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THE SEC AND THE FASB: THEIR ROLES

An Address By

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I am deeply grateful for the opportunity to participate in Accounting Day at this fine Institution. I must confess that I feel the same misgivings I always do when I find myself surrounded by accountants and others who have an easy familiarity with accounting concepts, for, despite my temerity in writing and speaking about accounting topics, I continue to feel that sometime the truth will out and everyone will know that I am the prototype of the story about the fellow who could only tell where debits and credits belonged by relating them to his office window.

Having discussed accounting in the past, I now find myself as an SEC Commissioner in the position where, regardless of the misgivings I may have concerning my technical competence, responsibility must be assumed and action taken in important accounting matters.

Certainly there is no more important accounting problem for the profession, for industry, and for the Commission than the establishment of accounting principles and the means by which they are established. And the problem takes the immediate form of relating the work of the Commission to that of the Financial Accounting Standards Board and moving in ways that will maximize the likelihood of success in the Board's endeavors. It is this problem which I would like to discuss with you.

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Prior to the adoption of the Securities Act of 1933, the efforts of the accounting profession in establishing principles had at best been spotty and faltering. There had been, as we all know, tentative beginnings in the publication of the Federal Reserve Board pamphlets in 1917 and 1929 and there had been under the leadership of George O. May promising discussions with the New York Stock Exchange. Nonetheless, achievements in developing principles prior to 1933 were sparse.

The financial debacle of the 1929 to 1933 period focused public attention on the insufficiencies of the financial world, including the reporting of financial information. This aspect of the financial world, along with virtually all others, was found wanting. Congressional investigations displayed the sad truth that in many instances investors had been supplied scant information, which, in addition to its scantiness, was also in many instances downright misleading. Indicative of these deficiencies was the fact that there was then by no means agreement that investors should be given information about their corporation's sales or selling and administrative costs.

Little wonder that Congress was unhappy with the performance of the profession. It considered requiring that the accounts of publicly held companies be audited by a corps of federally employed accountants. Only the earnest importunings of the profession and assurances of its adequacy to do a satisfactory job impelled Congress to forego this proposal. In the forefront of this effort was Colonel Arthur H. Carter, then the senior partner of Haskins & Sells and the head of the New York Society of Certified Public Accountants, who sparred somewhat amusingly with Senators Barkley, Glass and others, and eventually carried the day.

Congress did not completely succumb to the blandishments of the profession. Probably in some measure as a consequence of misgivings concerning the representations of a profession which had done a very poor job in facing up to the absence of sufficient standards, in some measure out of a conviction that only with governmental guidance could integrity be brought to financial reporting, Congress, in the Securities Act of 1933, vested in the Federal Trade Commission (the first administrator of that Act) very broad powers over financial reporting:

"Among other things, the Commission shall have authority, for purposes of this title, to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer; . . ."

A similar grant of power was given in the Securities Exchange Act of 1934 with respect to the financial statements in '34 Act filings. Accordingly, with respect to companies subject to the '33 and '34 Acts the Commission could prescribe all applicable accounting principles.

Unquestionably the Commission has preferred to have accounting principles established by the accounting profession's duly constituted authorities. First the Committee on Accounting Procedure from 1939 to 1959 tried its hand at the task. While many of its research bulletins had a positive effect, the deficiencies -- absence of sufficient research, too many ad hoc determinations, insufficient credibility -- led to the profession's decision to create a new standard-setting body, the Accounting Principles Board. This Board was designed and intended to function in a manner corrective of the shortcomings of the CAP. It was to be backed by in-depth research, it was to articulate the fundamentals of accounting, it was to make determinations on the basis of principle and not expediency, it was to have as its backbone the top partners of the major firms, thus assuring acceptability for its determinations.

The Board strove mightily to do what was expected of it. Initially it authorized academic research into the fundamentals of accounting which resulted in statements of the opinions of prestigious professors scorned and ignored by the Board. Rather quickly it became apparent that the pressure of managerial duties precluded the heads of firms from functioning adequately and they were replaced with top technical men, a move which probably resulted in more Board member time being spent on its problems, but denied the Board much of its authority. Increasingly, the determinations of the Board were less reflective of fundamental principle and more responsive to ad hoc necessities; there was less concern with the development of a coherent structure of accounting principles and more concern with solving problems one-by-one in whatever manner could command a two-thirds vote. While Statement No. 4

on fundamentals was an attempt to articulate a framework, it was never issued as an authoritative opinion and it was not closely related to the solution of subsequent individual problems.

Eventually the Board foundered, mainly, I think, on the problems posed by the conglomerate phenomenon. Having started with the rather defensible position of Accounting Research Bulletin No. 48, the Board and the profession, with, I must say, the unfortunate acquiescence of the Commission, gradually moved to a position which made it possible for companies to bury millions of dollars of value and create vast questionable earnings under the magic formula, "pooling of interests." By the time the Board reached agreement on the limits on this accounting technique most of the harm had been done and the resulting determination met with little more than a sigh of relief that something had been done. Few commentators found much more to commend it. Out of the nearly universal dissatisfaction with the Board came the AICPA Study on Establishment of Accounting Principles and its recommendations for the creation of a new body to develop accounting principles.

Very frankly, I am troubled as I read the history of the last forty years' effort of the accounting profession to establish a system of viable accounting principles. The FASB is the third structure created for the purpose; it is the third effort to avoid in the future the disillusionments with financial reporting that have recurred with dismaying frequency; it is the third chance of the profession to prove that the Commission can safely entrust leadership in this task to the profession.

These forty years have been characterized by alternating Commission moods of warm confidence in the ability of the profession to do the job and intense criticisms of the failures of the profession.

As one reads this history, and then looks at the continuing problems with adequate financial reporting, one is tempted to conclude that indeed the Commission should undertake a full exercise of its statutory powers and through its own efforts, bring forth a sufficient, workable set of accounting principles. This thought was expressed by some observers to the Wheat Committee which studied the means by which accounting principles might be established. For many reasons this was rejected: fear of accounting principles becoming embroiled in political pressures; mistrust of the efficacy of governmental involvement in professional standards; concern over the competence of the SEC or any other governmental body to deal with the technicalities of accounting principles; concern that the morale of the profession would be shattered -- at the base, a belief that in general it is better to leave such matters primarily to the private sector with governmental oversight only. The Commission has accepted this judgment and endorsed the creation of this new framework. In Accounting Series Release No. 150 we stated that FASB statements would be considered authoritative.

Nevertheless, I think it is important that everyone face up to the reality of the present situation. The Securities Exchange Act of 1934 specifically recognizes the existence of self-regulatory entities in the securities industry. There is no such recognition of the existence of such entities in the accounting or financial reporting area. In some measure this may be the consequence of the circumstance that when the relevant legislation was before Congress there were no subsisting self-regulatory entities within the profession; only in 1939 was the Committee on Accounting Procedure created. The extent, then, to which the accounting profession has been permitted to create the rules

under which it functions is not compelled by Congressional policy but, rather, a decision by the Commission, one which has been renewed now time after time for forty years, to allow the profession to exercise leadership.

The decision is not a delegation of authority. It has been rather a willingness to permit the accounting profession to develop accounting principles and reporting standards, always with the understanding that the final authority remained in the Commission to determine whether the practices and principles adopted by the accounting profession and reflected in financial statements filed with the Commission were consistent with the Commission's conceptions of what was necessary for the protection of investors. On occasions, the Commission exercised its power and responsibility by expressing disagreement with conclusions of the professional bodies, as, for instance, in its amendments of Regulation S-X pertaining to the disclosure of financial leases and their impact on income. These instances have been rare -- viewed in retrospect, rarer, I would suggest, than good policy would permit. But there have been enough of them to remind us of the statutory responsibilities of the Commission.

The FASB, like its predecessors, derives its power to impact financial reporting from two sources: one, the support of the profession (and also, perhaps to a lesser extent, industry and users) and its willingness to accord the Board's determinations sufficient acceptance, and two, the willingness of the Commission to accept for filing financial statements prepared in accordance with its determinations. If significant numbers of the accounting profession (and industry and users) refuse to recognize the superior claims of the Board's determinations, or if they accept them hesitantly and

grumblingly, then the Board will have lost one of the main supports necessary for its existence. If the Commission is compelled to conclude that its determinations are inconsistent with the protection of investors, then notwithstanding the enthusiastic support which we now give the Board, the Commission would be compelled to conclude with deep reluctance that filings reflecting the unsatisfactory principles would be unacceptable.

I do not foresee the deterioration of either of these supports. I am sure the accounting profession does not want accounting principles determined by a body which historically has been dominated by attorneys (in its forty-year history the Commission has had only one Member who came to it from the active practice of accounting). Consistently with the traditions of this country it wants the private sector to do this task -- and the Commission much prefers that. I can assure you on the basis of discussions among Members of the Commission since I have been a Member, as well as discussions with the staff, there is absolutely no desire or ambition to undertake the job of developing a system of accounting principles within the womb of the Commission.

I am confident that out of the experience of the past the private sector will be able to prove that it has found the means to develop a financial reporting system that reliably reflects economic activity without undue distortions and ambiguities. It seems likely that this tremendous effort we are all about is the last opportunity to keep this job out of the hands of government and, therefore, I think it is important that everyone involved do, in the vernacular, their damndest to make the effort work. This means industry, profession, Commission -- for I repeat, another failure will produce irresistible insistences that the chore be removed to other hands.

To avoid this universally undesired occurrence, I would suggest the following, not as a program, but as some of the measures and attitudes which might be adopted to maximize the effectiveness of the FASB.

First, the FASB must adopt a policy of "deliberate speed." It must carefully found its work in competent and extensive research, lest it fall into the main shortcoming of the CAP and the APB. It must ponder carefully the problems confronting it and the financial community and it must listen to the multitude of voices that wish to be heard concerning them. In that regard, I think the procedures it has adopted for public hearings, exposure drafts, and other means designed to assure full participation are most commendable. By the same token, however, it must move expeditiously to prove to everyone that it has the capacity to be decisive and to act. The seven members are not intended to be philosophers; they are intended to be the ultimate, or at least, the near ultimate, decision makers in the area of accounting principles. I am pleased that the Board has published its first discussion memorandum and made its first pronouncement; both of these events indicate action and forward movement, and the Board's ambitious schedule for 1974 indicates its awareness of the need for action.

Second, it is imperative that everyone recognize the authority of the Board and accord its determinations preeminent status. In a field that has been characterized by considerable latitude in the treatment of accounting principles it may be difficult for many to accept the primacy of Board pronouncements. To them I would ask whether they wish to contribute to the failure of the Board and all that would follow from that. Reginald Jones, the Chairman and Chief Executive Officer of General Electric Corp., at the

banquet which honored the organization of the FASB, urged his confreres in industry to support the Board and its work. He suggested that the test would come when the Board moved into controversial areas and highly revered oxen began to be gored. Under such circumstances, if the business community does not stand behind the Board, the chances for success will be substantially reduced.

I foresee that when, for instance, the Board moves into the area of pooling and purchase accounting there will be considerable concern among those wedded to one approach or the other. It is in such situations that the Board will have to exercise its highest capacities for statesmanship and the financial community its greatest restraints. After the hearings, the exposure drafts, the meditations, the Board will speak. The task of accepting its conclusions will, of course, be easier if its conclusions have the ring of principle, the aura of thoughtfulness, the merit of logical consistency, and not just the hollow authority of a compromised five out of seven vote. But I would suggest that in any event, short of a betrayal of its charter, whatever the conclusion, unless it clearly runs contrary to investor interest, everyone should accord such conclusions full value, even if it might hurt a parochial interest.

Third, I would suggest that the Board and the financial community as a whole should understand that the Commission has an ongoing role in the financial reporting process that, regardless of the confidence it has in the Board, it cannot abdicate or surrender.

During the transitional period from the APB to the FASB, while the latter was properly gearing up for its work with the appointment of members,

the gathering of staff, acquisition of quarters, development of the camaraderie that must attend a collegial group like the Board, the Commission could not remain quiescent in the face of ongoing and what it considered urgent needs for expanded and refined disclosure. The Commission confronted the increasing importance of leases as a financing mechanism and witnessed, as did others, the stops and starts of the APB in its waning hours in relating to this problem. It felt that while the APB had begun its efforts in this area well, under the pressures of concluding its business it faltered and in APB Opinion No. 31 gave investors less disclosure than they were entitled to. Having commenced work on this problem when it appeared to have been dropped from the APB agenda, the Commission carried through and published ASR No. 147.

Now, contrary to the assertions of some, this and other actions during this period were not the consequence of any lack of confidence of the Commission in the FASB, or an effort to upstage the work, or preempt its function. In some measure, as I suggested, they were the consequence of concerns that antedated the FASB and which needed more immediate attention than the FASB could give them. The Board, like any other organization, has limited financial and people resources, though certainly the financial support given it has been most remarkable, and it must make determinations of priority; it simply cannot solve all problems of financial reporting in its first year. But the financial reporting problems do not declare a holiday while the FASB becomes operational. They intrude and they must be dealt with.

This leads to a broader consideration of the Commission's ongoing role with respect to financial reporting. I think that the distinction which both the Commission and Dr. John C. Burton, the Chief Accountant of the

Commission, have articulated is a valid one. The Board's principal concern is that of measurement and quantification of economic data, while that of the Commission is disclosure. Quite obviously this formulation is not a shining, lucid line, and inevitably there will be uncertainties as to which action is on which side of the line; for instance, many thought the Commission's action on leasing went into areas of quantification and measurement.

Be that as it may, the fact is that the Commission has a continuing, ongoing responsibility that cannot be delivered over into anyone else's hands, even if those hands are as competent as the FASB. The Commission has the responsibility to be sure that insofar as possible with its resources and its energy investors are fully, accurately, reliably informed concerning all matters material to investment decisions. In making judgments concerning whether the Commission should act with respect to a specific disclosure problem the Commission should, of course, consider the work of the Board, its schedule of priorities, the urgency of the matter, the extent to which the problem is growing and not remaining static; if these considerations require the mandating of a disclosure, then I think everyone should recognize the Commission's action for no more than it is; the carrying out of a statutory responsibility, not a usurping of the Board's or anyone else's authority or role.

I would suggest that it will be fruitless for any of us to engage in extensive discourse about whether a matter is properly one of measurement and quantification or one of disclosure. Those discussions, in my estimation, resemble the medieval debates over the crowding of angels on the head of a pin. There will always be close questions and if we expend our energies in trying

to pin labels on those close questions, the pace of progress will be much slower. Rather, I would urge everyone involved in this process to simply get on with their work and leave the discussions of theory to those who will write the financial history of this time in years to come.

There is in my estimation absolutely no reason why the SEC and the FASB cannot collaborate most successfully in the ongoing work of raising the standards of financial disclosure. We must realize that the Board is a different animal from the APB or the CAP, that its mode of organization is to expand the sources of input in a constructive fashion, that it is given a different and broader charter, that in so many ways it has greater potential than its predecessors had. By the same token, I think the Board and the accounting profession must recognize that the Commission exists in the midst of accelerated business endeavor which has spawned in a nearly geometrical fashion problems of disclosure that need prompt attention lest investors be the losers. As a consequence, it will often be necessary for the Commission to respond openly and publicly to the problems which arise and it will not be possible to await the considered responses of the Board. This does not mean that we will not be amenable to modification of positions taken when the Board has considered a matter, but there will always be the need, for the protection of investors, for some quick response to emerging abuses.

I have no doubt that the Board has the technical competence to perform this role of "early warning system." However, I would suggest that it cannot now for several reasons. First, the procedures it has adopted do not countenance action, except where interpretations are involved, without a

necessarily time-consuming process. That is good and it is essential to the Board's credibility. Second, I would have concern that the Board's explicitly recognized functions might be undermined if it devoted considerable of its energies to this task. The task before it is huge and complex and I doubt whether it should undertake any diversion from it. Finally, and this is particularly true during this period when the Board is getting its sea legs, it is important that the entity which performs this function have the capacity to back up its judgments with binding authority -- and the Commission has that.

Finally, I would urge the Board to give highest priority to consideration of the conclusions of the Study Group on the Objectives of Financial Reporting, and in that respect I am most pleased that the Board has appointed a task force to deal with the "Conceptual Framework for Accounting and Reporting: Objectives, Qualitative Characteristics and Information." I am most impressed with the credentials of the men appointed to this task force and I envy them their opportunity to be involved in this most important task.

I think the problem of meshing the work of this task force with the other work of the Board will not be easy, since the Trueblood Committee report will impact the activities of the Board in virtually every instance. However, the broader task of this new task force and the other undertakings of the Board must proceed concurrently and I am sure the imagination of Marshall Armstrong and his fellow Board members will be equal to this task.

I confidently predict that this new collaboration between the Commission and the Board will be fruitful and productive of immense benefits

to the public. Already there is developing the easy, informal relationship that makes for happy collaboration. It is our purpose at the Commission to foster in every way possible this collaboration and we mean to keep the channels of communication not only open, but used with increasing frequency. Among professionals of the calibre of Dr. Burton and his staff and the Board members and their staff it is inconceivable that a modus vivendi satisfactory to everyone cannot be styled.