Remarks Of

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Financial Reporting Issues of Interest

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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.

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I. Introduction

I appreciate the opportunity to participate in this conference of the Financial Executives Institute ("FEI"). I wish to encourage the members of the FEI to remain involved in the legislative and regulatory process, particularly insofar as issues involving our capital formation system are concerned. While differences in approach may be advocated from time to time, I know that I share with the FEI the goal of fair and efficient capital markets, free from unnecessary governmental regulation.

It is my intention today to address briefly several issues that I hope are of interest to you: the FASB's stock option valuation project, the Financial Fraud Detection and Disclosure Act sponsored by Congressman Wyden, the AICPA's plan for public reporting on internal controls, the AICPA's recent committee finding implying support for additional corporate reporting requirements, and then to close with a few comments on the general topic of corporate governance.

II. Stock Option Valuation

Beginning with the subject of stock option valuation, it appears to me that the new executive compensation disclosure requirements which were adopted by the Commission last year have enabled the marketplace to discern the compensation policies and practices of companies. As a practical matter, this was not possible before.

The new executive compensation disclosure rules contain a requirement to disclose the value of employee stock options either on the basis of an assumed increase in stock price, or through valuation using a model such as Black-Scholes. This provision was not especially popular with the corporate community at the time, but such unhappiness pales in comparison to the current unhappiness with the Financial Accounting Standards Board's ("FASB") project to require a valuation of fixed

employee stock options on the date granted. Once this value is determined, it would be required to appear as a compensation expense on the company's income statement.

Supporters of the FASB proposal argue that the present treatment of option awards is inconsistent with the treatment of stock awards, which are expensed. They further argue that options have inherent value as of their grant date and are given to executives as a replacement for cash bonuses, which would require expensing. Although these are valid points, experts probably could debate the best option value methodology until the turn of the century without reaching a consensus. The Commission had a not so pleasant taste of this controversy in its own executive compensation disclosure project.

Further, while the impact of the FASB project with respect to most companies would be minimal, it arguably could hinder a small growth company from going public. It would be unfortunate if a stock option valuation accounting project, which may only marginally improve the quality of a financial statement, hindered the rise of even one future star company. Such an occurrence would be most negative for our capital formation system in my view.

Moreover, the FASB's stock option valuation proposal may run counter to the policy of encouraging employees to be owners. If a choice must be made between the two, I prefer the policy of encouraging employees to be owners rather than at best incrementally improving the quality of a company's financial statement.

In any event, it appears that the supporters of the FASB proposal have won, at least for the moment. An Exposure Draft has been issued for a new accounting standard that would require: (1) disclosure in the footnotes to the financial statements of the "fair value" of such grants made after December 31, 1993, and (2) an accounting expense for the "fair value" of stock options and other equity-based instruments granted to employees after December 31, 1996. Thus, as early as next year, all stock

option grants may need to be valued and disclosed in a footnote to the financial statements.

While I support the footnote disclosure requirement, I question whether an expensing requirement is necessary. I would argue that the true cost to shareholders of a stock option is the dilution experienced with the issuance of new shares, which can be described adequately through disclosure. Despite my misgivings, though, I am inclined to respect the FASB's decision.

Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since its inception, however, the Commission has looked to the private sector to establish and to improve accounting principles. I believe that this historical relationship should be maintained, even when the decision by the FASB is an unpopular one, and thus, I would not be inclined to support legislation designed to overrule the FASB.

It is my hope, though, that the FASB will consider deferring further the expensing implementation date. Apparently, the FASB is already strongly considering delaying the implementation of the disclosure requirement for one year. I hope that is the case. I submit that there first should occur substantial actual experience with the new disclosure requirement before expense recognition is required.

In my view, close examination of the disclosure period experience is particularly warranted in this instance, since there appears to be no consensus existing yet for any one option valuation methodology. I believe it is important that there exists a high degree of confidence that the option valuation method selected would in fact improve the quality of financial statements. In addition to accuracy, it is also important that the method selected provide comparability. This probably means the requirement of one option valuation method ultimately for not only the FASB's accounting rules but

for the Commission's disclosure rules as well. I am not sure that any one present valuation model satisfies these conditions of accuracy and comparability. Therefore, I encourage the FASB to move prudently and cautiously when selecting an option-pricing model. This evaluation process should be designed to achieve validity and reliability rather than implementation.

III. Other Accounting Matters

As I stated earlier, there are several other accounting matters that I wish to discuss briefly with you today. The first is Congressman Wyden's pending legislation. H.R. 574, the second is the American Institute of Certified Public Accountants' ("AICPA") plan for public reporting on corporate internal controls, and the third is the recent report of the special committee of the AICPA implying support for a variety of increased corporate reporting requirements.

For some time now, Congressman Wyden has sponsored the Financial Fraud Detection and Disclosure Act, which would place a greater burden on independent auditors to inform top corporate management, and, in some cases, the Commission, of illegalities discovered during audits. There apparently exists substantial support for this legislation in the House, and similar legislation has been introduced in the Senate by Senator Kerry.

As I understand it, H.R. 574 would require each audit under the Exchange Act to include, in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission:

- procedures for the detection of illegal acts,
- procedures to identify related party transactions, and
- an evaluation of the issuer's ability to continue as a going concern.

The bill also would require auditors to report detected illegal acts directly to the board of directors if:

- the illegal act is material to the financial statements,
- management and the board have failed to correct the illegal act, and
- the auditor reasonably expects to qualify its report or resign due to the illegal act.

Under the bill, the company would have one business day to notify the Commission that the auditor has given the board such a report. If the company does not so notify the Commission, then the auditor has to furnish the Commission with a copy of the report within the next business day.

Generally, I support H.R. 574. At the same time, I recognize that the one business day Commission notification requirement contained therein may prove difficult to comply with and that some parts of the bill may be unnecessary. I would argue that some parts of the bill are unnecessary since the Commission already has the authority to set auditing standards and since some of the audit procedures in the bill already are required under GAAS. However, on balance, I do believe that the legislation would provide important new protections against financial fraud, and I support the legislation as a general proposition.

Concerning the internal reporting requirements called for by both the AICPA and the Public Oversight Board, I am inclined to agree with the negative statements made by the Commission's distinguished Chief Accountant, Walter Schuetze, on this subject in July. As Walter stated:

> Unfortunately, the truth is that even companies with good internal controls make mistakes. Internal controls related to financial reporting typically relate to the recording of transactions, the authorization of transactions, and the safeguarding of assets. No amount of internal controls will keep banks from making loans that later go bad, prevent managements from entering into contracts that become loss contracts, or make each decision to fund research and

development pay off. Investors will be disappointed. And, in their disappointment, investors and others may point to the "clean" audit report on the effectiveness of the issuer's internal controls and ask, "How could this happen?"

Proponents of auditor reporting on internal controls should make sure that there is an obvious and readily understandable answer to this question before asking the staff of the Commission to consider the imposition of more, costly reporting requirements on public companies.

I believe that auditor reporting on internal controls will not stop the crooks of the world who are going to make the financial statements say what they want them to say regardless of the facts, and that auditor reporting on internal controls will not solve the more pervasive and more important problem of managements pushing pliable accounting standards.[1]

I believe that Walter is right, and I am inclined to be of the view that the AICPA's proposal for auditor reporting on internal controls does not pass muster under the proverbial cost-benefit test.

Finally, with respect to the apparent support of an AICPA panel for more corporate reporting requirements, I understand that the committee to date has not formulated any specific proposals. Since the process leading to the AICPA endorsement of a variety of increased corporate reporting requirements has a long way to go, I believe that it is important not to prejudge the preliminary work of this committee. I recognize that the Commission's current disclosure regimen is far from perfect and that the Commission should be open to all constructive suggestions for

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1 "Reporting by Independent Auditors on Internal Controls over Financial Reporting," Remarks delivered by Walter P. Schuetze, Chief Accountant, SEC, at a Symposium Sponsored by the CPA Journal, Washington, D.C. (July 15, 1993).

improvement. However, while I look forward to working with the AICPA on this matter, for the reasonably near future, I would be disinclined to support much in the way of additional corporate disclosure requirements. I would prefer to concentrate on the present Commission financial reporting improvement project of simplifying the existing disclosure requirements and of removing those that are unnecessary.

IV. Corporate Governance

I wish to close by saying a few words about corporate governance in the 90s. As everyone here is probably aware. the Commission significantly amended its proxy rules last year to facilitate shareholder communications.[2] In adopting the amendments, the Commission stated that the purposes of the proxy rules are best served by promoting free discussion, debate and learning among shareholders and interested persons. I wholeheartedly agree with this approach.

I hope that by removing unnecessary restrictions on discussions among shareholders regarding corporate performance and other matters of direct interest to all shareholders, the new rules will reduce the obstacles to effective and appropriate shareholder input. If so, the amendments should improve corporate governance. The amendments also should lower the expense of conducting a regulated solicitation by shareholders, management and others by minimizing costs related to the dissemination of soliciting materials.

The proxy and executive compensation reforms of last year should pave the way for more informed communications between shareholders and boards of directors, and I believe that the appropriate role for the Commission at this point is to stand back and to allow this dialogue to continue. In my view, the new proxy rules and executive compensation disclosure rules have gone a long way toward improving the ability of

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[2] Securities Exchange Act Release No. 31326 (October 16, 1992).

shareholders to understand the companies in which they invest, and to assert themselves when a company appears to be drifting from a sound business policy. However, it is incumbent upon shareholders, particularly institutional shareholders, not to abuse this ability to communicate effectively and attempt to micro-manage companies.

I believe that corporate governance activity in the 90s will consist generally of these themes of communication and negotiation, as opposed to the confrontation that occurred in the 80's. Thus, in my view, it is most important that public companies now have strong boards of directors.

In particular, I believe that independent directors will continue to be an integral component necessary to maintain the vitality of corporate America. Increasingly, one hears calls for true independence on boards, for men and for women capable of directing change in the focus of their companies, and for men and for women who are not afraid to stand up to management when necessary. I was encouraged to read in Director's Monthly recently that during the past five years, outside directors have assumed an increasing number of board seats and that this trend is expected to continue. I hope that is the case. If so, corporate governance matters will continue to be handled much more smoothly and effectively than they were in the volatile 80s.

This call for increased board representation by independent directors is not intended to question the ability or integrity of "inside" directors. For years, many of these men and women have devoted their time and energies to ensuring that their twin duties of loyalty and care have been fulfilled. It is, however, the primary function of the board of directors to monitor and to question management, and even to replace management when necessary. The conflicts of interest that these duties create for inside directors are greater than even the most scrupulously honest person should have to resolve.

Thus, I believe that the ideal hypothetical board should be comprised, except for the CEO, of members completely independent of management. At a minimum, boards should have a majority of outside directors. While not as important a factor as an independent board, I also generally prefer a board where the functions of Chairman and CEO are not vested in the same person. Further, I would argue that the audit, compensation and nominating committees should be comprised entirely of outside directors. In particular, the audit committee's responsibilities have become most important as has been reflected in some of the Commission's recent enforcement actions.

Finally, in order to align the board's interests with shareholders, strong consideration should be given to partially compensating directors with company stock or options. I am of the view that the policy of pay for performance is positive for our capital formation system and should be encouraged even for directors.

I wish to stress, however, that the job of a board should not be to micro-manage the company. The purpose should be to delineate clear goals for top management, to establish a system of incentives to help meet those goals, and to monitor diligently management's progress.

In April of this year, Chairman Markey held a hearing on the role of independent directors on corporate boards, and he apparently is contemplating the introduction of legislation on this subject. As I indicated earlier, I do share his concerns regarding the need for more outside directors and regarding the lack of true independence exhibited by many current "outside" directors. I do not, however, believe that legislation or additional rulemaking is the most appropriate method to address these problems. It is my opinion that change must be dictated by the marketplace itself, and there are indications that this process of change has already been initiated. I am please to report that according to a recent survey of corporate

boards, well over 90% of the companies surveyed now have a majority of outside directors on their board. I hope that this process of change continues.

Truly independent boards have the freedom to keep management challenged to strive for the best quality products or services, prices, and technological innovations. While it is understandable that management may become wedded to the strategies that have provided years of success, an objective eye is required to see when these managers become paralyzed in the face of today's changing markets. This is the time when a strong board must step in and dictate the future of the company. Hence, the reason that I stress the need for companies to establish voluntarily, more outside, "independent" directors as one suggestion to improve corporate governance without legislation or regulation.

V. Conclusion

Since I suspect that my time has more than expired, I will conclude. I have enjoyed participating in this conference, and I look forward to working with the FEI during the remainder of my Commission tenure, which unfortunately grows shorter.

Communication solves a great many problems, and I intend to continue a dialogue with the FEI. I believe that we share a common interest in maintaining a fair and efficient capital formation system. We can and should work together toward achieving that objective.