can be shifts within the spectrum. That is part of the selling that takes place. This is true, of course, for matters outside of accounting. It can be done in the process of selling people too. It is notable perhaps that six months ago relatively few people had ever heard of Jimmy Carter and now almost everyone has. While I wouldn't exactly draw a parallel between Jimmy Carter and replacement cost accounting, something similar could happen.

In the final analysis, one must recognize that change generally comes fairly slowly. This is partially due to the fact that change creates uncertainty and most of us abhor uncertainty. I have some sympathy for the views that have been expressed about this, and like Chuck, was taken yesterday by some of the analogies that were made between major changes in the tax law and major changes in accounting. Both tax laws and accounting changes may create fear and uncertainty associated with the changes, but that may be less than the fear and uncertainty associated with the present conditions. I doubt that we are really in that state today in accounting. I believe we will see changes take place gradually, although under some extreme conditions it may be that much more radical changes will be acceptable.

#### THE POLITICAL LEADERSHIP ROLE OF THE PROFESSION

Whether changes are more or less gradual, it is important that there be people within the system who are giving political as well as technical leadership. It is my opinion that in recent years the accounting profession has not been exercising much political leadership and that this is a major problem. On those occasions when the profession has exercised political leadership, for the most part it has been effective. For example, the Wheat Commission which set up the FASB framework was indeed an initiative of the accounting professional and a successful one. The Trueblood Study Group was also largely successful. It may be that the AudSEC standard on

sensitive payments will be another example of successful political leadership. I haven't seen the AudSEC draft so I can only respond to the encouraging words which Ralph Kent offered yesterday in this regard.

Where the profession has exercised leadership, its initiatives have been generally accepted. But too often its image has been one of reacting and resisting. I believe the SEC's activity, in many respects, appears greater than it has been simply because of the contrast between it and the accounting profession. When I consider the FASB and test its activities against the criteria of leadership which include political as well as technical activities, I am not quite as encouraged as Chuck about whether the FASB recognizes its leadership responsibilities. Although the need has been recognized to some extent, I don't think the Board has been as effective as it might be in the political arena.

Is Standards Setting a Judicial or a Legislative Process?

In part, I believe that some problems have arisen because the Standards Board has selected the wrong analogy to describe its role. The FASB apparently sees itself primarily in a judicial as opposed to a legislative posture. I believe that is an incorrect analogy.

Consider the procedures of the FASB. The emphasis on due process, filing of briefs, confidentiality of the deliberative process, the virtual gag rule imposed on members of the Board and its staff are all characteristics which imply that the Board considers itself to be a supreme court as opposed to a legislature. However, I believe the role of the FASB is more closely analogous to a legislative operation than to a judicial one. I don't mean to say that there is no need for many of its procedures. The point is that the Board's approach has inhibited the necessary selling of the solutions that it has proposed.

If we recognize that standards setting is a political process we must also recognize that the process must be largely an open one. Concerned parties have to know what is happening. They have to have the opportunity to affect what is happening. I think that people feel frustrated today because they do not know what is going on at the Standards Board.

In part, the Board may be reacting to concerns about what happened to the APB where everyone knew everything that went on almost as soon as it happened. That was occasionally frustrating to the APB members. They felt that the grapevine which disseminated information to the general public resulted in people taking initiatives which blocked some of what the Board wanted to achieve.

While such concerns are legitimate, I nevertheless suggest that a relatively free flow of information is part of the political process. It is far better to be involved in an open system than one where there is uncertainty as to what is being done, what arguments are most persuasive, and what are the most effective means of responding.

#### The Image of Leadership at the FASB

To some extent I believe that the Standards Board decision to operate as they have has not created the image of an alive and vibrant organization. One of the problems which result from this is the personnel problem. As I have talked to a number of staff people at the Board, I have a feeling that there are staffing problems there due to the fact that the Board imposes substantial constraints on what the staff members can do and how they can express themselves outside of the Board's environment. Again, that is a judicial as opposed to a legislative approach, and I believe it is an inappropriate approach.

I also believe that the Board's approach has been reflected in a series of speeches given by members of the Financial Accounting Standards Board in which the speakers seem to be

reciting the catechism rather than selling ideas. Board members say, “This is what we’ve done.” They say, “Here are our procedures.” It may be that I’m a little sensitive because I’ve shared platforms with a great many Board members and I have heard about the procedures a number of times. But I really believe that the Board should be seen as an organization of exciting people, and that isn’t how it seems. The one exception, which perhaps is a reflection of a change in attitude, is Marshall Armstrong’s speech in San Diego. There he really went out and did some gospel preaching, and I think it helped him considerably.

The ability of the individual Board members, which I think is considerable, does not generally come across. Even the Supreme Court, which makes collective decisions, allows individuals to be identified to a greater extent than does the FASB. I do not believe that the Board should be seen as a group in which individuals are submerged.

The Board cannot be above the arguments either before or after it has issued its statements. I think its members should be out explaining their views, speaking on matters of substance. This would be very helpful both for the total system and for the reception of the Standards Board.

In summary, while I believe that the FASB has a very tough job to do, and on the whole does it very well, I do believe the Board should revise its self-image. The FASB is a legislative operation, and its members and its staff should recognize their role in the political process of standard setting.

## DANGERS TO THE SYSTEM

Turning now to comments about dangers to the system, let’s consider some of the perils that exist and what might upset the forecasts of general continuation and a partially successful future for the current standard setting mechanism.

## Congressional Action

One danger is the possibility of legislative initiative in the Congress. As you are probably all aware, there is currently brewing an investigation coming out of the Senate Government Operations Committee. The Subcommittee on Reports, Accounting and Management, chaired by Lee Metcalf, is exploring a number of aspects about accounting. No one is quite sure just what this is going to amount to. No one is quite sure just what the objectives are. But the Subcommittee has asked the Commission to supply them with a full history of the Commission's decisions in the area in developing accounting standards and information about the relationship between the Commission and the accounting profession. So it is conceivable that out of such an investigation could come legislative initiatives.

More likely, I suspect, are legislative initiatives that might arise in response to perceived deficiencies of the FASB. It may be that at some point Congress would become convinced that a particular standard established by the FASB is somehow contrary to national interests and would take actions which would, in effect, eliminate the Standards Board.

## Misuse of the Measurement System

Another potential danger to this system that I see, and this could come from Congress or from elsewhere, is that policy makers may see fit to use our present system of measurement to achieve results other than measurement. This is a very real danger in my view. We are dealing here with a delicate balance.

At the present time, our measurement system and faith in our measurement system in this country are valuable economic assets. This system can be easily destroyed if we develop accounting standards with the objective, for example, of achieving better tax results, of

improving the balance of payments, of lowering utility rates, or of achieving more environmental protection. These are some of the objectives I have seen articulated in letters of comment which have come to us and to the FASB arguing for a particular accounting principle.

Accounting is not totally neutral in terms of its effects upon people. But at the same time we cannot afford to allow our measurement standards to become dominated by effects which may result from a particular policy. At times it may appear that short run economic results can be achieved at a very low cost by means of accounting. We have seen in New York and other municipalities various accounting devices which have been used as low cost methods of avoiding problems for a short period of time. Of course, these methods did not avoid the problem for very long. As we look back, they might now seem to have been rather high cost expedencies rather than low cost solutions.

This is one of the reasons I came out on the other side of tax conformity, a concept that no one talked about yesterday. I believe that certain accounting concepts should be incorporated in the tax laws, but if we were to develop a situation where the tax base turns out to be the book income, it would create far more adverse pressures than positive ones.

I am continually concerned that standard setting and sound economic measurements have been polluted by other forces. Let me just cite some specific examples. The Standards Board has seen the argument vigorously presented that if insurance companies are prohibited from carrying catastrophe reserves, those companies would be forced to reinsure overseas and that such a development would adversely effect the balance of payments. This argument was presented in a number of individual responses including the response of one leading legislator. Similarly, at the SEC, we have heard it argued before the Commission on at least two occasions that the anti self-insurance edict of the FASB would cause companies to buy insurance when it is uneconomical for them to buy insurance. The argument is that this is the wrong result because it will lead to uneconomic action. We have also heard that if banks are required to reflect the

current fair value of assets received from REITs in swap transactions, rather than simply record those assets at the book value of the loans which were originally extended, this will have the effect of driving REITs into bankruptcy and will have adverse social consequences.

Such factors cannot be ignored, but if they are allowed to become dominant, we will start down a road which I believe we do not want to follow. Some day someone will think that it will be an encouragement to companies to invest in pollution control devices if the cost of the equipment could be charged to retained earnings. That's where we could be heading.

So there are serious concerns that exist. There are real dangers to our accounting system that may result from its use for purposes other than measurement. I think the cost of such uses are very high.

#### RESPONSIBILITIES OF AUDITORS

Finally, I want to just touch upon the continued responsibility of auditors to use professional judgment in individual circumstances. I cannot resist raising this issue because I heard Ralph Kent chide the SEC gently, or not so gently, at lunch yesterday with respect to the question of preferability. He stated that there are no preferable standards and hence the Commission is unreasonable in asking auditors to reach professional judgments where there are no standards.

I doubt that any rulemaking or standards setting will ever supplant in any sense the need for professional judgment. It is my belief that an auditor has a responsibility because of his training and experience to develop judgments over a period of time as to what is consistent and most appropriate measurement within the framework of an accounting model. I believe that he has the ability and the responsibility to evaluate a particular factual situation and to make judgments in light of the circumstances about the best way to report the facts. I do not believe that only management is in the position of being able to determine preferability. Both the auditor and management have that ability and the responsibility.

Our position on this issue reflects a fundamental standard which was established by the Accounting Principles Board in APB 20. This Opinion states that accounting changes must be justified on the basis of preferability. But in even broader terms, I believe that the individual auditor looking at individual circumstances must always use professional judgment as to what accounting best reflects the reality of those circumstances. Irrespective of how good or how bad generally accepted accounting principles or standards are, they will never supplant the need for adequate professional judgment by individual auditors.

#### **SURVIVAL MAY DEPEND UPON NON-TECHNICAL AS WELL AS TECHNICAL SKILLS**

In summary, my conclusions are very close to Chuck Horngren's conclusion. I believe that conceptually we have a sound system of setting accounting standards which should survive into the 1980's. It is a system which has vulnerabilities. There are ways in which accounting principles could be misused. There are potential dangers that some people or organizations may attempt to modify the accounting model to serve purposes other than measurement. And there are dangers that the system could be damaged because of disagreements with the profession.

All of these dangers are quite real, and the one of the greatest needs during this critical period is to have leaders who recognize the political realities of the environment. If this system is to survive into the 1980's, it will be because there are leaders within the system who not only use their technical skills to find solutions to difficult accounting problems but also use their non-technical skills to sell those solutions.