

Remarks Of

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Washington, D.C.

“Neutrality of Accounting
Standards”

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* The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
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“Neutrality of Accounting Standards”

I. Introduction

I appreciate the opportunity to participate in this conference. It has been my privilege to work with many fine accountants in both the Office of the Chief Accountant and the various Divisions during my tenure at the Commission. I have learned much about accounting from these individuals, although I acknowledge that I have a great deal yet to learn. In particular, I have benefitted from the presence of the Commission’s distinguished Chief Accountant, Walter Schuetze, who I understand you heard from yesterday.

II. Miscellaneous

It is my intention today to focus on the need for neutrality in the accounting standard-setting process. However, before I launch into my discussion on neutrality, there are several important accounting public policy issues which I should mention, even if only briefly. At the forefront of these is the litigation explosion currently imperilling the accounting profession. I know that litigation reform is a subject of particular interest to the members of the American Institute of Certified Public Accountants (“AICPA”).

The accounting profession in general has been battered by the propensity of Americans to litigate, particularly when they lose money. While some of the wave of litigation against accountants has been well deserved, some has not. More often than not, accountants are the last solvent party after a company declares bankruptcy and thus end up paying a disproportionate share of settlement and verdict dollars.

The traditional response pursued by the accounting profession to this crisis has been litigation reform legislation. The efforts in this area to date have not been very successful, and it appears that those supporting litigation reform legislation are still pushing a large rock uphill.

Some of the difficulty here is probably attributable to the fact that virtually all of the litigation reform legislation introduced thus far limits all litigation and makes no distinction between meritable litigation and meritable litigation. I believe this approach is flawed and should be abandoned. I suggest that the AICPA seriously consider pursuing a narrower, more pragmatic legislative vehicle. A targeted legislative focus may be somewhat less attractive to the accounting profession but may also have a greater chance of success, I suspect that a new, realistic legislative approach would be more warmly received by the Commission as well

I also wish to suggest some other partial solutions to the litigation problem. While U. S. accounting standards are the best in the world, they appear to me to be very complex and difficult to apply. If the standards were simpler, there may be less litigation. Thus, a major push for an accounting standard simplification effort seems to be in order.

Further, the AICPA could push even more forcefully for the exercise of greater care in auditing practices. On occasion, I have been made aware of situations where auditors appeared to become unduly influenced by their client with the result being a deficient audit. Improved financial accounting and reporting and more careful adherence to existing auditing standards should lead to less litigation.

I am sure that everyone is aware of the Commission's initiative to rid the securities industry of rogue brokers. I have also become aware of some rogue accountants, who seek business at any cost, during my Commission tenure. I suspect that the AICPA could be more vigilant in ferreting out individuals who have no place in the accounting profession. Their continued presence fans the litigation fire already raging. I know that the creation of a self-disciplinary accounting organization is under active consideration, and that strikes me as a sound idea worth pursuing.

Moreover, I have never understood why accounting firms should not be permitted to organize in corporate form. A partner in New York should not be required to personally guarantee the work of a partner in Chicago. That awkward circumstance not only increases the litigation stakes, but it also tends to chase some talented individuals out of the accounting profession and discourages some from even entering the profession. Maybe it is not achievable, but I would support appropriate legislation authorizing the creation of national accounting corporations. If such legislation were to be enacted, at a minimum, it would alleviate some of the stress produced by the litigation problem.

In addition to the avalanche of litigation, there are a number of other pressing issues challenging the accounting profession. Accounting standards that will enable investors to more easily understand a company's derivative activities remain a priority. Currently, a review of a company's financial statements is not very helpful in this area. That needs to change and soon.

In addition, the profession should be more careful to ensure that contingent liabilities, particularly environmental liabilities, are accounted for appropriately. I suspect that everyone here is aware of the magnitude of the potential environmental liabilities confronting publicly held companies today. The accounting practices in this area are spotty, and, if not improved, will eventually add to the litigation problems already confronting the profession.

Finally, and possibly most importantly, it is paramount that the process of creating an acceptable body of international accounting standards be accelerated. I knew that Chairman Beresford has focused on this topic in his presentation. The appetite of U. S. investors for foreign securities appears to be increasing at an exponential pace. It would behoove the Commission, the accounting profession, the securities industry, and our capital formation system if the bulk of these transactions occurred on U.S. soil and not in Tokyo, Frankfurt, Hong Kong,

or London. The presence of a sound core of international accounting standards would enable the United States to remain the focus of international securities transactions even when our cost of capital may not be so cheap and without any need to diminish the investor protection safeguards and disclosure system which have allowed our capital formation system to flourish. I understand that the AICPA is actively involved in international accounting matters, and I strongly encourage you to continue to strive for progress in this area.

III. FASB Stock Option Valuation Project

One accounting issue which has received a substantial amount of attention recently is the Financial Accounting Standards Board's ("FASB") ongoing consideration of the accounting for employee stock options and other stock-based compensation. Even President Clinton has recently transmitted a letter on this subject. Of course, the FASB has proposed a requirement that companies take a charge against income on the grant of both stock options and other types of equity-based compensation.

The FASB proposal responds to accounting concerns that corporate transfers of something of value should be recognized in the income statement and to certain abuses which have occurred in the executive compensation area in the past. The Commission is committed to informing shareholders about the abuses, as shown by our executive compensation disclosure project which was completed last year. In fact, I would argue that the Commission's disclosure initiative has largely solved this abuse problem.

The FASB expensing proposal has touched off a firestorm of protest from certain members of the business community and has even attracted Congressional interest, mostly con, but some pro. While the adverse impact on this proposal has been wildly overstated in my judgment, I recognize that a stock option expensing requirement may have significant negative

consequences for some small, high-technology companies that rely on employee stock options to attract talented individuals into their employ. I know that this is an important concern for an industry that must keep pace with rapidly advancing technology and global competition. Since I further acknowledge that the FASB expensing proposal may only marginally improve the quality of financial statements, I question whether the benefits of the proposal will exceed the costs. However, some of the opposition is beginning to sound too shrill for my comfort level. I do not share the view that implementation of the FASB proposal would mark the beginning of the end of our capital formation system.

What has really left me bewildered is that some of the opponents in their fury have attacked the existence of the FASB and have even requested Congress to step in with substantive legislation. While it is entertaining to observe a few individuals who have spent the bulk of their professional life lambasting government in general, and Congress in particular, now bleat for Congressional intervention, I find the underlying notion of substantive Congressional involvement in the accounting standard-setting process to be a frightening proposition. Laying aside the irony of the situation, I cannot imagine Congress as the appropriate forum to determine the specific accounting standards that are necessary to protect investors and to provide for the smooth and effective functioning of our capital markets. Do the members of this audience really want Congress actively involved in the accounting standard-setting process? I doubt it. Congressional calls and letters, of course, and a hearing now and then, maybe, or possibly even a sense of the Senator or a sense of the House resolution, but please no substantive accounting legislation.

What the opponents have apparently overlooked at the moment is the fact that the FASB project is far from complete. The comment deadline for the exposure draft was December 31 of

last year. These comments must be reviewed and analyzed. The field test of the proposed standard is yet to be completed. Public hearings on the proposal will be held in Connecticut and California in March. Furthermore, the exposure draft suggests a three-year period of footnote disclosure before any expense would be recognized in registrants' financial statements. It also should be noted that the FASB has solicited comment on the use of disclosure as an alternative to recognition in the financial statements. In summary, I submit that it is way too early to whine to Congress on this proposal, as well as to howl for the FASB's destruction.

With respect to the attack on the FASB, I am equally confused. 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. 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 markets attractive for both domestic and global capital formation.

IV. Neutrality of Accounting Standards¹

The FASB 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.

The existing process for setting accounting standards, with its emphasis on providing neutral, unbiased information to investors and to policy makers has been successful and should continue. Working in partnership, the Commission and the FASB have established what are widely recognized as the most comprehensive accounting standards in the world, providing

transparency of the economic conditions, events, and transactions affecting public entities. The financial statements prepared in accordance with these standards allow investors to decide how the underlying facts should affect security prices and the allocation of capital.

It is my view that the proper role of accounting standard-setting bodies should not be to judge whether an economic goal or political or social policy is good or bad, but to create the means for communicating reliable and complete information to investors and to the public in general. This information should permit knowledgeable investment decisions, fuel public debates, and allow public policy makers to formulate well-informed and real solutions to problems facing the nation.

I do believe that it is appropriate for Congress to have an interest in accounting issues, particularly one that may have far-reaching implications such as the accounting for employee stock options. For the reasons which I alluded to earlier, however, I am of the opinion that it is inappropriate for Congress to dictate accounting standards through legislation. And, while I believe that the FASB should not view its proposals in a vacuum and should keep national priorities in mind, I also am of the view that it would be inappropriate to require the FASB to halt the development of an individual project because it may conflict with the economic, political or social goals of a specific industry or group. I am concerned that if the FASB's agenda is limited to those projects that meet Congressionally favored goals, then the process no longer may be perceived as standard-setting by an independent body within the accounting profession. The notion that reported information may be biased toward fulfillment of economic, political or social goals may have serious repercussions on the credibility of the financial information that fuels our securities markets, and these markets have flourished under the existing system.

In the course of its active oversight function, the Commission has consistently concluded that the FASB performs its tasks well. The Commission has also strongly supported the FASB as the appropriate body to engage in private sector accounting standard-setting. The Commission's willingness to look to the private sector for leadership in establishing accounting principles has been with the understanding that the Commission may exercise its authority and either override, supplement or otherwise amend the standards established by the FASB, or adopt standards of its own. In order to fulfill its statutory obligations to set accounting standards for registrants, the Commission must act in what it considers to be the public interest. While I would be reluctant to do so, the Commission ultimately may need to exercise its oversight authority with respect to the FASB's stock option valuation project, but, at a minimum, it would be premature to do so until the FASB process has run its course.

IV. Conclusion

I see that my time is about to expire so in keeping with the schedule I will conclude. I am satisfied with the current accounting standard-setting process, and I see no reason for substantive legislative involvement. I view the potential for such intervention as a threat to the concept of neutrality which would not be a positive development in my judgment for our capital formation system. I consider it extremely important to continue to develop neutral accounting standards as opposed to standards designed to maintain a preferable cost of capital for certain companies.

I wish to reiterate that I am extremely proud of the Commission's accounting staff. They have demonstrated to me that the highly regarded reputation of the U. S. accounting profession is well deserved. I look forward to working with each of you in the future on the many public policy issues currently confronting the accounting profession. Please communicate to me your concerns with respect to the issues of importance to you.

ENDNOTES

1. This material is adopted largely from a letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Senator David Boren et al. dated January 10, 1994, and from a letter from Walter Schuetze, Chief Accountant, U.S. Securities and Exchange Commission to Chairman John Dingell, House Energy and Commerce Committee, dated December 6, 1993.