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THE ROLES OF THE SEC AND FASB IN PROVIDING TIMELY GUIDANCE ON EMERGING ACCOUNTING ISSUES

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Introductory Remarks

It is a great pleasure for me to be here today among so many successful professional women to address this important gathering of the American Society of Women Accountants. I am particularly pleased to have the opportunity to discuss a subject of great importance to the accounting profession, the Commission, and the business community alike, the roles of the SEC and the FASB in providing timely guidance on emerging accounting issues.

In the context of financial reporting, timely guidance means the setting of accounting and disclosure standards, or otherwise establishing rules, so that companies report similar events and transactions in a similar manner.

While providing timely guidance may seem at first blush to be a rather simple task, it has, in fact, proven to be an extremely difficult challenge for the accounting profession. Indeed, someone recently brought to my attention a report of "The Special Committee on Cooperation with the Securities and Exchange Commission," which was adopted by the Council of the American Institute of Accountants -- the predecessor of the AICPA -- in May 1940. That report reflects the long-standing nature of the problem that I will discuss briefly today.

That report stated that "[r]ules and principles of accounting, however carefully defined, will not fit all cases. Developments in business and finance continually give rise to new problems in the application of accounting principles." This point is still valid today, notwithstanding the substantial improvements in standard-setting mechanisms and in the standards themselves, during the more than 40 years since this report was issued. Even non-accountants understand that the accounting profession will continuously be presented with novel circumstances requiring the setting of new standards if financial reporting is to keep pace with a constantly changing economic environment.

Attention has recently been refocused on the Financial Accounting Standards Board's (FASB) role in the area of timely guidance as a result of a report issued last August by the Structure Committee of the Financial Accounting Foundation on the operating efficiency of the FASB. That report recommended, among other things, that "the FASB should develop a plan . . . to provide timely guidance for implementation questions and emerging issues." I will discuss that report later; first, however, I would like to emphasize the significance of this issue from the perspective of the SEC.

SEC Perspective

1. Need for Timely Guidance

Historically, the Commission's experience in administering the federal securities laws demonstrates that there always has been a need for timely guidance on emerging accounting issues. These issues evolve from a continuously changing economic environment, which fosters the development of new accounting standards, and leads to novel applications of existing practices. This emergence of new practices and implementation of new standards can create problems of inconsistency and incomparability in financial reporting.

As we all know, the credibility of financial reporting is directly dependent not only on the accuracy of financial reports, but also on the ability to compare them with others. Thus, it is essential that companies and their auditors seek to avoid such inconsistency and incomparability and that they account for similar transactions and events in a similar manner. In order to achieve this end, timely guidance is an absolute necessity.

Furthermore, the need for timely guidance is not removed simply by the drafting of more specific standards. Regardless of the specificity of accounting standards, issues requiring timely guidance will inevitably arise. In part, this is attributable to the uncertainty inherent in the application of new accounting practices and principles. It is also due to the sheer number of public companies and accountants involved in the registration and reporting processes, and the differing factual situations they generate. In this connection, more than 9,000 public companies, which are audited by over 800 different accounting firms, file financial statements with the Commission. In addition, a substantial number of first-time registrants are constantly entering the disclosure system.

It is also important to recognize that among the parties involved in the registration and reporting processes, there may be those motivated to depart from the Commission's standard of full and fair disclosure. While I trust that most parties adhere strictly to both the form of, and the underlying rationale for, financial reporting standards, there is ample evidence that certain others attempt to benefit from their own liberal interpretations of the standards -- particularly where transactions are structured to obfuscate their true substance and no specific timely guidance is available to encourage their compliance. Moreover, experience has also shown that independent accountants may often be either unable or simply unwilling to insist on appropriate accounting by their clients without having explicit professional timely guidance.

2. Role of the SEC

For our part, the Commission is granted broad powers under the federal securities laws to protect investors in their securities transactions. These powers include the authority to promulgate rules necessary to provide standards for full and fair disclosure.

In discharging its responsibility on matters of accounting, the Commission has traditionally placed a great deal of reliance on the private sector. In instances in which the private sector can move quickly to an acceptable solution on emerging issues, the Commission has generally been willing to accept such a solution. Frequently, however, the Commission has found it necessary, because timely guidance was not forthcoming from the private sector, to issue its own timely guidance in the form of rules, interpretations, staff accounting bulletins ("SABs") or, most often, through publicized individual registrant determinations.

For example, during the 1970's, the Commission provided the impetus for a major FASB project on accounting for leases by establishing comprehensive disclosure requirements in that area. In addition, the Commission's moratorium on the practice of interest capitalization provided the impetus for the FASB to establish standards on that subject.

Another example of the Commission's response to a developing accounting problem is its August 1982 release concerning the proper accounting treatment of quasi-defeasance transactions, that is, transactions intended to have the same substantive effect as a legal extinguishment of debt. The question was whether or not transactions, where amounts are dedicated to future servicing and repayment of debt, could be treated as an early extinguishment of that debt which would result in immediate gain recognition. The FASB was initially evaluating this issue, and had announced a tentative conclusion that the debt should not be considered as extinguished unless the debtor has no further legal obligation to pay. This tentative conclusion was consistent with the existing practice of the overwhelming majority of companies. However, in order to ensure consistent financial reporting during the interim period while the FASB was considering a final standard, the Commission announced, in Financial Reporting Release No. 3, that all registrants should follow the tentative recommendations of the FASB.

Just last month, the Commission again indicated its concern for timely action when it issued a proposal concerning the capitalization of a company's internal costs of developing computer software to be marketed to others. This proposal arose from the same type of concern which prompted Commission action on interest capitalization in 1974 -- a trend was developing in accounting practices that was having an adverse effect on financial statement comparability. While most companies charge to expense all of the internal software development costs as incurred, a growing number of companies have begun to capitalize some of them. Because the propriety of capitalization is not always clear, the Commission has proposed to prohibit the capitalization of these costs by registrants that have not previously disclosed the adoption of such a practice until such time as more definitive guidelines in this area can be developed.

There is, however, a major difference between the computer software capitalization issue of today and the interest capitalization issue of almost ten years ago. This difference, I believe, supports my earlier statement that timely guidance on accounting matters will always be necessary, even where standards may already be in place. When the Commission prohibited the adoption of the practice of capitalizing interest costs, it was addressing a controversial accounting practice for which the professional literature did not provide sufficient guidance. In contrast, accounting for computer software development costs has been addressed in three separate FASB pronouncements in the context of the relationship of these costs to research and development costs, which, of course, must be charged to expense as incurred. Unfortunately, however, this existing literature was not sufficiently clear to prevent the diversity of practice which had been developing. As a result, we at the Commission believed that some guidance was necessary.

These examples point to a need for timely guidance on financial accounting and reporting matters, and demonstrate that the Commission, in fulfilling its statutory responsibility, can and will provide that guidance. The FASB, therefore, has the challenge to strengthen its own role in this area.

In this connection, I would now like to turn to a discussion of the August 1982 report of the Structure Committee on the Financial Accounting Foundation ("Structure Committee").

FASB Project

As you know, the Financial Accounting Foundation exercises general oversight of the FASB. Its Board of Trustees is responsible for appointing the FASB membership, raising funds for FASB operations, and reviewing the FASB budget. The Trustees -- consisting of representatives from public accounting, academe, industry and the investment community -- are required periodically to review the basic methods of establishing and improving financial accounting standards.

The review leading to the August 1982 report focused primarily on the effectiveness of the FASB's due process procedures, its workload and output, and cost-saving opportunities. While the report was generally favorable, it did include a number of recommendations designed to improve the FASB's operations. Among these was a recommendation that "the FASB should develop a plan, for consideration by the Board of Trustees, to provide timely guidance on implementation questions and emerging issues."

In response to this report, the FASB appointed a seven-member task force on timely financial reporting guidance ("task force"), consisting of prominent representatives from industry, and the accounting and legal professions, to study the recommendation and to advise the Board of Trustees as to an appropriate response. The task force, in turn, issued an "invitation to comment" to solicit the views of the FASB's constituency on two major issues: (1) the effectiveness of the FASB in providing accounting guidance for implementation of its standards and in responding to emerging issues, and (2) whether the FASB should rely on another organization to develop such guidance. Commentators were also encouraged to respond to certain specific questions concerning their perception of, and experience with, the FASB's ability to provide timely guidance.

The response to the invitation to comment was extensive and broad based. Over one hundred and seventy commentators, including accountants, bankers, academicians, lawyers and government representatives, submitted their views.

Task Force Recommendations

After reviewing the input of the commentators, the task force has recently announced several tentative recommendations designed to improve the FASB's ability to identify and deal with accounting and financial reporting issues on a more timely basis. As I understand it, these recommendations would call for the FASB to establish an advisory group that would assist it in identifying and defining financial reporting problems and, possibly, suggesting solutions. It was also recommended that the applicability of FASB technical bulletins be broadened to permit more emerging problems, issues involving implemention of accounting standards, and specialized industry accounting questions to be addressed.

As you know, technical bulletins are issued by the FASB staff without formal deliberation by its board members and without the lengthy due process procedures required of other FASB pronouncements. Thus, technical bulletins can be an effective vehicle for addressing accounting problems quickly, including most of the narrow issues previously addressed in FASB statements and interpretations. The task force also suggests that as FASB board members would not be involved in deliberating the issues covered by technical bulletins, they would have more time to consider issues involving broad standards and concepts, including completion of the conceptual framework project.

I believe that these tentative recommendations have considerable merit. The concept of an advisory group is very similar to the implementation group formed by the FASB in 1982 to address questions arising from Statement 52 on foreign currency transactions. In my view, that group did an excellent job of identifying and defining implementation questions, which would be a principal function of the recently recommended advisory group.

I attach even more importance to broadening the applicability of FASB technical bulletins. When the process of issuing technical bulletins was first introduced in 1979, the Commission anticipated that the bulletins would be an effective vehicle for addressing detailed implementation questions on a timely basis. However, under the existing guidelines, technical bulletins can be issued only under limited circumstances and only when they are not expected to have a significant effect on financial reporting.

Most of the emerging issues that we have grappled with at the Commission have been outside this narrow scope.

I also support efforts to expedite the conceptual framework project. A more developed conceptual framework should assist the entire financial community by providing structure and direction to financial reporting.

Authoritativeness

An important issue related to the question of how to provide timely guidance, is the degree of authority to be attached to that guidance. Technical bulletins do not impose the same degree of authority as other FASB pronouncements, as evidenced by the fact that an auditor does not have to modify its reports when the guidance in a technical bulletin is not followed by its client company in preparing its financial statements. In contrast, an auditor must modify its report in instances in which a provision of an FASB statement or interpretation is not complied with. Despite this distinction, however, the task force has indicated that both preparers of financial statements and independent accountants have stated that they will follow the guidance provided in technical bulletins.

Notwithstanding the indication that technical bulletins will be followed despite their lack of authority, the experience of the Commission staff strongly suggests that the effectiveness of accounting standards is enhanced by the degree of authority that they carry. This is so because authority provides the leverage that is needed by many accountants to ensure that standards are being applied consistently. Therefore, we are prepared to bolster the effectiveness of technical bulletins with respect to public companies, by affording them the same status as SEC Staff Accounting Bulletins, which have proven to be an effective means of achieving consistent financial accounting and reporting. SABs, of course, represent interpretations and practices followed by our staff and are not Commission rules, but there is an extremely strong presumption that they should be followed.

Conclusion

I conclude by repeating that timely guidance on accounting and financial reporting matters will always be necesary in a dynamic, rapidly changing economic environment, and that we at the Commission attach tremendous importance to such guidance, regardless of whether it is provided by the private sector or by us. While the Commission supports efforts to enhance the ability of the private sector to provide timely guidance for the accounting profession, whether it be by the tentative recommendations of the task force or some other plan, I believe that the SEC will still be called upon from time to time to provide additional timely guidance as part of its administration of the federal securities laws. The challenge to the accounting profession is to limit the extent and frequency of SEC involvement and this challenge represents a good test of whether the Commission's emphasis on self-regulation can in fact be justified.