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Remarks by

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A Note about Private-Sector
Standard Setting

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Thank you very much for inviting me to be the luncheon speaker at this fourth annual conference on financial reporting.

Let me say at the outset that my remarks represent my views and mine alone and that I do not speak for the Commission and other members of the staff.

I want to speak today about private-sector standard-setting and specifically the relationship of the Commission with the Financial Accounting Standards Board and the FASB's standard-setting process. The occasion for these remarks is that Congress is considering whether it should intervene in the standard-setting process because of the FASB's tentative conclusions that, if ultimately adopted, would result in the value of stock options issued to employees being reported as a compensation cost/expense in companies' financial statements.

On one hand, Senator Levin and Representative Bryant have been concerned that the use of stock options to compensate high level management employees has resulted in hundred million dollar pay days for certain CEOs, which are never reflected in their companies' financial statements. On the other hand, Representative Eshoo and Senator Bradley have introduced "sense of the House" and "sense of the Senate" resolutions objecting to the FASB's tentative conclusion, and Senator Lieberman, et al, have introduced a bill that would set aside any decision that the FASB may reach. Senator Lieberman's bill would preclude the recognition of the value of employee stock options as an expense, as a matter of law. Those who have supported Senator Lieberman's bill say that a requirement to recognize a cost/expense for stock options issued to employees would be harmful to business and would put US businesses at a competitive disadvantage with foreign companies.

My purpose today, however, is not to take a side in the substantive debate on whether the value of stock options issued to employees should or should not be recognized as compensation cost/expense and, if so, how that value should be measured. What I want to do today is talk about the standard-setting process.

As you know, the Federal Securities Laws, enacted in the 1930s, are intended to protect investors through the disclosure of reliable, material information. Financial statements, prepared by managements and audited by outside independent accountants, are a central feature of this disclosure system. Indeed, I think that financial information--financial information having a high degree of relevance, reliability, and, most of all, transparency--is the lubrication that allows the engine of our system here in the United States to run at a very high rate of RPMs. To be sure, product

has to be manufactured, services have to be available, and product and services have to be packaged, distributed, and sold for businesses to be successful, and no amount of financial maneuvering or engineering will be able to turn poor or substandard product or services into successes. Similarly, no amount of financial reporting should turn a good product or quality services into business failures. However, the way we recognize, measure, and report these business activities to investors and potential investors is crucial to the turning of the wheels of commerce and business.

Since 1938, the Commission, without abdicating its responsibilities in this area, has looked to the accounting profession for leadership in establishing and improving accounting standards. Working in partnership, the SEC and the accounting profession have established what are widely recognized as the most comprehensive accounting standards in the world. These standards provide for transparency of the economic conditions, events, and transactions affecting public entities and allow investors to decide how the underlying facts should affect security prices and the allocation of capital. I believe that it is, in large part, the commitment in this country to an accounting system that has the objective of providing complete and unbiased financial information to investors that has made the United States' securities market attractive for both domestic and global capital formation.

The Financial Accounting Standards Board has been the private-sector body designated by the accounting profession to set accounting standards since 1973. The FASB's Concepts Statements, which set forth the fundamental precepts the FASB uses in setting standards, stress that financial reporting should not be viewed as an end in itself but as a means to provide information that is useful in making economic and business decisions. In order to achieve this objective, the FASB listens to the concerns of all of its constituencies and then writes and issues, without bias or favoritism, standards that are designed to reflect economic conditions, events, and transactions as objectively as possible. The FASB's Mission Statement accents this approach by stating that the FASB must, among other things: (1) be objective in its decision making, (2) weigh carefully the views of its constituents, (3) promulgate standards only when the expected benefits exceed the perceived costs, and (4) bring about needed changes in ways that minimize disruption to the continuity of reporting practice.

To implement the Concepts Statements and Mission Statement, the meetings of the FASB concerning proposed standards are open to the public, and prior to acting on any significant proposed standard, a discussion memorandum or similar initial document exploring all the issues is published for public comment, public hearings are held, drafts of the proposal are published for public comment, and the proposal may be "field tested." After studying

information from all of these sources, the FASB then redeliberates the proposal. The Commission staff, through the Office of the Chief Accountant, reviews each standard-setting proceeding carefully by reading comment letters, observing FASB meetings and public hearings, and expressing its concerns and interests to the FASB and its staff. Once a standard is adopted, the SEC staff continues to consult with the FASB staff on implementation issues and whether interpretations or changes in the standard may be necessary to achieve the objective of the standard. I strongly endorse this process for setting accounting standards and believe that it should continue, unabated, in the future.

The success of this process is of vital concern not only to the Commission, investors, and the accounting profession, but also to Congress. In my view, it is certainly appropriate for Congress to question whether this standard-setting process fulfills the goals of the federal securities laws and to oversee the efforts of public and private standards-setting bodies in implementing those laws. It also is appropriate for Congress to be concerned with whether the accounting profession is acting in the best interests of investors.

Accounting standards setting, however, is a complex task. Very often, in seeking to address one question, the FASB and the SEC must be careful that they are not creating new, tougher questions. And should the neutrality of the process even temporarily be overshadowed by the interests of one industry or group, or one set of interests over another, accounting standards may result that make it difficult not only for investors but also for public policy officials to make informed decisions based on the true facts. Examples may be found on both sides--where actual economic conditions were shielded from the public's view and appropriate decision making was delayed (such as through the use of regulatory accounting principles and the construct of "net worth certificates" for certain thrifts) and where economic conditions were portrayed more accurately and fueled what many consider appropriate and timely public policy debates (such as the recognition and quantification of postretirement health care costs).

If the effort to legislate in this area is successful, and Congress indeed sets aside an eventual FASB decision, where does it stop? Would, for example, those who opposed timely recognition of costs and liabilities for employee pension benefits and postretirement health-care benefits now want to go to Congress and ask Congress to overturn FASB Statements 87 and 106 on pensions and postretirement benefits? US manufacturers can say that having to recognize those costs and liabilities on a timely, accrual basis instead of on the cash basis is incorrect because it decreases income and equity before cash flows out. That it puts them at a disadvantage with foreign competitors who are not directly burdened

with those costs and liabilities but pay for such benefits indirectly through income tax regimes on the cash basis.

Would those who have to mark to market certain of their marketable securities now wish to go to Congress and ask for relief from the requirements of FASB Statement 115? US commercial banks and insurance companies can say that their shareholders' equities are too volatile because of that requirement. That foreign banks and insurance companies do not have to mark to market their holdings of certain marketable securities and therefore are at a competitive advantage.

Would those who have to recognize foreign-currency transaction gains and losses currently in income now wish to go to Congress and ask for relief from the requirements of FASB Statement 52? US companies can say that their incomes and stockholders' equities are either under or overstated because of that requirement. That foreign companies are allowed to defer such gains and losses and thus have an advantage over US companies.

Would those who have to charge research and development costs to expense when incurred now wish to go to Congress and ask for relief from FASB Statement 2? US companies can say that that companies should be able to defer such costs if, in their judgment, the amounts will be recovered in the future through royalties or sales of product. That foreign companies may defer such costs and therefore they enjoy an advantage over US companies.

I do not know how long this piece of yarn is, once Congress starts pulling on it.

I do not mean to be disrespectful to those who have asked Congress to step into this debate on the accounting for stock options issued to employees. Nor do I mean any disrespect to any members of Congress for entering into this debate. I just believe that Congress is not the forum to determine the specific accounting standards that are necessary for the protection of investors and that provide for the smooth and efficient functioning of our capital markets. Let me use an analogy. I think it is quite appropriate for Congress to decide, after consultation with the medical profession, that the health of US citizens would be improved if there were less emissions of pollutants from automobiles and to pass a law saying that emissions should be reduced. But I think Congress should leave the design of fuel-injection systems, catalytic converters, and exhaust systems to automotive engineers.

The FASB, with its technical expertise, and the SEC and its staff, are uniquely positioned to perform the task of setting accounting standards. Based on my experiences as the chief adviser to the Commission on accounting and auditing issues, as one of the

original FASB members, and as a practicing accountant for over thirty years, this process achieves its best results when the establishment of specific accounting standards is left to those bodies having technical expertise.

The standard setting process in the United States, although the best in the world, is not perfect. There is room for constructive advice from Congress, the business community, investor groups, and others on how the process may be improved and strengthened. In designing specific standards, however, in my opinion, it is best to use the technical expertise available in the process that currently is in place and has worked for decades, rather than preempting that process through Congressional action.

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