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**THE STANDARD SETTING PROCESS  
AND ITS ECONOMIC IMPACT**

REMARKS BY

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Since I come from the Securities and Exchange Commission and I am neither an accountant nor an economist, I will have to view this conference from a somewhat different angle than the other participants will. Thus, I can not venture to predict the extent to which you will be able to determine the economic consequences of setting financial accounting standards or even the extent to which possible economic consequences are of legitimate concern in determining what such accounting standards should be. About all I can say about this is that it is obviously desirable, indeed necessary, to explore the economic consequences of standards setting, both in general and in particular instances, even though the subject is a difficult one. Certainly, it would be unfortunate if the

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(2)

establishment of a particular standard produced unintentional, unperceived and harmful economic consequences.

On the other hand, there is also a danger that undue concern with possible adverse economic affects could impair the usefulness of financial statements to investors or even the integrity of the standards setting process. The Commission also confronted a problem of this general nature when the Federal securities laws were enacted in the early 1930's with their mandate of full disclosure in connection with securities offerings and transactions. There was wide-spread concern that such disclosure would reveal much that was better left hidden, with possible horrendous impact on the competitive position of enterprises and the willingness of investors to purchase the securities of somewhat risky ventures. These fears were not wholly unjustified, but I think full disclosure has, nevertheless, proved its worth. Of course, at least in retrospect,

(3)

these broad and indefinite fears have a limited relationship to the specific and difficult questions which are being explored at this conference. Nevertheless, that experience, although some forty years behind us, still has some relevance.

This conference also has relevance to an issue which concerned the Commission in the 1930's and still concerns it in the 1970's, and that is the question of who should be responsible for establishing accounting standards and specifically - whether this should be done by the Commission or some other government body, or whether it should remain with the private sector, as the Commission determined in 1938 and determined again in Accounting Series Release No. 150 at the end of 1973. As you know, this issue has recently received re-examination by committees of the Congress.

It seems to me that the answer to this question should depend basically upon whether the government or the private sector can do a

better job, although there is, of course, room for much argument as to what, exactly, is a "better" job. One way of seeking an answer to this question is to take a look at the manner in which the job is being approached by the private sector with a view to comparing this with the probable approach that the government might take.

This conference is, I think, a part of or at least closely related to the conceptual framework project of the Financial Accounting Standards Board, which seeks to resolve fundamental questions with respect to the objectives of financial reporting, the purpose which they are intended to serve, the definition and measurement of the elements of financial statements, and the qualities which they should have, including not only relevance, objectivity and comparability, but also the extent to which they can and should reflect economic reality. The FASB has been engaged in various phases of this project for several years, and has devoted a vast amount of painstaking effort to that project and the end is not yet.

This conference represents an aspect of that project. At the same time, and notwithstanding the fact that the conceptual framework project is by no means complete, the FASB, in spite of some early concerns, has resisted the temptation to defer dealing with difficult problems until the project is finished.

I think that this kind of careful, exhaustive and fundamental approach to providing a basic foundation for the standard setting process, involving the commitment of very substantial resources and the collaboration and involvement of a great many talented persons, is one which would be rather unlikely to be duplicated by a government agency. Such an agency might well be concerned, as the SEC, for example, is, with a great many other important issues and it would be under pressure to produce results quickly while operating within a rather modest budget. This conference, then, is a part of the process by which the private sector appears to

be demonstrating that it is capable of doing the job. This does not mean that the government has no place in the process, rather the contrary. Over the years, the private sector has not always done so well. At times there has been a reluctance, or even an inability, to resolve controversial questions with respect to which reasonable men and women could and did differ, and at times, I think, it appeared that pressure to accommodate the desires of some corporate managements has detracted from the usefulness to the public of the financial information which was presented. My friend Abraham Briloff, who I admit is hardly a dispassionate observer, has catalogued a disconcerting assortment of such situations. In addition, in our day to day administration of the disclosure statutes we sometimes encounter accounting problems as to which investor protection appears to call for immediate, if perhaps temporary, action.

The government and specifically the Commission, therefore, will continue to play

(7)

a role as Chairman Williams has stated "of oversight - the prodding, guidance, and review necessary to insure that the profession meets these challenges in a manner which harmonizes with our responsibilities under the federal securities laws."

As I mentioned, Congressional committees have also devoted attention to the question of whether accounting standards should continue to be set in the private sector. While I do not claim any ability to forecast future approaches by the Congress, I sense very recently a tendency on the part of the committees to focus their attention upon auditor independence and the performance and regulation of auditors rather than upon the standards setting process. I am therefore hopeful that the profession and the Commission has begun to satisfy their recent concerns with respect to standards setting.

Having thus repeated the Commission's historic preferences for standard setting in the private sector under SEC oversight, I suppose I should mention our current initiatives with



respect to accounting practices of oil and gas producers which might appear on the surface to be somewhat inconsistent. I think this activity is a special and, I hope, unique situation. Congress in the Energy Policy and Conservation Act, directed the Commission to assure the development of accounting practices to be followed in this area. While it authorized the Commission to rely on the FASB, it directed us to solicit public comment with respect to the question of whether or not we should recognize or otherwise rely on accounting practices developed by the FASB rather than exercising a direct grant of rulemaking power applicable to the area. The Commission, accordingly, because of the importance of this matter and in response to a number of requests has decided to hold public hearings. I do not believe that such a process will or should be a precedent with respect to other FASB pronouncements. As I am sure you all know, the oil and gas

proceedings have generated a lively controversy with respect to what some observers believe to be the economic consequences of applying the provisions of FASB Statement No. 19.

Under the circumstances, I should add to the usual disclaimer that Commission people make with respect to their remarks, that nothing that I may say with respect to this conference should be regarded as implying any judgment with respect to the issues in the oil and gas matter since any such judgment must, of course, await the hearings.

While this conference is devoted to the economic consequences of accounting standards, another concern related to economics is the desire that financial reporting reflect economic realities. At the same time, the effort to do so should not compromise other important objectives, such as reliability, comparability and uniformity which were found in Professor Benston's study for this conference to be more important than

economic value. Thus, the Commission has been concerned for some time with the need for financial reporting to reflect the impact of inflation. We concluded in connection with our replacement cost rules that this information should be presented as supplemental information rather than attempting to modify the financial statements themselves. It appears that the FASB's conclusion to define objectives in its proposed Statement of Financial Accounting Concepts as encompassing the overall area of financial reporting rather than being restricted to financial statements is consistent with this approach.

Further, supplemental disclosure of the impact of inflation on business operations would permit the methodology concerning the measurement issues associated with such disclosure to evolve and develop as preparers and users work with such methodology and make refinements and improvements in it. In this regard, the attributes of reliability and objectivity associated with the historical cost framework must be weighed against the subjective

judgments that would be necessary if one determines that the most relevant data to present is outside the historical cost framework.

While we recognize that our replacement cost requirements are far from perfect and seem to present serious problems, particularly in the cost-benefit area, we continue to believe that disclosure concerning the impact of inflation upon business enterprises is important. Inflation has a serious impact upon the usefulness of historical cost data and failure to reflect that impact in some way may create a misleading impression that earnings are greater than they are in reality and that enterprises are adequately providing for the maintenance of their capital stock when such may not be the case. I suspect that even unsophisticated investors have become aware of inflation, however, I still believe that a measure of its impact is an objective which should be pursued.

The staff of the Commission currently has under study a review of our existing

replacement cost rules. Any ultimate decision as to changes resulting from such review will depend, in part, on the direction of the conceptual framework project in the ensuing months. Several commentators, including Professors Benston and Krasney in their paper "The Economic Consequences of Financial Accounting Statements," indicated that disclosure of capital expenditure forecasts was relevant additional financial information for sophisticated investors. I believe that capital expenditure forecasts by industry segment represents one area of additional financial information that would provide meaningful information to investors and would meet the objectives of financial reporting outlined in the exposure draft. It is conceivable that an extrapolation of this concept appears to be an issue worthy of consideration by the staff of the Commission and other interested parties in their deliberations concerning replacement cost and forecasting. Further, it appears that disclosure of capital expenditure forecasts meets the objectives of financial reporting that the FASB has set forth in its

exposure draft.

Arthur D. Little, Inc. in their impact of inflation on financial reporting and decision making project for the Financial Executives Research Foundation proposed that the impact of inflation be disclosed as part of management's discussion and analysis of reported results in its annual report to shareholders. The Little study recommended that in certain capital intensive businesses, major capital spending plans should be disclosed with an estimate of expenditure per unit of anticipated production where applicable (e.g., where the plant is unlikely to be replaced). This possibility as well as others which will provide meaningful information concerning capital expenditure forecasts should be explored as a possible form of additional disclosure concerning a company's future cash flows. The Little study goes on to indicate that in many businesses it would be appropriate to state how much it would cost to reproduce facilities needed to replace the market position currently enjoyed by the business entity. An industry by industry

approach to the disclosure of the impact of inflation on reported results appears to be an approach which is worthy of consideration.

Another issue that needs to be considered as one reflects upon the topic at hand is the traditional form versus substance discussion. Accounting should reflect the economic substance of an event, not its form. For accountants to be able to report upon, and for investors to be able to evaluate, management's performance, they must gain a working understanding of the operations of a company and the true nature and costs of its business. The theoretical underpinnings in accounting literature concerning such issues as leases and revenue recognition clearly indicate support for accounting reflecting the economic substance of a transaction.

A corollary issue involved in this discussion is the need to eliminate accounting alternatives for situations that are essentially the same facts and circumstances. The Commission, since its inception, has supported the establishment of a framework of accounting

standards and the elimination of accepted accounting alternatives for similar facts and circumstances. One of the most important implications of a framework is increased comparability so that users can compare enterprises using data in which the accounting standards employed are consistent for the same facts and circumstances.

Accordingly, I believe that comparability is one of the most important qualities of useful financial information. As I mentioned, the Benston study found the three most important characteristics in order of rank to be reliability, comparability and uniformity.

Further, adding credence to financial reporting should be a major objective of a conceptual framework and is an important mission of the FASB and the Commission. I believe that a conceptual framework should foster consistency of treatment of similar facts or circumstances in helping to provide such credibility to users of financial information. The FASB's work product over the last five years has eliminated accounting alternatives for the same facts and circumstances in such areas as



accounting for research and development costs, investments in marketable securities and leases. The Commission, as a general policy, continues to support the FASB's efforts to eliminate accounting alternatives for similar facts and circumstances, thus enhancing the comparability of financial reporting.

With respect to the economic consequences of accounting standards, attention has been directed to the impact of such standards and the changes in them upon the behavior of various distinct groups of people who have an interest in financial reporting. This includes management, creditors and lenders, equity investors (who may be broken down into institutional and individual investors and short-term and long-term investors), regulatory agencies and others. Examination with respect to these various groups involves both the question of whether they are able to, and do, look behind the accounting numbers to the underlying realities with the result that a change in accounting practices would not influence their behavior or whether they do not do this.

Secondly, even if they can look behind the numbers, are there external circumstances which nevertheless cause a change in their behavior as a result of a change in accounting standards. Thus, management, for example, should be entirely capable of looking through the numbers to the realities of their business. It may be, however, that the extent to which external judgments concerning management performance and procedures for determining management compensation are based upon reported accounting results, may nevertheless influence management's behavior. Similarly, sophisticated creditors given the information which meets their particular needs, especially cash flow information, would seem capable of looking to the pertinent realities. On the other hand, certain legal consequences such as events of default may depend upon the reported figures. One would hope that rather than modifying accounting standards to avoid untoward consequences flowing from these external factors, these factors themselves could be appropriately modified.

With respect to investor behavior, proponents of the efficient market theory conclude that the market, given all of the necessary information, will respond to it in a sophisticated and economically appropriate way. Others would suggest, however, that the figures do have their impact, at least in the short run, and in the case of less sophisticated investors and less actively traded stocks. However one evaluates these various possibilities, the important thing is to develop responses based upon competent and empirical research and thoughtful analysis. This conference provides an important opportunity for this kind of examination.

In summary then, this conference and the related undertakings of the FASB, particularly the conceptual framework project, are significant steps in the adequate analysis of the issues underlying the continuing improvement of the process of financial reporting. I am therefore very happy to have had the opportunity to have some connection with that endeavor.