



U. S. Securities and Exchange Commission
Washington, D. C. 20549 (202) 272-2650

**News
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ACCOUNTING IN A RAPIDLY CHANGING WORLD

REMARKS OF

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**AICPA EIGHTEENTH ANNUAL CONFERENCE ON
CURRENT SEC DEVELOPMENTS
WASHINGTON, D.C.**

JANUARY 8, 1991

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**AICPA Eighteenth Annual Conference on
Current SEC Developments
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January 8, 1991

It is a pleasure to be here to address this National Conference on Current SEC Developments. I am grateful to the American Institute of Certified Public Accountants for affording me this opportunity to share my views on issues that are of mutual concern to the Commission and the accounting profession.

The dramatic collapse within the past two years of the centrally planned economies of Eastern Europe and the Soviet Union has clearly demonstrated the superiority of the market economy as a model for the greatest economic growth. Many nations are now scrambling to establish or to enhance a "market" economy. Ironically, sometimes we may take for granted essential factors in the functioning of our market economy, such as the integrity of our accounting system.

An essential element for the efficient functioning of our market economy is the availability of relevant and reliable financial information. Millions of participants in the market depend on this financial information and the system of accounting principles that underlies it to make everyday operating decisions and long-range strategic plans. These participants include those

who seek capital to expand their enterprises or embark on new ventures, and those who through investment risk their savings to provide that necessary capital in the expectation of sharing in future returns. The accounting profession (including both practitioners and standard setters) and the Securities and Exchange Commission have a strong common interest in maintaining the integrity of our system of accounting principles and in ensuring that it remains the irreproachable standard of excellence for the world.

Despite the strength and resilience of our economy, it is, of course, not trouble free. If anyone had doubts that this decade of the 1990s would present new and significant challenges to our financial system, those doubts should, at least within the first eight days of 1991, have been dispelled. It would appear to be our destiny to live in "interesting times." In the number and complexity of the challenges we face, and the magnitude of the stakes, I am reminded of a remark by the late Will Rogers. Once, in a time of national peril, Rogers relieved our anxiety by facetiously suggesting that the way to solve the problem of the U-Boats in the Atlantic was to seal it off and drain off the water. When asked what he would do with the water, Rogers said "That's Operations -- I'm in charge of Strategy."

Today our financial system suffers from many problems, and I do not believe that the major challenges confronting our financial regulatory system should be evaded. If those problems are to be solved we will have to work together, and work hard, to

develop the solutions. We will not be able to pass along the job of implementing the details to a "department of operations."

Credible and reliable financial statements are essential to efficient and fair securities markets. Indeed, the success of U.S. capital markets is in no small part attributable to the quality of U.S. accounting and auditing standards. Those standards are the product of our uniquely American blend of public and private sector responsibilities. While retaining ultimate statutory responsibility for the nation's accounting principles,^{1/} the Commission has always encouraged the accounting profession's constructive efforts toward self-regulation and self-governance in the standard-setting process. The Commission also has encouraged private-sector efforts to develop meaningful responses to important challenges. Again and again, the private sector has helped to establish sophisticated U.S. accounting standards that are often the benchmark for the profession around the world.

^{1/}Section 7 of the Securities Act of 1933 provides that a registration statement filed with the Commission for a public offering of securities must contain information, including financial statements audited by independent accountants, specified in Schedule A of that Act. Items 25 and 26 of Schedule A authorize the Commission to prescribe the detail and form of the financial statements. With respect to annual and periodic reports filed under the Securities Exchange Act of 1934, Section 13(b)(1) of that Act authorizes the Commission to prescribe the form in which information is set forth, the items or details to be shown in the balance sheet and the earnings statement, and the methods to be followed in their preparation (including specifically "the appraisal or valuation of assets and liabilities").

The Turning Point in Financial Services Modernization.

In the area of financial services modernization -- the overhaul of our financial regulatory system -- we may well have reached a turning point. Indeed, we must all hope that it is not ultimately written that 1991 was for the U.S. financial services industry what 1848 was for European politics -- a year when reform movements reached an historic turning point, but ultimately proved unable to mold and change their system to avoid serious problems. It has been said that "luck" is when preparation meets opportunity. In the case of financial services modernization, we should not lose this opportunity to put our financial house in order and to return to a soundly based financial system in which institutions are worthy of public trust.

The financial markets both in this country and abroad have become intensely competitive. Because capital can flow so freely across national borders, closing markets and raising barriers to outsiders will not suffice to protect inefficient ways of doing things. If we look abroad, we can see very active efforts to increase liquidity and to lower costs in order to encourage the development of financial sector companies with excellent products, strong balance sheets and a low cost of production. In this country, we suffer in all too many situations from antiquated statutes (including restrictions on interstate banking and impediments to efficient offering of securities on a national basis because of a balkanized state securities regulatory

system). These unnecessary restrictions, which add to the cost of capital in this country, are of our own creation. Happily, we have it within our power to reform them.

Currently, for example, the Bank Holding Company Act prevents securities firms and most commercial firms from making major capital investments in U.S. banks. The effect of the Act is generally to restrict corporate investment in banks to those who already own banks. Of course, these are the very entities that do not appear to have enough capital to meet domestic financing needs, to say nothing of international competition. By contrast, no such investment barrier exists between securities firms and commercial firms. Indeed, nine of the twenty largest broker-dealers have parent firms from outside the securities industry, including large diversified firms like General Electric and Sears, and oversight by the Commission ensures that the securities subsidiaries remain properly capitalized.

It would be perfectly feasible to allow commercial firms to acquire banks, as long as the capital of the banking subsidiary is not improperly used to support a commercial parent's activities, and the bank's deposit insurance is not extended to protect other financial services or commercial activities. Broadening the available capital base for banks in this manner would maximize the liquidity and efficiency of the banking system. Indeed, more than 75% of the total U.S. capital reserves are held by nonbanking firms, and all of this capital is precluded from investment in banking under current law.

The Department of the Treasury has been in the process of studying these problems, and it soon will present a plan that will build a more modern financial regulatory system. The Commission long has advocated that the cornerstone of any new regulatory scheme should be the concept of functional regulation. Banking activities of a diversified group would be carried on in a banking subsidiary, which would be regulated by banking regulators. At the same time, under this approach all securities activities of this diversified group would be performed in a securities subsidiary, regulated by the Commission. Similarly, the notion of functional regulation should be applied to financial reporting. All companies seeking funds from the investing public should do so under a uniform system of financial disclosure and accounting standards, whether or not the reporting company is a bank or thrift or a manufacturing company. The long-standing anomaly represented by Section 12(i) of the Exchange Act is inconsistent with functional regulation, results in unnecessary duplication and should be repealed. Likewise, the registration exemptions of bank and thrift securities (under Sections 3(a)(2) and 3(a)(5) of the Securities Act) should be repealed, as should the exemption from supervision of broker-dealer sales practices that banks use in selling their own securities to their customers.

Investor Confidence and Regulatory Philosophy.

A significant current challenge is an erosion of confidence in the financial statements of financial institutions. Today's

newspaper, for example, reported the stock of one major money center bank trading at a price/earnings multiple ("P/E") of 2, and two others trading at P/E's of 3. These low P/E multiples of major U.S. banks demonstrate that investors do not find those reported earnings entirely credible. Other examples of major firms with a low ratio of market capitalization to book value also demonstrate lack of credibility of bank balance sheets. From my perspective, widespread doubts concerning the believability or reliability of financial statements create a cloud of uncertainty over an entire industry, including both strong as well as weak firms. The effect of such uncertainty will predictably be to raise the costs of capital for the sound institutions as well as for the weak, because the market will charge a premium for the uncertainty surrounding risk.

Full and complete disclosure of all material information is the legal obligation of all who seek public investment in the capital market. It is, of course, the traditional view of the Commission, predicated on the basic philosophy which Congress implemented more than 50 years ago in the federal securities laws, that this full and complete disclosure is also the best means for promoting the efficiency and integrity of the financial marketplace. The use of accounting standards to conceal financial problems and to mask true operating results of business activity should never be tolerated, as this prevents accurate decisionmaking in the market as a whole.

The accounting rules promulgated by the Federal Home Loan Bank Board during the 1970s and 1980s are a tragic example of this phenomenon. Richard Pratt, the former Chairman of the Bank Board, recently testified before Congress that the thrift industry had a negative net worth of almost \$180 billion in 1981, at the very same time that these firms were publicly reporting a positive net worth of more than \$30 billion. Rather than confronting the financial crisis facing the thrift industry, regulators permitted the magnitude of the problem to be concealed through a host of accounting distortions. This enabled many weak or even insolvent institutions to grow rapidly, pay dividends out of capital (or even out of deposits after all capital was exhausted), make acquisitions, pay lavish corporate salaries and engage in other money-losing activities on a widespread basis. It is difficult to believe that investors would have extended funds to these institutions if their true financial condition had been publicly disclosed, instead of masked by a "fairy tale" portrait.

During the past five years the failures of banks and thrifts have caused losses for investors of at least \$10 billion. This amount represents one of the largest aggregate losses for investors since the creation of the SEC from any single, related problem. The widespread scale of these losses makes it imperative that we explore all available improvements to the quality of information provided to bank investors.

In this regard, at the SEC we have raised the issue of whether we can improve the current accounting conventions that permit a financial institution's holdings of marketable securities to be valued on the basis of yesterday's costs, even if actual market values are readily available and reliably quoted. Of course, this question is not simple, and there are many dimensions of the question that have to be studied before change would be appropriate.

In considering this issue, we need to remember that the integrity of financial statements is at risk when transactions are entered or avoided for reasons of their accounting treatment rather than their business utility. A case in point is the practice known as "gains trading," in which some institutions sell their "investment securities" that have risen in value, while continuing to value at cost securities that have fallen in value. This practice causes "volatility" in earnings and capital by making the true operating earnings look better than they were in fact. To counter that, we have suggested that both gains and losses should be reported to give a more balanced picture. Another approach would be to disallow the firm from recognizing gains on sales of "investment" securities until their maturity.

Under this alternative, instead of recording both gains and losses on transactions in investment securities, the bank would record neither the gains nor the losses. In either case, producing an undistorted - positively or negatively - financial portrait should be our objective. It's a bit like that standard

item on every playground - the teeter-totter. It only works if there is a child on each end. Reporting of transactions in investment securities will only work if both the gains and losses are considered or not considered in reaching a balanced picture of the firm's results of operations.

Of course, improving the reliability of financial statements will increase the availability of capital, at lower cost, for banks. When investors and creditors do not believe reported earnings or the balance sheets of a particular type of company, then both strong and weak institutions will have to pay more for credit, and will have more difficulty selling their securities in order to raise capital at all. A firm with a P/E ratio of 12 has much greater access to capital than a firm whose earnings are 20% percent greater, but whose P/E ratio is 2.

In short, I believe that more reliable information as to the value of loans, securities or other assets is the way to maximize public confidence and to reduce capital costs. Once investors know that problems are being concealed by an unknown factor, then their confidence in the entire system is undermined. The answer to this credibility problem may be better application of existing standards. The answer may simply be improved disclosure. It may ultimately lie in improved standards, once a full review has been done. The answer may even be a combination of these techniques. However, the answer is not greater uncertainty, or looking the other way to techniques that are utilized to make firms' performance and net worth look better than they should.

The FASB Project & Disclosures About Market Value of Financial Instruments.

This brings me, of course, to the role of the Financial Accounting Standards Board (FASB), and its important project on disclosure and accounting for financial instruments. Since 1985, FASB has had underway a major project that would, among other things, examine the fundamental question of whether a primarily historical-cost measurement basis for financial assets remains realistic in today's environment.

The FASB is the preeminent institution in the private sector charged with the promulgation of accounting standards, although the Commission retains ultimate authority as to the content of financial statements filed with the Commission by publicly held companies.^{2/} The Commission endorsed the establishment of the FASB in the belief that the FASB would provide an institutional framework permitting timely and responsible standards to flow from research and the exchange of diverse viewpoints. The structure of the FASB is designed to foster input from a broad constituency that includes industry representatives, public accountants, financial analysts, investment bankers and academicians. Moreover, the FASB's rules of procedure ensure that its deliberations are open to public observation and

^{2/} Statements and Interpretations of the FASB are considered by the Commission as having substantial authoritative support, while practices contrary to FASB promulgations are considered to have no support. See Accounting Series Release No. 150 (December 20, 1973).

participation. The Commission strongly supports the vital integrity of this process.

In December, the FASB decided to accelerate consideration of the portion of its 1985 financial instruments project that relates to the accounting for investment securities, as well as to consider the treatment of related liabilities within the narrow scope of this project. The FASB staff already has consulted extensively with many representatives from industry, public accounting and government as it gathers facts for this project. We expect that the FASB will fully consider every meaningful perspective on this issue in the course of the standard setting process.

Of course, as you may be aware, the Commission's interest in this FASB project has already stimulated quite a bit of comment. Last September, in the course of testifying on behalf of the Commission before the Senate Banking Committee, I presented the Commission's view that banks and thrifts should report investment securities at market value. This testimony further stated that steps to clarify the accounting treatment for investment securities should be part of a broader move to consider appropriate market-based measures of valuation for financial assets. However, the Commission acknowledged that a comprehensive implementation of market value accounting for illiquid financial assets such as loans presented more difficult issues that would require careful and deliberate study before any

change was made in the accounting treatment of such items, if any such change should be made.

I might add that the Commission's testimony did not suggest that industrial companies should mark their property, plant and equipment to market, and it did not recommend that commercial and real estate loans should be marked to market more than is already required by current principles. However, the Commission's testimony did reflect our strong belief that the quality of financial information provided to bank and thrift investors must be improved.

The Commission intends to review very carefully the FASB's examination of accounting for investment securities, as well as its broader project addressing the disclosure, recognition and measurement of all financial instruments. As always, the Commission will remain in close communication with the FASB as the process goes forward. The Board's recent release of draft standards on "Disclosures about Market Value of Financial Instruments" is an encouraging development in the overall process for considering carefully every aspect of this issue.

Entities that invest in financial instruments for which market quotations are not readily available would be required by the proposed rule to share with investors their own reasonable estimates of market value, unless the cost of that process could be shown to be excessive. Financial analysts would have the opportunity to evaluate the usefulness of disclosures regarding the fair value of the enterprise's liabilities.

Since the proposed rule does not specify the valuation methods that must be used, reasonable alternatives would be permitted. To address any lack of comparability among companies, disclosure of methods and assumptions would be required. The proposed standard also is novel because it permits each company to evaluate for itself the practicability and cost effectiveness of furnishing the required market value information.

The comment period closes April 30 for this proposal, and the Commission's staff will study the incoming letters as closely as will the staff of the FASB. Moreover, we will monitor the public hearings on the subject. Of course, every point of view will be considered by the FASB and the Commission. The Commission looks forward to a careful and thorough process for considering this proposed standard.

How all relevant concerns are best reconciled is, of course, no small part of the task which FASB and the Commission face. In the meantime, however, financial statement issuers and auditors should not presume that they have the unfettered ability to report investment securities or other assets at historical costs. Current accounting principles constrain the use of historical cost when asset realization comes into doubt. Certainly, management and independent accountants must diligently observe these limits and should exercise cautious judgment in their assessments of realization.

Perhaps most notable among these limiting principles, particularly in view of current economic conditions, is the

requirement that marketable securities otherwise eligible for reporting at historical cost must be adjusted to their lower realizable amount if their decline in market value is "other than temporary." Avoidance of recognition of declines in value without substantiation of the temporary character of the decline should be challenged by the auditor, for it likely will be challenged by the Commission's staff.

At a time when the public -- and investors -- are being asked to make decisions that could result in substantial public cost, they are entitled to expect full information concerning problem situations. Certainly, capital that consists of nothing more than unrealized losses on securities is not really capital at all. Companies whose management produces earnings solely through "gains trading" may not really be well run. Whatever specific technique is ultimately utilized, at a time when there is substantial public uncertainty as to the health of our banking system, it is now time to provide the public with, as Sergeant Friday would say,

"Just the facts, ma'am."