

April 21, 1977

Statement of Marshall S. Armstrong, Chairman,
Financial Accounting Standards Board,
Before the Subcommittee on Reports, Accounting and
Management, Committee on Governmental Affairs,
United States Senate

Hearings on Accounting and Auditing Practices and
Procedures

Good morning, Mr. Chairman. I am Marshall S. Armstrong, Chairman of the Financial Accounting Standards Board. Thirty-five years ago I entered public accounting in a regional firm headquartered in Indianapolis, ultimately becoming its managing partner. My working life has been dedicated to public accounting, first as a practitioner and then as one charged with responsibility for setting standards for public financial reporting. I have been active in professional associations -- and was selected in 1970 to serve as president of the American Institute of CPAs. Much of my energy has been committed to the improvement of accounting practices. Aside from my four years as Chairman of the FASB, I spent six years as a member of its predecessor, the Accounting Principles Board. I also served for five years on the AICPA's auditing committee. Having made the decision recently to step down as Chairman of the FASB at the end of 1977, I appear before you today as a knowledgeable observer of the matters under consideration by your Subcommittee -- as one who is especially sensitive to the public interest -- one without a self-interest.

Accompanying me today is Mr. Alva O. Way, Vice President of the Financial Accounting Foundation and Chairman of its Committee on Government Relations. The Foundation is the organization that has responsibility for funding the Board, selecting its Members, and overseeing its operations.

The Financial Accounting Standards Board, as I am confident you know, has one charge -- to improve financial accounting standards.

I welcome this opportunity to appear before the subcommittee to present the views of the Financial Accounting Standards Board on a study prepared by your Staff entitled "The Accounting Establishment." With your permission, Mr. Chairman, I am submitting, for the record, on behalf of both the Board and the Foundation, a printed Statement of Position. The Statement provides our comments on the Study and certain of its recommendations in greater detail.

We strongly disagree with the Study's recommendation that the Federal Government assume the direct responsibility for financial accounting standards for publicly owned corporations. Our Statement of Position corrects and supplements the Staff Study in certain major respects and strives to balance the record.

Mr. Chairman, I was particularly pleased to learn at the hearing on Tuesday that both you and Senator Percy are in favor of retaining and improving the existing structure for establishing accounting standards, rather than establishing a new Federal agency. I want to assure you that the FASB takes these hearings seriously and believes they serve a public purpose. I also want to assure you that the FASB will cooperate in endeavoring to meet your concerns as to accounting standard-setting as it presently operates. We also were pleased that Congressman Moss is in favor of blending the expertise of the FASB and the private sector with the public interest responsibility of the SEC.

The principal points I wish to make in my testimony today are that:

- The public interest will be served best if the accounting-setting process remains in the private sector, with effective review and participation by the SEC.

- The Financial Accounting Standards Board is independent and objective in its work and, with its due process procedures for broad public participation, has achieved acknowledged success in improving the quality of financial information available to the American capital markets; and

- The Financial Accounting Standards Board is the most effective and most promising vehicle to advance accounting standards necessary to maintain and enhance the strength of the capital markets.

Let me take a moment at the outset to highlight the organization of the Board.

The Board was established in 1972 as a separate, independent entity charged to improve financial accounting and reporting. The Board consists of seven full-time Members appointed by the Trustees of the Foundation, to serve five-year terms.

The Board is supported by a full-time salaried staff of approximately 80, about 25 of whom are experienced accountants from public accounting practice, industry and the academic world. The Board also engages specialists as con-

sultants on particular projects. A 29-member Financial Accounting Standards Advisory Council representing a broad constituency advises the Board. For most projects, the Board has task forces representing many disciplines to assist in understanding highly technical problems, and to assure a neutral and even-handed approach to the issues on a subject. The Board benefits greatly from the advice and assistance of the Council and the task forces.

The initiative for accounting standard-setting has been in the private sector since it assumed that responsibility voluntarily in the early 1930s. Later in that decade the SEC indicated its willingness to permit the private sector to continue this initiative role, subject to the Commission's review and participation. This was a wise decision in my judgment. The success that has been achieved is ample evidence of the ability of the private sector to do the job, and to do it well.

The FASB has the talent, the will, and the commitment to set standards that will assure communication by U.S. enterprises of the financial information needed for a healthy, growing economy. That is a unique type of information. It must not be diluted or compromised.

Should the Federal Government assume the direct responsibility for setting accounting standards, I foresee grave problems that could result in severe disruptions to the American capital markets:

- The Government, by attempting to implement national policy through accounting standards, could divert financial reporting away from the pervasive purpose of furnishing objective information needed for efficient and equitable allocation of the nation's resources;

-There could be significant dissipation of sizable voluntary efforts that the Board has been able to muster in this complex area;

-Government intervention could change the process from a voluntary effort to an adversary process;

and

-A transition to standard setting by government would cause serious disruption of the progress that is under way in further improving accounting standards and could erode standards of proven soundness.

While Mr. Way will speak of those problems at greater length, as one involved in the accounting standard-setting process for much of a lifetime, I must express my great concern about a takeover by the Federal Government.

The structure of the FASB has evolved over the last forty years, and is today, I believe, a model for self-regulation in the private sector. It is still in the process of evolution, and I trust will continue to evolve to that end as the Trustees and the Members of the Board respond, as they will, to continuing needs for improvement.

The Board's success as a self-regulatory body results principally from two factors:

-The spirit of independence and objectivity in which it operates,
and

-The wide public support and participation which it has been able
to evoke.

As Chairman of the Board, I assure you that the spirit of independence drives the Board. The six other Members have diverse backgrounds, and are men of strong conviction. Mr. Chairman, I say without reservation that the Board has functioned with complete independence: without domination by the Trustees, by the sponsoring organizations, by the major accounting firms, by business concerns, or by anyone else.

However, notwithstanding the careful structuring of the FAF and the FASB to assure the integrity, independence, and objectivity of the Board, and the FASB's extensive procedures to assure broad public participation, the Staff Study asserts that the AICPA, the major accounting firms and others "dominate" the FAF and through it the FASB, in order to serve the "special interests" of the major accounting firms' large corporate clients.

Mr. Chairman, the record proves the contrary, and clearly reflects the FASB's independence and objectivity as well as the breadth and depth of public participation in the Board's processes.

Dramatic evidence of this independence, objectivity and public participation is provided in Exhibit B of the Statement of Position we have filed with the subcommittee.

I commend it to you for careful study.

As Exhibit B clearly shows, from the eight FASB standards analyzed, sponsoring organizations disagree among themselves; major accounting firms disagree with each other, their clients and the AICPA; and the FASB's most consistent support in terms of positions taken on technical issues seems to come from users of financial statements.

Further, one sees from the analysis that the least supportive of FASB decisions were business enterprises. Views expressed by a majority of business enterprises were rejected by the Board on 12 of 19 issues. The Financial Executives Institute disagreed with the Board on 6 of the 10 issues it addressed, and the NAA disagreed on all 5 on which it took a position.

The facts are persuasive; they buttress assurance that I give this Subcommittee about the independence of the Board, and of its Members.

In all, the record clearly demonstrates that no one "dominates" or "controls" the Board and that it receives a range of conflicting views on most issues.

The Staff Study implies that the Board promulgates accounting standards after private deliberation and without adequate public participation. I can personally assure the Subcommittee that the process has in the past had extensive public exposure and, if the recommendations of the Structure Committee are adopted, will have even more public exposure in the future. A brief recitation of the procedures followed in developing an accounting standard may be helpful.

When a major matter is added to the Board's agenda, a task force is drawn from knowledgeable members of the community to assist the Board in identifying the issues with which it should deal, and in drafting a neutral Research Discussion Memorandum addressing those issues.

With guidance from the task force, the staff of the Board prepares a Research Discussion Memorandum setting forth the issues, the arguments, and alternative solutions and implications. The Board currently distributes over 27,000 copies of each Memorandum to the public and will furnish copies to anyone on request, and without charge.

After adequate Notice, the Board holds a public hearing on the subject matter, at which all interested parties have an opportunity to submit position papers and to express their views. So far the Board has held 15 public hearings.

After consideration of the public comments and careful deliberation, the Board prepares an Exposure Draft of a proposed Statement, which, if approved by affirmative vote of at least five of its seven Members, is released to the general public for additional comment.

Again, thousands of copies of the Exposure Draft are circulated, and copies are available to all on request.

Finally, after considering the comments received on the Exposure Draft, a final Statement of Financial Accounting Standards is issued. The Statement contains a detailed discussion of the reasoning underlying the Statement,

alternatives considered and modifications resulting from comments received on the Exposure Draft. Our Rules of Procedure also require the Statement to include publication of the dissenting views of any Member of the Board.

Transcripts of the public hearings, together with the position papers and other communications received, constitute a permanent public record maintained by the Board and open to all for examination.

In addition to the Statements themselves, the Board issues Interpretations of its Statements and has announced guidelines for reconsideration and review of its pronouncements.

A standing committee of professional accountants and preparers and users of financial statements consults with the Board about the need to consider, on short notice, problems emerging from new business practices or changes in general economic conditions.

This brings me, Mr. Chairman, to the substantial and continuing progress by the FASB in establishing meaningful and useful financial accounting standards. This progress includes the significant steps that the Board has taken towards (1) eliminating unjustified accounting alternatives, (2) providing a conceptual framework for financial accounting and reporting, and (3) defining the objectives of financial statements.

In its less than four years of operations, the FASB has issued 14 statements of financial accounting standards, 18 interpretations, 20 exposure drafts, 13 discussion memoranda, and has held 15 public hearings, as summarized in Exhibit D of our Statement of Position.

By way of very brief summary, a number of the FASB's statements have dealt with broad, pervasive accounting questions long in need of resolution and have eliminated a number of alternatives. Examples are:

- Accounting for Research and Development Costs. (FASB Statement No. 2), which eliminated alternative accounting practices for such costs by requiring that they be charged to expense when incurred.
- Accounting for Contingencies. (FASB Statement No. 5), which eliminated the diversity in practice as to when an enterprise must record a loss from a loss contingency.
- Accounting and Reporting by Development Stage Enterprises. (FASB Statement No. 7), which eliminated special accounting practices and special reporting formats previously followed by development stage enterprises.
- Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements. (FASB Statement No. 8), which eliminated all alternative methods of accounting and reporting for those situations.
- Accounting for Leases. (FASB Statement No. 13), which eliminated inconsistencies in lease accounting practices and provides specific and objective criteria for determining when a lease is a capital lease.

-Financial Reporting for Segments of a Business Enterprise. (FASB Statement No. 14), which requires comprehensive and consistent reporting of segment information.

Still other FASB Statements have been issued in response to emerging problems perceived as urgently in need of solution, including:

-Reporting Accounting Changes in Interim Financial Statements.
(FASB Statement No. 3)

-Reporting Gains and Losses from Extinguishment of Debt. (FASB Statement No. 4)

-Classification of Short-Term Obligations Expected to be Refinanced.
(FASB Statement No. 6)

-Accounting for Income Taxes - Oil and Gas Producing Companies.
(FASB Statement No. 9)

-Accounting for Certain Marketable Securities. (FASB Statement No. 12)

The FASB also has a number of significant matters on its current technical agenda, resolution of which will also eliminate accounting alternatives. Among these are: "financial accounting and reporting in the extractive industries," which relates to Public Law 94-163; "accounting by debtors and creditors in troubled debt restructurings"; "accounting for employee benefit plans"; and "conceptual framework for financial accounting and reporting."

The accounting profession and more recently the FASB are also criticized for not prescribing a comprehensive set of objectives for financial statements and a conceptual framework within which further improvements in financial accounting and reporting can develop consistently.

From its formation, the FASB has devoted substantial resources to establishing a comprehensive conceptual framework for financial accounting and reporting, including objectives of financial statements. On April 1, 1973, the Board placed this project on its first technical agenda and in June 1974 issued a discussion memorandum on objectives and held public hearings in September of that year. In December 1976 the Board published its tentative conclusions on the objectives of financial statements and issued a second discussion memorandum involving objectives, qualitative characteristics, basic elements of financial statements, bases of measurement and units of measure. These issues are extremely complex and require logical, objective and thorough analysis by knowledgeable, experienced experts. The second public hearing on this project is scheduled for this summer.

I also want to emphasize, there has been no abdication of power by the SEC in setting accounting standards. The Commission independently reviews accounting standards promulgated by the Board and has, in fact, initiated the Board's consideration of several subjects. Since the promulgation of Regulation S-X in 1940, the SEC has contributed directly to the development of accounting standards, often accepting statements by the profession and adapting them by rules as its own requirements, and in other cases developing its own rules.

As one last point, I would like to highlight an important distinction in the area of corporate accountability regarding corporate failures and financial difficulties, and also in the "questionable" and "improper" payment areas. Needless to say, revelations of these problems are distressing, and we share the subcommittee's concerns.

Nearly all of these problems involved, as our Statement of Position makes clear, outright fraud or dishonesty, falsification of books and records, inadequate or circumvented internal controls, judgments proved faulty by subsequent events or simply poor or inadequate management. Those contributing factors, however, do not involve any question of the adequacy of accounting standards. In only four of the twenty cases discussed in the staff study were there any suggestions that accounting standards may have been inadequate. Our Statement No. 2 eliminated the accounting alternative of capitalizing research and development costs, which is criticized as contributing to the problems in three of those cases. As I am sure you understand, the FASB is concerned with accounting standards, not auditing standards, and does not regulate auditing.

Finally, Mr. Chairman, every step in the brief history of the Financial Accounting Standards Board is well documented and is available in the public record that we have maintained. We have attempted to summarize that experience in our Statement of Position, and I believe that it fully supports what I know to be the case: That we have proceeded in our task of establishing and improving accounting standards with complete independence and an acute awareness of our public responsibility. As set forth in our Rules of Procedure, "No interest, personal or otherwise, will be placed before the public interest." We have been faithful to that trust.

Thank you for your attention, Mr. Chairman.