A DECADE OF SETTING FINANCIAL REPORTING STANDARDS

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"The Role of the SEC: Past and Future"
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I. Historical Reliance on the Private Sector

   A. Commission has statutory responsibility to determine the accounting practices followed by public companies.

   B. Commission has placed historic reliance on the private sector for the initiative in setting standards (ASR 4).

   C. ASR 150 issued to formalize its position of reliance and to provide open support and encouragement to the efforts of the newly formed FASB.

II. Commission Regulation of Other Organizations

   A. Commission's posture with respect to setting accounting standards is unique by comparison with self-regulatory organizations which Commission has statutory responsibility to regulate (e.g., stock exchanges, NASD).

      i. SRO's establish their rules (without any due process), but they are only effective subject to Commission approval.

      ii. Commission goes through complete due process of its own on SRO rules before giving SRO its approval.

   B. Different Commission Posture Makes Sense for Accounting Standards

      i. SRO rules regulate the activities of their own members; FASB is independent of its constituency.

      ii. SRO's house, protect, promote and regulate the business of their members. The FASB was established solely to develop and improve accounting standards.

iii. SRO's do not follow prescribed standards of due process. In contrast, the FASB has extensive due process which is subject to Commission oversight.

iv. Commission reliance on the private sector allows one set of standards to be developed for both public (regulated) and private entities (unregulated).

III. Influence of Environment in Late-60's and 70's on Commission Actions in the 1970's

A. In the late-60's, there was widespread speculation in the securities market. Promoters and managers took advantage of inadequacies in accounting principles to inflate reported earnings, build conglomerates and promote real estate and franchising ventures. The speculative market bubble burst, many investors suffered losses, and accountants were the objects of extensive litigation.

The accounting profession was not sufficiently alert to situations where managements used accounting principles to create earnings, and they were not equipped to deal with the large volume of complex corporate mergers or the intricacies of real estate and franchising ventures. (Four Seasons Nursing Home, National Student Marketing, Talley Industries, Stirling Homex.)

B. In the early 70's, the Equity Funding Fraud, the Franklin National Bank failure, the bankruptcies of Penn Central, and a series of other highly publicized bankruptcies of major corporations further eroded confidence in the accounting profession and the standard-setting process and increased the calls for government intervention.

C. At the same time those events were occurring, the oil embargo in 1974 and the ensuing energy crisis attracted the attention of Congress to the financial accounting practices of companies in the petroleum industry.

D. Illegal corporate political contributions, improper payments and foreign bribes (United Brands, Northrop, Gulf Oil, Lockheed, ITT) were revealed as an outgrowth of the Watergate investigations. The large number of major corporations involved and the fact that the improprieties were not brought to light by the independent auditors raised serious doubts about the reliability of internal control systems and financial statements. The SEC worked to cope with the improper corporate payments problem through investigations, enforcement proceedings and a program of amnesty for corporations making voluntary disclosures. The SEC also proposed legislation to amend the Exchange Act regarding certain such acts which was ultimately enacted in the Foreign Corrupt Practices Act of 1977.

E. In 1974-75, the urgent emerging problems caused by the country's deep recession created major audit problems in the REIT, banking and insurance industries because of heavy losses on loans, real estate investments and stocks. In response, the SEC issued ASR 166 (Unusual Risks and Uncertainties). Eventually, the FASB issued FAS 12.

This environment created a growing unrest in the private sector and resulted in threatening statements from Congress and increased concern about FASB's ability to deal effectively with emerging problems.

F. Congressional oversight of the SEC, which involved corporate accountability, and accounting and auditing matters, increased dramatically.

1. The Moss Subcommittee (House) issued a report in October 1976 which concluded that the FASB's questionable record did not justify the SEC's continued reliance on the private sector.

2. The Metcalf Subcommittee (Senate) released its 1760 page staff report in March 1977 entitled, "The Accounting Establishment," which criticized the SEC's delegation of authority to the private sector and the profession's lack of independence, and proposed transfer of control of the professions's affairs to the Federal government.

3. Testimony of SEC Commissioners in Spring, 1977 at the Metcalf Subcommittee hearings established a position that placed severe pressure on the profession. The Chairman indicated that the SEC would implement a more vigorous oversight position to ensure the timely resolution of accounting and auditing issues. Chairman Williams urged Congress to give the profession a fixed period of time to take positive and effective action.

4. Moss introduced a bill in June 1978 after January public hearings which effectively provided for public regulation by the SEC of the accounting profession.

5. Congressional activities in this area waned when Moss did not seek reelection in 1978 and Metcalf died in December 1977. The subsequent Eagleton subcommittee hearings in 1979 reflected continued congressional interest in the profession and the Commission's oversight, but did not result in any legislation

because of the SEC's continued support for the profession in view of the progress made.

IV. Activities of Chief Accountant's Office in the 70's

A. In the 70's, there was a need for the Commission to be highly visible and active in prodding the private sector to act or in acting itself.

B. The FASB was in its formative stages, the profession was under siege in the wake of highly publicized bankruptcies and scandals, and Congress was exerting considerable pressure through its oversight committees.

C. During this time, OCA was active in recommending disclosure rules to the Commission where it was perceived that private sector efforts were falling short in providing investors with essential information for investment decisions:

- The staff concluded that professional standards (APB Opinions 5, 7, 27 and 31) had not resulted in adequate information about leases. In the absence of definitive action by the private sector, the Commission implemented its own lease disclosure requirements in 1973 (ASR 147). These called for lessees to disclose the present value of their financing lease obligations and the impact on net income of capitalizing such leases.

- ASR 190 (March 1976) required the disclosure of certain replacement costs to assist the investor in understanding the economics of a business in an inflationary economy. The Commission did not believe that data on the impact of changing prices should be limited to adjusting data for changes in the general price level, which was the direction the FASB had taken in a December 1974 Exposure Draft.

- In response to concerns that an increasing number of companies in different industries were changing accounting methods to a policy of capitalizing interest costs, the Commission placed a moratorium on interest capitalization until the FASB could address the issue (ASR 163, November 1974).

- In ASR 177 (September 1975), the SEC required certain large registrants to disclose selected quarterly financial data in notes to their annual financial statements. This release established auditor association with quarterly data.

- In response to Congressional dismay that major oil companies were not using uniform accounting standards, making financial statistics for the industry unreliable, provisions were included in EPCA (October 1975) that directed the SEC to assure the development and observance of accounting practices for oil and gas producers for purposes of developing a reliable energy data base. The FASB elected the successful efforts method of accounting, only to be overruled by the SEC, which was required by EPCA to conduct independent rulemaking proceedings.

  The Commission issued ASR 253 (August 1978), calling for footnote disclosure of oil and gas reserves and announcing its intention to experiment with the development of reserve recognition accounting measures.

D. Impact of Enforcement Activities

In response to the economic conditions, the Commission was very active in enforcement matters involving accounting and auditing. Some of these actions had an impact on accounting standards.

V. The Present Role of the SEC

A. Establishment of Accounting Standards: FASB

The Commission believes the progress made by FASB justifies its conclusion that the initiative for establishing and improving accounting standards should remain in the private sector, subject to Commission oversight. While the FASB has performed in a generally satisfactory manner, progress has not met all our expectations. The principal disappointment has been the absence of significant progress on the conceptual framework project. In addition, we believe that there is a continuing need to deal timely with emerging problems.

In its recent periodic review of the operating efficiency of the FASB, the FAF Structure Committee concluded that the FASB is operating efficiently and effectively. One of the Committee's recommendations is that the Board should develop a plan for consideration by the board of trustees to provide timely guidance for implementation questions and emerging issues. The Commission staff functions as an observer to a recently formed task force on timely financial reporting guidance which will address this issue.

Much has been said recently about the Big GAAP/Little GAAP and Standards Overload issues. The FASB is presently studying the financial reporting problems of small companies. The Commission believes that there should only be one GAAP and has dealt with the problems of smaller companies through exemptions from the registration and reporting process and from certain compliance disclosures.

B. Although the Commission acknowledges that significant progress has been made by the private sector, the Commission's statutory responsibility for the integrity of the financial information disseminated by public companies requires that it be concerned with the accounting principles, the auditing standards by which it is reviewed, and the independence and competency of the profession which performs that review. The Commission will continue to seek to fulfill its responsibility by close oversight of the various private sector initiatives but will not hesitate to take appropriate regulatory action when necessary.

C. The Commission has for the past several years devoted significant resources to reviewing and evaluating existing regulations and releases. This process (which is basically completed) has resulted in substantial revisions to Regulation S-X and other accounting related requirements. In addition, a Codification of Financial Reporting Policies was published. However, the substance of the Commission's requirements remain unchanged.

D. Recent evidence as to the Commission's readiness to act to fill the gap wherever necessary are: the Fidelity 21A release, which warned registrants in severe financial difficulty to disclose material information to investors; the quasi-defeasance release, which gave support to quick FASB action on a significant emerging problem; SAB 42, which communicated the staff's position on significant accounting problems emerging in the application of GAAP to business combinations involving financial institutions; the elimination of the 2-step income statement for banks, which addresses a financial reporting issue not dealt with by the private sector; and a recent interpretive release on FAS 52, which encourages supplemental disclosures about the impact of foreign operations on the financial statements of issuers to facilitate understanding of the impact of the new standard in the year of its adoption. Other significant actions by the Commission include disclosure about foreign loans by bank holding companies and the recent moratorium on adopting a policy of capitalizing certain computer software costs.

E. The Commission's recent Research Forum indicates substantial support from users for the Commission's role in establishing accounting related disclosure requirements. The Forum also generated several research projects in the segment, quarterly reporting and off balance sheet financing areas.

F. Although the SEC's role with respect to the accounting profession may be perceived to be less visible today, it is nonetheless unchanged, and the Commission is poised to take appropriate action when necessary.

VI. The Future Role of the SEC

A. The Commission has four basic functions in the accounting area: (1) rulemaking; (2) oversight; (3) enforcement; and (4) resolving individual registrant problems. While the emphasis and visibility of these basic functions vary with time, they have been performed since 1933 and will continue to be performed as long as the SEC exists.

B. Concluding comments about the role of the Commission and its staff in making judgments about the adequacy of financial statements furnished to investors by individual companies -- including the application of accounting standards in audited financial statements.