

C. Meetings and Public Communications

The FASB meets with interested parties on its own motion or at the request of others as a means of obtaining information as to the impact of implementation of proposed standards and as a means of learning of the concerns of the public. While the Board necessarily has to budget its time and is unable, as a practical matter, to accede to every meeting request, it or its staff regularly participates in meetings when the subject is likely to result in new or additional relevant information which otherwise may not be obtainable. Although the Study has criticized these informal meetings, the FAF's Structure Committee has recommended in its recent report that the FASB and its staff hold more informal meetings as a means of further encouraging and increasing public participation in the standard-setting process.

It is interesting to note that the Government's Cost Accounting Standards Board also views meetings as an important means of getting additional information. At every stage of the CASB's deliberations, its staff consults informally with industry representatives and other affected groups in order to discuss and evaluate the need for a cost accounting standard, possible alternatives, the expected costs and benefits, and foreseeable practical difficulties in implementation.

On occasion the Board has issued public invitations requesting information relevant to its work. For example, promptly upon commencing operations in 1973, the FASB issued an "open letter" to accounting firms, the financial and business community, analysts, and all interested persons requesting information on the experiences of preparers, auditors and users of financial statements "which would indicate that existing pronouncements need interpretation, amendment or replacement." The Board received over 100 replies, some more than 30 pages, advising as to these matters for consideration by the Board. More recently, the Board issued an open invitation to all interested persons to submit research papers on the economic effects of accounting standards, with particular reference to existing standards and to projects on the FASB's agenda. In issuing this invitation, the FASB stated that all papers submitted would be reviewed and some selected for presentation at its planned conference on economic consequences of accounting standards in early 1978.

III. PROGRESS AND SUCCESS OF THE FASB AND ITS PREDECESSORS

Review of a complete and balanced record shows that the FASB and its accounting standard-setting predecessors have been successful in establishing meaningful financial accounting standards, responsive both to pervasive and persistent problems of the past and to newly emerging problems in need of prompt solution.

A. Significant Accounting Pronouncements

In its less than four years of operations, the FASB has issued 14 Statements of Financial Accounting Standards, 18 Interpretations, 20 Exposure Drafts and 13 Discussion Memoranda and has held 15 public hearings, as enumerated in Exhibit D. The FASB's pronouncements, the more significant of which are also summarized in Exhibit D, demonstrate the dedication and attention of the FASB to its objective of establishing and improving financial accounting standards. When considered in conjunction with Exhibit B's analysis of responses on FASB proposals, Exhibit D also demonstrates that the FASB is not "dominated" or "controlled" by "special interest groups", and is willing and able to reduce or eliminate accounting alternatives when reasonable to do so.

By way of brief summary, certain of the FASB's Statements have dealt with broad, pervasive accounting questions long in need of resolution, such as:

- Accounting for Research and Development Costs. (FASB Statement No. 2)
- Accounting for Contingencies. (FASB Statement No. 5)
- Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements. (FASB Statement No. 8)
- Accounting for Leases. (FASB Statement No. 13)

Other Statements have also addressed and resolved long-standing issues, including:

- Accounting and Reporting by Development Stage Enterprises. (FASB Statement No. 7)
- Financial Reporting for Segments of a Business Enterprise. (FASB Statement No. 14)

Still other FASB Statements have been issued in response to emerging problems perceived as urgently in need of solution:

- Reporting Accounting Changes in Interim Financial Statements. (FASB Statement No. 3)
- Reporting Gains and Losses from Extinguishment of Debt. (FASB Statement No. 4)
- Classification of Short-Term Obligations Expected to be Refinanced. (FASB Statement No. 6)
- Accounting for Income Taxes—Oil and Gas Producing Companies. (FASB Statement No. 9)
- Accounting for Certain Marketable Securities. (FASB Statement No. 12)

Two examples will suffice to illustrate the FASB's willingness to act where it is reasonable to reduce or eliminate accounting alternatives. In its Statement No. 2, "Accounting for Research and Development Costs", the FASB eliminated three alternative accepted practices by requiring that all research and development costs be charged to expense when incurred unless related to an item with an alternative future use. Another example is FASB Statement No. 8, "Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements". Prior to that Statement, there were a variety of generally accepted methods of translating foreign currency, including current—non-current, monetary—non-monetary, and variations. Additionally, a variety of methods were applied to defer recognition of exchange gains until they could be utilized to offset exchange losses. The FASB provided for translation of asset and liability accounts at specified rates, thereby eliminating all other alternatives, and eliminated deferral techniques by requiring exchange gains and losses to be included in determining net income for the period in which the rate changed.

The FASB also has a number of significant matters on its current technical agenda. Among these are: "Financial Accounting and Reporting in the Extractive Industries", which relates to Public Law 94-163; "Accounting by Debtors and Creditors in Troubled Debt Restructurings"; "Accounting for Employee Benefit Plans"; and "Conceptual Framework for Financial Accounting and Reporting".

As for the FASB's predecessors, the Committee on Accounting Procedure issued a total of 51 Accounting Research Bulletins between 1939 and 1959, and its successor, the

Accounting Principles Board, issued 31 Opinions and 4 Statements on a variety of accounting matters through 1973, some of the more significant of which are summarized in Exhibit D.

It is interesting to note that for all of its 1,760 pages of text and reproduced information and data, the Study devotes less than two pages to the FASB's accounting standard-setting activities and mentions only four of the FASB's Statements—Nos. 2, 7, 9 and 12. Again, the Study's criticisms are wide of the mark, and neither stand analysis nor support its assertions.

For example, FASB Statement No. 2, discussed above, prescribed a uniform standard and eliminated the very practices which are cited in the Study as having contributed to the financial difficulties of Lockheed, R. Hoe and Talley Industries. In criticizing Statement No. 2 as causing small developing companies to report reduced earnings, the Study also ignores the conclusions of a study conducted by the United States Department of Commerce on the potential economic impact of Statement No. 2 on small developing firms; following interviews with 40 lenders and investors, 11 small, high-technology firms, 11 accountants and selected Government agencies, the Commerce Department's study concluded that the "FASB's Statement Two should not have a significant impact on those firms who have heretofore capitalized R&D."

The Study also points to Statement No. 7, "Accounting and Reporting by Development Stage Enterprises", as showing that the FASB sided with established operating companies against their developing potential competitors. Here again, the FASB eliminated a variety of previously acceptable alternatives for development stage companies and required them to apply accounting standards applicable to established operating companies. The Study again fails to note that the FASB did not issue Statement No. 7 until it had considered the potential economic impact on development stage enterprises; as indicated in paragraph 49 of Statement No. 7, the FASB held discussions with 15 venture capital enterprises, whose consensus was that the FASB standard would have little effect on the availability or terms of their future capital.

Similarly, with regard to Statement No. 9, the Study fails to credit the FASB with acting promptly to resolve an accounting issue which arose as a direct result of enactment of the Tax Reform Act of 1975. That Act substantially reduced or eliminated percentage depletion as a federal income tax deduction for many oil and gas producing companies, and accounting literature at the time did not address certain questions because before the Act tax deductions generally exceeded capitalized costs. In Statement No. 9, the FASB required, commencing January 1, 1975, all enterprises to record deferred income taxes for intangible development costs and other costs of exploration and development of reserves entering into determination of financial accounting income and taxable income in different periods, unless they had excess statutory depletion. This and other accounting issues applicable to oil and gas producing companies are currently being considered in the FASB's Extractive Industries project.

The Study's last venture into accounting analysis relates to Statement No. 12, "Accounting for Certain Marketable Securities". Here the FASB required marketable equity securities to be reflected on balance sheets at the lower of cost or market, and required that any difference from cost be recognized currently in income for securities classified as current assets and in stockholders' equity for securities held for long-term investment. Contrary to the Study's assertions, the FASB reduced accounting alternatives as to like asset classifications of marketable equity securities, and did not discriminate when

it exempted specialized industries (insurance companies, broker-dealers and investment companies) because those enterprises already were carrying their marketable securities at current market. Statement No. 12 more properly should be regarded as having improved consistency in accounting for marketable equity securities.

B. Conceptual Framework and Objectives

A particular aspect of the Study's criticism of accounting standard-setting requires special mention. The Study asserts that the accounting profession and more recently the FASB have failed to prescribe a comprehensive set of objectives for financial statements and a conceptual framework within which further improvements in financial accounting and reporting can develop consistently.

The accounting profession has been engaged in several major efforts since the mid-1960's to define objectives and to provide an underlying conceptual framework. APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", was issued by the Accounting Principles Board in 1970 with a stated purpose of providing an enhanced understanding of the broad fundamentals of accounting and guiding the future development of financial accounting. In 1971 the AICPA commissioned the Trueblood Study Group to hold hearings and to investigate the objectives of financial statements; the Trueblood Study Group's "Objectives of Financial Statements" was issued in October 1973.

From its formation, the FASB has continued these efforts and devoted substantial resources to establishing a comprehensive conceptual framework for financial accounting and reporting, including objectives of financial statements. On April 1, 1973 the Board placed this project on its first technical agenda and in June 1974 issued a Discussion Memorandum on objectives and held public hearings in September of that year. In December 1976 the Board published its tentative conclusions on the objectives of financial statements and issued a second Discussion Memorandum entitled, "Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement". As discussed more fully in Exhibit D, this project is expected to lead to FASB pronouncements involving objectives, qualitative characteristics, basic elements of financial statements, bases of measurement and units of measure. These issues are extremely complex and require logical, objective and thorough analysis by knowledgeable, experienced experts. The second public hearing on this project is scheduled for this summer.

C. The Soundness of the Structure for Selecting and Applying Accounting Standards

The Study asserts, incorrectly, that the structure for selecting and applying accounting standards in the preparation of financial statements does not provide the public with meaningful or accurate financial information, and that the existence of accounting alternatives results in financial information serving the interests of large accounting firms and their clients, to the detriment of the public.

A brief review of scope and purpose of financial accounting and reporting will demonstrate the soundness of the existing structure for selecting and applying financial accounting standards and how it assures meaningful and useful information for the public.

Financial accounting and reporting is the process of recording, classifying, summarizing and interpreting transactions and events, and presenting that information in a meaningful and useful manner in financial statements. Accounting standards delineate the scope and method of financial communication, namely, what and how to communicate to the reader.

General purpose financial statements constitute the principal source of financial information to the investing public, creditors and others concerned with the operations and formation and deployment of resources of a business enterprise. These financial statements are to be contrasted with limited purpose or supplementary financial statements intended to serve a limited or specific need of particular users. Managerial accounting, for example, is specifically tailored to the particular needs of management in monitoring day-to-day operations. Similarly, tax accounting and systems of accounts for regulated industries serve particular regulatory purposes. The Government's Cost Accounting Standards Board is also an example of a body charged with a specific function—setting cost accounting standards for government contracts, particularly in connection with defense procurement. Governmental authorities, such as tax and ratemaking bodies, typically have statutory authority to prescribe the form and content of such financial reports as they deem necessary to fulfill their functions.

Financial accounting and reporting is to be distinguished from auditing. Auditing standards establish the procedures by which information that has been recorded, classified, summarized and interpreted in books and records and presented in financial statements is reviewed to determine whether the financial statements are presented fairly in conformity with generally accepted accounting standards. An example, using revenue recognition, may be helpful. Accounting standards set forth criteria for determining the timing of revenue recognition which management should apply. Auditing standards set forth procedures to be followed by independent auditors when expressing an opinion on financial statements as to whether, based on the circumstances and underlying data, (i) the appropriate accounting method has been applied in relation to the accounting criteria, and (ii) the amounts are supported by that data.

The FASB is responsible for establishing and improving financial accounting and reporting standards. It does not have any responsibility for setting auditing standards or regulating auditing. This distinction is significant, especially with respect to the Study's assertions that cases of corporate failures and financial difficulties and "questionable" or "improper" payments are evidence of failure of financial accounting standards. As discussed below, these and other of the Study's related criticisms are not justified, for they are based on lack of understanding of the FASB's responsibilities and the nature, scope and purpose of financial accounting standards and financial statements.

1. *Generally Accepted Accounting Principles.*

Any body of accounting standards must be responsive to the myriad of variables, circumstances and transactions bearing upon the sources of financial information and the presentation and ultimate use of that information through the medium of financial statements. In this context, the accounting profession and the SEC long ago developed the related concepts of "generally accepted accounting principles" and "substantial authoritative support" as a means of providing a realistic, but structured, framework within which accounting standards could be evaluated for acceptability and appropriateness.

"Generally accepted accounting principles" (frequently referred to as GAAP) is an accounting term encompassing conventions, rules and procedures necessary to define accepted accounting practice. The term includes not only guidelines of general application, but also practices and procedures.

Only those accounting principles for which there is "substantial authoritative support" are regarded as being "generally accepted" by the SEC for purposes of financial statements filed with it under the Federal Securities Laws. Forty years ago, in 1938, the SEC stated

that, as a matter of administrative policy, financial statements applying accounting principles for which there was no substantial authoritative support would be viewed as misleading and would not be accepted in filings and reports with it. In the absence of unusual circumstances which must be demonstrated and disclosed, an auditor cannot render an unqualified opinion, and financial statements will not be acceptable under the Federal Securities Laws, unless the independent auditor can conclude that the financial statements are presented fairly in conformity with generally accepted accounting principles.

2. *Selecting Generally Accepted Accounting Principles.*

Professional accounting literature, developed largely through the efforts of the accounting profession and its designated standard-setting bodies (the FASB and its predecessors*) with SEC encouragement and participation, has long contained enumerations of the sources of generally accepted accounting principles—that is, those principles for which there is substantial authoritative support.

Contrary to the Study's assertion, there is not unrestrained "picking and choosing" among accounting principles when more than one acceptable principle exists. First, the profession's Code of Professional Ethics and SEC policy require that the accounting principles applied be not only generally accepted but also *appropriate* in the circumstances. Second, the accounting profession and the SEC both recognize certain generally accepted accounting principles as presumptively binding, and, in the absence of unusual circumstances, require that these generally accepted principles be applied in the preparation of financial statements.

Under Rule 203 of the AICPA's Code of Professional Ethics, a member of the AICPA may not express an opinion that financial statements are presented fairly in conformity with generally accepted accounting principles if the statements depart from an FASB Statement or Interpretation or an APB Opinion or Accounting Research Bulletin, unless the accountant can demonstrate that, due to unusual circumstances, the financial statements would otherwise be misleading. In its Accounting Series Release No. 150 in December 1973, the SEC reaffirmed its long-standing administrative policy and endorsed the FASB for purposes of financial statements filed with it under the Federal Securities Laws, stating that any accounting principle contrary to an FASB Statement or Interpretation or an APB Opinion or an ARB would be presumed to have *no* substantial authoritative support and thus be unacceptable, unless the Commission determined otherwise either generally or in specific cases.**

Rule 203 and the SEC's long-standing policy have proven successful in narrowing the selection of accounting principles and have contributed significantly to consistency and certainty in the preparation of financial statements. The FAF and FASB understand there have been almost no instances since 1973 where the SEC has accepted financial statements departing from an FASB or APB pronouncement or an ARB.

* The Accounting Principles Board (1959-1973) and the Committee on Accounting Procedure (1939-1959).

** Accounting Series Release 150 is currently the subject of litigation in *Arthur Andersen & Co. v. Securities and Exchange Commission*, Civil Action No. 76 C 2832 (N.D. Ill., filed July 29, 1976). In August 1976 the Court refused to issue a temporary restraining order, and on September 3, 1976 the Court denied motions to enjoin the application of ASR 150. Motions for summary judgment and an SEC motion to dismiss are currently pending before the Court.

Rule 203 and the SEC also recognize that, in unusual circumstances, literal compliance with presumptively binding generally accepted principles issued by the FASB and its predecessors may not always insure that financial statements will be presented fairly. In those cases, as well as cases not covered by an FASB or APB pronouncement or an ARB, authoritative literature provides direction for the selection of generally accepted accounting principles. The AICPA's Statement on Auditing Standards No. 5 enumerates these sources as including pronouncements of the SEC or other regulatory bodies, AICPA Industry Audit Guides and Accounting Guides, industry accounting practices, APB Statements, and AICPA Accounting Interpretations and Statements of Position.

In recognizing the requirement of fair presentation of financial statements in relation to the selection and application of generally accepted accounting principles, authoritative literature requires the auditor, when expressing an opinion, to judge the fairness of overall presentation of the financial statements within the framework of generally accepted accounting principles as the standard for the exercise of this judgment. After referring to the necessity of appropriate generally accepted accounting principles being applied, Statement on Auditing Standards No. 5, paragraph 4, enumerates the auditor's judgmental determinations as follows:

“(c) the financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation . . . ; (d) the information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed nor too condensed . . . ; and (e) the financial statements reflect the underlying events and transactions in a manner that presents the financial position, results of operations, and changes in financial position stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements.”

Statement on Auditing Standards No. 5 also states that generally accepted accounting principles recognize the importance of recording transactions in accordance with their substance, and directs the auditor to consider whether the substance of transactions differs materially from their form.

3. *Limitations on Accounting Changes.*

In addition to establishing parameters for the *selection* of accounting principles (looking first to the official pronouncements of the FASB and its predecessors), the accounting profession and the SEC have also limited the circumstances in which a generally accepted principle, once adopted by an enterprise, can thereafter be changed for events and transactions of a similar type in favor of another generally accepted principle. Contrary to the Study's assertions, neither preparers nor auditors of financial statements have a free choice, or the right to change accounting principles once applied, to present matters in the most favorable light. There is no merit to assuming that accounting changes are bad *per se*.

APB Opinion No. 20 states there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. This presumption may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable or if an official pronouncement of an authoritative standard-setting body requires or expresses preference for another principle or rejects the principle then being applied. Opinion No. 20 requires that the change and its effect on income be disclosed in the financial statements, together with justification clearly explaining why the newly adopted principle is preferable. The SEC

additionally requires a publicly-owned company to report the date and reasons for the change, and requires the company's independent accountant to advise in writing whether, in his opinion, the change is to a generally accepted principle preferable in the circumstances.* Thus, both management and the independent accountant must be prepared to justify in filings under the Federal Securities Laws, as to which liability for false or misleading statements attaches, that the accounting change will constitute an improvement in financial reporting.

While the FASB has not addressed accounting changes generally, in its first Interpretation, "Accounting Changes Related to the Cost of Inventory", it clarified the application of APB Opinion No. 20 to changes in the composition of elements in inventory cost that might result from changes in determining inventory cost for Federal income tax purposes. The FASB concluded in this instance that an accounting change could not be justified as preferable solely on the basis of tax savings, but had to constitute an improvement in financial reporting.

A change to another acceptable accounting standard frequently may also tend towards greater comparability. For example, a change from accelerated to straight-line depreciation is a change to a more prevalent depreciation practice. Similarly, the Study criticizes Texaco for changing from "full cost" to "successful efforts" accounting for its exploration and drilling costs. What is not mentioned, however, is that Texaco was the only major oil company using "full cost" accounting and, in changing, comparability of financial statements of major oil companies improved.

4. *Accounting Alternatives.*

Financial accounting encompasses all operations, of all companies, in all industries, and in all environments. In common experience there are significant operational differences between companies within a particular industry or even within a single company. It is therefore frequently appropriate to apply different accounting principles in order to reflect the realities of different circumstances and different transactions. Nevertheless, the Study criticizes the FASB and the SEC for not achieving uniform accounting principles and for permitting alternatives to exist. The Study makes no attempt to determine the reasons underlying the existence of accounting alternatives and overlooks the substantial and continuing progress being made in eliminating alternatives not justified by different circumstances or wholly different transactions.

(a) *The Study's Outdated Analysis.* The Study supports its criticism of accounting alternatives by reproducing (page 134) a table which is represented as showing a variety of alternative accounting methods available to account for the same business transaction.

The Study's reliance on that table is misplaced, for the data presented are based on a 1965 research study which was not updated in the Study to reflect 12 years of progress, including that by the FASB and the Accounting Principles Board. The Study also makes no effort to distinguish among those alternatives necessary to reflect different circumstances or wholly different transactions, even though the 1965 research study took care to do so when originally published.

* This SEC requirement is currently the subject of litigation in *Arthur Andersen & Co. v. Securities and Exchange Commission*, Civil Action No. 76 C 2832 (N.D. Ill., filed July 29, 1976). In August 1976 the Court denied a motion by Arthur Andersen for a temporary restraining order, and on September 3, 1976 the Court denied a motion to enjoin the application of this rule. Motions for summary judgment and an SEC motion to dismiss are currently pending before the Court.

Of the 42 “alternatives” listed in the Study’s table, 30 are not alternatives or are of such minor import as to be immaterial in effect on financial statements, as shown in the following tabulation updating and correcting the Study:

14	apply to circumstances which clearly differ and for which there are recognized criteria for determining the appropriate practice, or apply to wholly different transactions.
4	have been eliminated.
1	is now the sole practice.
1	is not an accounting method.
10	relate to items having no material effect on financial statements.
2	are rare and disappearing.
<u>10</u>	are practices which may be alternatives.
<u>42</u>	

Of the 10 practices which may be alternatives, 2 are currently under study by the FASB in its Extractive Industries project.

Exhibit E contains a detailed discussion of the Study’s outdated analysis, “alternative” by “alternative”, and includes a reconciliation supporting the 1977 tabulation shown above.

(b) *Alternatives Necessitated by Different Circumstances or Transactions.* In the attempt to narrow the number of acceptable accounting alternatives, the essential problem usually is to determine which transactions and their surrounding circumstances are sufficiently similar that one accounting method will reasonably provide meaningful and useful information, and which ones are sufficiently different that no one method will do so. For the latter situations, a further question is whether criteria can be developed that will give guidance as to which method should be used for a particular set of circumstances or for particular transactions.

That differing circumstances or wholly different transactions can require a different accounting method can be illustrated by the different methods for revenue recognition. Generally accepted accounting principles base the recognition of revenue upon the principle of realization in most circumstances. Where the collection of receivables can be estimated with reasonable accuracy at the time a transaction is complete, revenue is *realized* at the time of sale and its *recognition* for financial accounting purposes is ordinarily appropriate at that time. Thus, for example, many companies selling merchandise on the instalment plan have extensive credit experience, and can estimate within a close range the ultimate collections at the time of sale. With appropriate provision for bad debts, they *should* recognize revenue at that time for they have then taken all substantive steps necessary to earn the profit.

Other instalment or deferred payment sales may be made by companies having little credit experience, however, with down payments so small as not to lend assurance that the total contract price will be collected. In those circumstances, the principle of realization is *not* satisfied, and it would not be appropriate to recognize the entire revenue and profit at the time of sale.

From the above example, it can be seen that, though there is more than one method for recognizing revenue, there are criteria to determine the use of one over another in particular circumstances. Indeed, having more than one method is necessary to provide meaningful and useful information.

(c) *Other Alternatives.* As indicated in the above tabulation, some areas remain for which more than one generally accepted accounting method exist and for which generally accepted accounting principles do not prescribe criteria for applying a particular method based on particular circumstances.

An example is inventory, where the three principal methods are first-in, first-out (FIFO), last-in, first-out (LIFO) and average cost. Despite the lack of stated criteria, however, business enterprises apply inventory methods with reference to their particular circumstances, operations and prospects, and not in a vacuum. These considerations might include levels and necessity of cash flow (including tax considerations); current and predicted rates of inflation, nature of inventory components and frequency of inventory turnover, practicalities such as recordkeeping, and regulatory requirements and considerations. APB Opinion No. 22 requires disclosure of whatever inventory method is used, and APB Opinion No. 20 restricts change to another method unless management can justify that the new method is preferable in the circumstances. As mentioned above, the FASB decided in its first Interpretation that tax savings alone were not adequate justification for a change in inventory method.*

The Government's Cost Accounting Standards Board, which is charged, among other things, with achieving whenever possible uniformity and consistency in costing governmental contracts, has considered the question of alternative inventory methods. After lengthy study, publication of a proposed standard, and analysis of letters of comment, the CASB issued a cost accounting standard in 1975 permitting all three of the above generally accepted financial accounting methods of valuing inventory for government contract cost purposes, and requiring each contractor to adopt and adhere to a written policy of inventory valuation for each category of inventory.

5. *Materiality.*

In view of the literally thousands upon thousands of transactions and events reflected in financial statements, it would be impossible to communicate financial information in meaningful and useful terms without some basis for judging fairness and significance when portraying a business' operations and financial position to a user of financial statements. Yet the Study implies that the convention of "materiality" may not be in the public interest because it permits large corporations to avoid disclosures smaller companies must make, and thus their financial statements may result in "misleading" conclusions when compared with those of smaller companies.

Materiality, as it applies to accounting, is inherent in the exercise of judgment and is the standard adopted by Congress in the 1930's as the basis for all disclosure, both in financial statements and in reports and filings with the SEC, and for determining liability. The Federal Securities Laws require only the disclosure of material information, and predicate liability of management, accountants, underwriters and others on whether there has been a misstatement of, or an omission to state, a material fact.

* A conspicuous area in which uniform accounting standards might have been prescribed by the Federal Government, but have not been, is in the determination of taxable income. Essentially, the Treasury Department is determining periodic business income for Federal income tax purposes, just as financial accounting determines periodic business income for financial reporting purposes. Yet, both the Internal Revenue Code and IRS regulations provide corporate taxpayers with an enormous number of options and elections. This is illustrative of the difficulties in attempting to provide uniform standards covering a broad and diverse constituency.

The SEC has defined materiality, without objective criteria, in these terms:

“The term ‘materiality’ when used to qualify a requirement for the submission of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered.” (Rule 405 under the Securities Act of 1933.)

Similarly, the Government’s Cost Accounting Standards Board has regarded materiality in subjective rather than solely quantitative terms. A subjective concept of materiality has also been adopted by the courts as a means of guiding preparers and auditors of financial statements as to the inclusion of information which will be perceived useful by investors. The problems with a subjective definition are recognized, but as the number of court cases has increased and standards of liability have become more stringent, there has been a tendency to disclose more and more information. Concerned with the “unreadable prospectus”, the SEC has urged periodically in public releases that care be taken to include only material information, on the theory that an over-abundance of information obscures disclosures essential to investment decisions.

The FASB, too, is concerned with the concept, and currently has “Criteria for Determining Materiality” on its technical agenda. In 1975, the FASB issued a 246-page Discussion Memorandum on this topic and held hearings in mid-1976. The Board intends to progress further on its Conceptual Framework project before completing this project, inasmuch as a number of the more significant issues in assessing materiality are also involved in its Conceptual Framework project.

D. Corporate Accountability Problems.

1. Corporate Failures and Financial Difficulties.

By its failure to distinguish between the functions of financial accounting and reporting and those of internal controls and auditing, the Study creates the inaccurate impression that shortcomings in financial accounting are somehow largely responsible for the cases it cites of corporate failures and financial difficulties.

Analysis of the Study’s 20 cases* of corporate failure and financial difficulties indicates that virtually all involved fraud, dishonesty, falsification of books and records, inadequate or circumvented internal controls, errors in judgment proved wrong by subsequent events, or simply poor or inadequate management—but not inadequacy of accounting standards. This is not to minimize the significance of these problems or suggest they are not proper subjects for Congressional concern. On the other hand, we believe it important to place the factors contributing to these problems in proper perspective.

In a few of the cases cited it was asserted that use of accounting principles acceptable at the time may have been among the contributing factors. In these cases, however, the accounting issue arose from *applying* an accepted principle in circumstances where there were insufficient, inaccurate or misrepresented facts required to satisfy accepted criteria for the *use* of the principle, rather than acceptability of the accounting principle itself.

* Continental Vending; Four Brokerage Firms (Orvis Brothers, Francis I. du Pont, Dempsey-Tegeler, and Hayden Stone); Equity Funding; Four Seasons Nursing Centers; International Controls; Lockheed; Mill Factors; National Student Marketing; Penn Central; Republic National Life Insurance; R. Hoe; Stirling Homex; Talley Industries; U.S. Financial; Whittaker Corporation; Giant Stores; and Ampex.

In the four cases cited where there was any suggestion that an accounting principle may have been inadequate, the alleged inadequacies have been eliminated in subsequent authoritative pronouncements or guidelines. In three of those cases, Lockheed Aircraft Corporation, R. Hoe & Co., and Talley Industries, the ability to defer research and development costs was criticized, among other things. In 1974, the FASB eliminated accounting alternatives permitting deferral of those costs in its Statement No. 2, "Accounting for Research and Development Costs", which requires those costs now to be charged to expense when incurred, unless they have an alternate future use. In the fourth case, Continental Vending Machine Corporation, the court held that adherence to generally accepted accounting principles was not a conclusive defense in the particular circumstances presented, because additional disclosure about receivables from an affiliated party was necessary to present fairly Continental Vending's financial statements. Guidelines in the AICPA's subsequent codification of auditing standards and in the SEC's regulations now prescribe such disclosures.

It is interesting to note that a number of the most recent and disturbing examples of significant financial difficulties and even corporate failure have involved banks, notwithstanding close Federal regulation under the banking laws and required supervisory audits by bank examiners. As the General Accounting Office's recent report on banking problems indicates, financial difficulty and corporate failure play no favorites between regulated and unregulated industries when proper management standards and internal controls are stretched or ignored.

2. Questionable Payments.

A number of the corporate accountability problems cited by the Study relate to "questionable" or "improper" payments by corporations. As the SEC noted in its "Report on Questionable and Illegal Corporate Payments and Practices" submitted to a Senate Committee in May 1976, virtually all of these situations involved the deliberate falsification of books and records. The vast majority of these situations have involved off-book accounts, slush funds and other practices involving circumvention of internal controls. They have not, however, reflected a weakness or inadequacy in accounting standards or principles.*

Where irregularities in the financial accounts relating to improper payments did come to the attention of the auditors, the amounts involved generally were quantitatively immaterial in relation to the assets, revenues, income or net worth of the reporting company. Only comparatively recently has the SEC developed the concept of "qualitative materiality", whereby the disclosure of certain matters, because of their nature, are regarded as material to investors and shareholders without regard to their quantitative significance to the company's financial statements. The FASB's Discussion Memorandum, "Criteria for Determining Materiality", covers both quantitative and qualitative materiality.

The development of disclosure standards in the limited area of improper payments, first by the SEC and also by Congress if legislation is adopted, does not support the Study's

* Recently proposed SEC Regulation 13B, "Accuracy of Books, Records and Reports", and Senate Bill S. 305, recognize implicitly that the prevention of illegal and questionable corporate disbursements through the falsification of accounting records rests in the enforcement of internal accounting controls, rather than in new accounting standards. The AICPA's Auditing Standards Executive Committee has also taken action in recent months to clarify auditors' responsibilities relating to illegal acts and the detection of errors and irregularities.

assertions that financial accounting standards are inadequate, or should be established by the Federal Government. Rather, the issues involved in such situations were issues principally of general corporate reporting.

IV. SEC REVIEW AND PARTICIPATION IN THE STANDARD-SETTING PROCESS

Congress created the SEC in 1934 to be the expert representative and guardian of the investing public, and the SEC has been actively involved in accounting matters since its inception. The Commission's policy decision in 1938 to permit the accounting profession to play an active role in establishing and improving accounting standards was made, not as "delegation" of power to the profession, but to assure that Congress' mandate in the Federal Securities Acts as to the position of the accounting profession and the importance of financial statements would be met. As stated at the time, and reaffirmed in 1973 in Accounting Series Release 150, the Commission accepts as authoritative only those accounting standards with which it does not disagree and which it finds are necessary or appropriate for the protection of investors. While looking to the accounting profession to take initiative in setting accounting standards, the Commission has reserved, and over the past 40 years frequently has exercised, its power to anticipate or set aside the profession's standards for those the Commission has found preferable.

ASR 150 benefits public investors by providing a framework for the preparation of financial statements filed under the Federal securities laws, parallel to that imposed on independent auditors through Rule 203 of the AICPA's Code of Professional Ethics. By recognizing the FASB and its predecessors' pronouncements as authoritative and binding and presumptively not misleading for purposes of the SEC's administrative policy, ASR 150 has contributed significantly to certainty and consistency in the preparation of financial statements for publicly-owned companies. ASR 150 is an administrative statement of policy to guide, but not inflexibly control, the SEC's staff in taking such action on a day-to-day basis as may be appropriate to resolve specific accounting problems of individual publicly-owned companies. As a statement of policy which is not finally determinative as to the selection or application of accounting standards or the acceptability of individual filings and reports, ASR 150 has been held not to constitute a substantive rule, for the SEC has not delegated any of its authority, or given up any right to reject, modify or supersede FASB pronouncements through its own rule-making procedures. Contrary to the Study's legal analysis, the Federal District Court referred to on page 178 of the Study clearly understood the benefits and the circumstance of ASR 150 as not being violative of the Commission's rule-making procedures, and not in any sense amounting to any "delegation" or "abdication" of its Congressionally mandated responsibilities. As the Court said in refusing to enjoin application of ASR 150 by the Commission (Study at pp. 1554-55):

"ASR 150 emerges, then, as a method by which the SEC will evaluate accounting principles. It does not ordain the result of that evaluation. It does not prescribe per se approval to or rejection of any accounting principle. It merely acknowledges a fact, the existence of an authoritative body of principles, and says that it will credit those principles.

"It is not a conditional imperative, which is the characteristic of a substantive rule.

"Nor is ASR 150 rendered invalid by the hyperbole that the SEC has delegated impermissibly its rule-making authority to FASB. True, ASR 150 will encompass not only past, but future accounting principles approved by the FASB, but those

prospective principles will have no greater force than the present ones do. The SEC will consider them authoritative, which they clearly are and will be, but ASR 150 does not even suggest that the SEC will abdicate its ultimate responsibility to judge the propriety of the accounting principles employed by a registrant.”

The SEC's record over the years conclusively disposes of any claim that it has “delegated” its responsibilities over accounting matters to the FASB, the AICPA, the accounting profession or anyone else.

In 1940, within two years of first announcing the policy reaffirmed in ASR 150, the Commission adopted its comprehensive Regulation S-X, setting forth its requirements as to the form and content of financial statements filed with it under the Federal Securities Laws. On numerous occasions since then the Commission has amended Regulation S-X to meet new disclosure needs.

The Commission has also issued over 200 Accounting Series Releases (over 70 within the past five years) covering a variety of accounting, auditing and related financial and accounting matters, some of which have conflicted with, or effectively amended or superseded, standards set by the accounting profession's authoritative standard-setting bodies.

For example,

- in its ASR 96, the Commission rejected APB Opinion No. 2 and permitted financial statements filed with it to reflect either of the two most prevalent alternatives for reflecting the effect of the investment tax credit;

- in ASR 147, the Commission characterized lessee disclosures required by APB Opinion No. 31 as inadequate, and imposed additional disclosure requirements of its own;

- in ASR 148, the Commission adopted accounting rules for certain liabilities on the balance sheet, which prompted FASB Statement No. 6, “Classification of Short-Term Obligations Expected to be Refinanced”;

- in 1975, the Commission became concerned that gain from early extinguishments of debt, then required by APB Opinions to be reflected as ordinary income, were inflating earnings of some companies and urged the FASB to take prompt action, indicating that it would do so if the FASB did not; the result was FASB Statement No. 4; and

- in recent weeks, the Commission has proposed to amend Regulation S-X to adopt FASB Statement No. 13, “Accounting for Leases”, and to accelerate its retroactive applications except for companies unable to resolve problems in connection with restrictive clauses in loan indentures or other agreements.

The Commission has taken still other steps to implement its views in other areas, notwithstanding the existence of accounting standards established by the profession's standard-setting bodies. Among other examples are accounting for business combinations as poolings of interests (ASR's 130, 146 and 146A); catastrophe reserves (ASR's 134 and 145); disclosure of inventory profits (ASR 151); capitalization of interest (ASR 163); disclosure of unusual risks and uncertainties (ASR 166); disclosures relating to the adoption of LIFO (ASR 169); disclosure as to holdings of securities of New York City and accounting for securities subject to exchange offers and moratoria (ASR 188); and disclosure of replacement cost data (ASR's 190 and 203).

The Commission also provides for additional financial information in its general corporate disclosure requirements. For instance, concerned with recent bank failures and financial difficulties, the Commission issued a disclosure guide which requires additional financial statistical information in registration statements of bank holding companies under the Securities Act of 1933. The required information includes average balance sheets for each reported period, analysis of investment portfolio loans and deposits, and return on equity and assets. Similarly, prior to FASB Statement No. 14, "Financial Reporting for Segments of a Business Enterprise," the Commission required revenue and income information with respect to reporting companies' lines of business and revenues for classes of similar products as part of its general disclosure requirements.

Through its continual review of the application of accounting standards in financial statements included in reports and filings of publicly-owned corporations, the SEC also has daily opportunities to evaluate the selection and application of accounting standards to the facts and circumstances of particular cases. This is a very important part of the financial reporting system because it permits the SEC, which otherwise might have to consider accounting standards only in general or theoretical terms, to evaluate the selection and application of standards to the facts and circumstances of particular cases. The SEC has not hesitated to insist upon changes in the accounting standards applied when it has found this to be in the interests of investors.

Since 1975, the SEC has published Staff Accounting Bulletins for the purpose of broadly disseminating the views and practices of its staff on the form and content of financial statements filed with it. In its release announcing these bulletins, the SEC noted that the dynamic and evolutionary character of financial reporting required new and revised interpretations and practices, and that the Commission viewed these bulletins as a means of publicizing broadly, particularly for the benefit of smaller accounting firms with less frequent SEC contacts, SEC staff practices and policies as they evolve.

Staff Accounting Bulletins published to date have covered a wide range of accounting and reporting subjects, including business combinations, financial statements for foreign companies, balance sheet presentations, real estate companies, finance companies, taxes, consolidated financial statements, qualitative disclosures, interim financial statements, replacement cost disclosures, and requirements with respect to accounting changes.

The Commission meets its statutory responsibilities in still other ways which belie the Study's assertion of "delegation".

Pre-filing assistance and interpretative advice are available for resolution of particular accounting problems. These may occur in situations where a company and its independent accountants disagree but typically occur when unusual circumstances are presented, with a solution usually resulting following discussions with the SEC's Division of Corporation Finance and/or the Office of the Chief Accountant. The Commission has also announced procedures by which its views may be obtained when its staff, upon request or on its own motion, presents questions involving matters of substance or where the issues are novel or highly complex. Additionally, the SEC's Rules of Practice provide that any person desiring issuance, amendment or repeal of a substantive or interpretative rule or general statement of policy may petition for such action.

The SEC maintains close review liaison with the FASB: The Commission's Chief Accountant attends meetings of the Advisory Council; members of the Commission's accounting staff attend meetings of the FASB's task forces, the Screening Committee on Emerging Problems, and the FASB's public hearings; and FASB staff members regularly attend meetings of the Commission's Advisory Committee on Corporate Disclosure and its

Replacement Cost Advisory Committee. Projects have been put on the FASB's agenda at the Commission's request, and the FASB included data in its December 1976 Discussion Memorandum on "Financial Accounting and Reporting in the Extractive Industries" which the SEC had prepared to elicit views pursuant to its responsibilities under PL 94-163.

V. CAN GOVERNMENT DO BETTER?

The comprehensive financial information and corporate disclosures required in the United States have greatly contributed to its status as the world's major capital market. Despite troublesome issues involving "questionable" or "improper" corporate payments, the fact remains that the United States' financial accounting standards and corporate disclosure requirements are the most highly developed and most rigidly enforced in the world, providing financial information relied on for its integrity, accepted for investment decisions and presented in a manner understandable to the investing public. The role of the FASB as the authoritative standard-setting body, with support within the private and public sectors and SEC review and participation, should not be displaced or its authority diminished, in favor of experimentation with an untried system of direct Federal accounting standard-setting.

The Study recommends Federal Government accounting standard-setting based on the unfounded conclusion that a Government agency will achieve uniformity in setting accounting standards which the FASB and its predecessors have been unable and unwilling to do. As discussed above and in Exhibits D and E, the FASB and its predecessors have made significant progress in eliminating alternatives not justified by differing circumstances and transactions, and in some cases have eliminated all alternatives in favor of a uniform standard.

To support its recommendations, the Study cites the Cost Accounting Standards Board and suggests creation of a Federal board for financial accounting standards modeled after the CASB. However, the Study devotes less than four pages to the CASB and attempts little or no discussion or analysis of the CASB's published accounting standards other than to conclude that "most of them have been responsive to the Federal Government's needs for uniform and meaningful cost accounting standards." The Study similarly contains no discussion or appraisal of other Federal Government experiences in setting accounting standards, nor does it mention that Government standard-setting bodies have been adopting FASB Statements in rule-making proceedings for companies under their jurisdiction. Some discussion and appraisal of this seems appropriate. The FAF and FASB believe that when viewed objectively, the Federal Government's experience to date does not support the Study's assertions and certainly is not a basis on which to consider the changes the Study recommends.

The following appraisal is not a criticism of Government efforts in setting accounting standards. Rather, it points out two critical facts overlooked by the Study. First, the scope of the Federal Government's efforts in setting accounting standards is limited when compared to the scope of the FASB's work. The FASB is charged with improving standards of financial accounting and reporting for all operations of all companies, in all industries and in all environments. The Federal Government's efforts, on the other hand, have been restricted to particular kinds of transactions or industries or for a specific function of Government. Second, the Federal agencies involved, after studying the facts, have concluded that the existence of accounting alternatives is not necessarily inappropriate *per se*.

A. Cost Accounting Standards Board

The CASB was created as an agent of the Congress in August 1970 by an amendment to the Defense Production Act of 1950 and was formally organized in 1971. The Comptroller General of the United States is Chairman and appoints the other four members of the Board, of whom two are from the accounting profession (currently a partner and the retired senior partner of two "Big Eight" firms), one from private industry and one from the Federal Government. The Act prescribes the CASB's function as follows:

"The Board shall from time to time promulgate cost-accounting standards designed to achieve uniformity and consistency in the cost accounting procedures followed by defense contractors and subcontractors under Federal contracts."

Standards promulgated by the CASB are submitted to Congress and, unless disapproved within 60 days by concurrent resolution, have the full force and effect of law.

The CASB, like the FASB, is a panel of experienced experts, and the two Boards and their staffs maintain continuing liaison and comment on each other's proposed pronouncements. Additionally, two members of the CASB, including the Comptroller General of the United States, are members of the FASB's Advisory Council. The CASB also relies on cooperation in technical matters from a special AICPA committee formed for that purpose.

The Study cites the CASB as a particular instance of a Government agency performing a standard-setting function similar to that performed by the FASB. Analysis of the purpose and mandate of the CASB reveals several factors which significantly distinguish its task from that of the FASB and does not support the Study's recommendation that the Federal Government take over financial accounting standard-setting.

First, the scope of concern to the CASB—developing cost accounting standards for companies contracting with Federal Government agencies, principally in defense procurement—is much narrower and more specialized than the FASB's responsibility for developing accounting standards to be applied in the preparation and presentation of financial statements for all publicly and privately-owned companies.

Second, the objective of the CASB—to achieve increased comparability and uniformity of cost accounting procedures for Government contracts in order to facilitate Government procurement—is a particularly appropriate objective to be carried out by a Governmental entity. By contrast, the FASB's objective of establishing and improving financial accounting standards is designed to meet the varied needs of investors, creditors and other members of the public engaged in investment decisions and private capital formation and allocation. As discussed above, this task is infinitely more complex, the constituency is significantly larger and more diverse, and the subject matter is not limited to a special function of Government.

Third, the volume of work produced by the FASB and the CASB does not support the Study's assertions. Both bodies have been in existence a relatively short time—just under four years for the FASB and a bit more than six years for the CASB. Without considering the differences in scope and complexity of subject matter and periods of existence, the FASB's output of 14 Statements, 18 Interpretations, 20 Exposure Drafts, 13 Discussion Memoranda, and 15 public hearings compares favorably with that of the CASB.

The Study repeatedly criticizes the accounting profession and the FASB for failing to achieve "uniformity" by not eliminating alternative accounting methods. However, the

CASB has also concluded that uniformity in cost accounting is not always desirable, if indeed possible. In its Statement of Operating Policies, Procedures and Objectives (March 1973) the CASB recognized "the impossibility of defining or attaining absolute uniformity, largely because of the problems related to defining like circumstances." This statement continues: "The Board does not seek to establish a single uniform accounting system or chart of accounts for all the complex and diverse businesses engaged in defense contract work. On the other hand, if the Board were to be satisfied that circumstances among all concerned contractors are substantially the same, the Board would not be precluded from establishing a single accounting treatment for use in such circumstances." Statement of Operating Policies, Procedures and Objectives (March 1973), p. 2.

A brief review of several of the CASB's cost accounting standards is illustrative.

In January 1975, the CASB issued Cost Accounting Standard 409 relating to depreciation, an area in which the Study is critical of the FASB and the accounting profession for not eliminating alternative methods. The CASB studied the depreciation question over a long period, through extensive research involving distribution of a preliminary draft standard, analysis of comments from over 100 respondents, a field survey of over 100 profit centers selected as representative of industry, analysis of data developed by the Treasury Department and the AICPA, publication of a proposed standard, analysis of an additional 200 letters of comment, and discussions with representatives of many groups. After this analysis and review, the CASB concluded in the preamble to its Standard:

"[N]o particular method [of depreciation] is necessarily appropriate for all contract cost accounting situations. The Board is establishing criteria by which the method or methods appropriate in the specific situation can be determined." (40 FR 4259)

A second area of CASB study has been accounting for costs of material. In 1976, after a lengthy study comparable to its study of depreciation, the CASB issued its Cost Accounting Standard 411. Standard 411 prescribes that, while a contractor must adopt a written policy with respect to the accumulation and allocation of the cost of material and must consistently adhere to that policy, any of the following five methods of costing can be used for Government contract purposes: (1) first-in, first-out (FIFO), (2) moving average cost, (3) weighted average cost, (4) standard cost, or (5) last-in, first-out (LIFO).

CASB Cost Accounting Standard 404 for capitalizing tangible assets is another instance where the CASB concluded that diversity of normal business practice made it undesirable to adopt a uniform cost standard. Standard 404 requires each contractor to establish and adhere to a "reasonable" capitalization policy, but does not require a single standard for all contractors nor provide a specific definition of "reasonableness". In its preamble, the CASB stated "in most cases, the contractor is best able to determine what policy will be most suitable for his situation. . . ." (38 FR 5318)

These Cost Accounting Standards are instructive in that they reflect, even in the comparatively narrow area of costing for Government contracts, that alternative accounting practices frequently are necessary or desirable. The experience of the CASB is independent verification that use of a single accounting method does not necessarily assure the most meaningful and useful information.

B. Securities and Exchange Commission

Significant to evaluating the effectiveness of the FASB in providing meaningful financial information to public investors are SEC's actions to amend or rescind certain of its own requirements and guidelines in order to conform them to subsequent FASB Statements.

—in ASR 173 and ASR 184, the SEC rescinded its guidelines in ASR 148 concerning the classification of commercial paper and short-term debt expected to be refinanced, and directed that financial statements filed with the Commission after December 26, 1975 follow the criteria set forth in FASB Statement No. 6.

—in ASR 178, the Commission amended its Regulation S-X and rescinded its interpretation and guidelines in ASR 141, in order to conform certain of its requirements respecting accounting for research and development costs to FASB Statement No. 2, issued in October 1974.

—in ASR 181, the Commission amended Article 5A and certain rules in Regulation S-X specifying requirements for the form and content of financial statements and schedules filed by certain companies in promotional, exploratory or other stages of development. Noting that these requirements had been adopted by the Commission when there were no authoritative statements of the accounting profession regarding the appropriate accounting and reporting directly applicable to such companies, and referring to ASR 150, the Commission took its action as the result of FASB Statement No. 7, issued in June 1975.

—most recently, in Securities Act Release No.—5812 and ASR 211, the Commission proposed to amend its Regulation S-X and rescinded its interpretation in ASR 132, in order to conform certain of its requirements respecting accounting for leases to FASB Statement No. 13, issued in November 1976.

These significant actions cannot be brushed off and viewed as evidence that the SEC has “delegated” its accounting responsibilities. Each one of these actions was taken or, in the last case, proposed, in full compliance with the Administrative Procedure Act and with ample opportunity for public comment. The only proper analysis is that an agency of the Federal Government, charged with statutory responsibilities to the public, has determined, after opportunity for public comment, that the FASB's accounting standards provide meaningful financial information for public investors.

C. Other Federal Agencies

Conforming Federal accounting practices to FASB pronouncements has not been limited to the SEC. For example, both the Interstate Commerce Commission and the Civil Aeronautics Board have taken action to incorporate FASB Statements and in some cases APB Opinions into their uniform systems of accounts. In fact, the ICC has been directed to take such action by Congress, as discussed below.

1. Interstate Commerce Commission

The Interstate Commerce Commission has been setting accounting standards for common carriers subject to its jurisdiction for over 70 years.* Since the mid-1950's, the ICC

* The Interstate Commerce Act of 1867 authorized the ICC to require annual reports from carriers, and in 1907 the ICC established a uniform system of accounts, which has been revised substantially over the years.

has been conforming its uniform system of accounts in many respects to generally accepted accounting principles, and in recent pronouncements the ICC has relied on the FASB (and its predecessor, the APB) as the authoritative source of such principles.* The ICC's Director of Bureau of Accounts is a member of the FASB's Advisory Council.

Since August 1974, the ICC has promulgated a number of significant amendments to its uniform system of accounts to conform to generally accepted accounting principles. In almost every case of revision, the ICC has determined that the pronouncements of the FASB and its predecessor set forth principles appropriate to be adopted by the ICC as being consistent with the purposes of the Interstate Commerce Act and in the public interest.

For example, in December 1975 the ICC's Bureau of Accounts issued two Accounting Series Circulars for the express purpose of conforming the ICC's rules to recent statements by the FASB. Circular No. 154 incorporates FASB Statement No. 6 into the uniform system of accounts. Circular No. 157 establishes standards of accounting for loss contingencies and also incorporates FASB Statement No. 5 into the uniform system of accounts. In October 1976 the ICC's Bureau of Accounts stated that its standards applicable to accounting for marketable securities were those set forth in FASB Statement No. 12, and required carriers to conform to Statement No. 12 or to provide full footnote disclosure of the required information.

In 1974, the ICC made three major changes in its uniform system of accounts, in each case relying on an Opinion of the Accounting Principles Board. These changes required that a statement of changes in financial condition be included in annual reports (APB Opinion No. 19); that investments of more than 20% in non-consolidated subsidiaries be accounted for on the equity method of accounting (APB Opinion No. 18); and that the principles of interperiod tax allocation set forth in APB Opinion No. 11 be followed by carriers subject to its jurisdiction.

Earlier this year, the ICC adopted the principles set forth in FASB Statement No. 13, "Accounting for Leases", as part of its uniform system of accounts.

Finally, Congress, in the Railroad Revitalization and Regulatory Reform Act of 1976, directed the ICC to prescribe a cost and revenue accounting system for railroad carriers in accordance with generally accepted accounting principles, and directed that disclosure in all reports comply with generally accepted accounting principles and SEC requirements.

2. Civil Aeronautics Board

Pursuant to the Federal Aviation Act of 1958, the Civil Aeronautics Board ("CAB") established a uniform system of accounts to be used by air carriers subject to its jurisdiction. Since then, the system has frequently been revised with the objective of conforming it to generally accepted accounting principles.

By way of recent illustration, on December 23, 1976 the CAB revised its method of accounting for changes in the valuation allowance for a marketable equity securities portfolio to reflect the standards established by FASB Statement No. 12. Previously, on

* During the 1950's, industry, the accounting profession and Congress expressed concern with respect to the major disparities between accounting principles, particularly for railroads, prescribed by the ICC in its uniform system of accounts, and generally accepted accounting principles. In April 1957 the Legal and Monetary Affairs Subcommittee of the House Committee on Government Operations held hearings on railroad accounting procedures for the purpose of investigating charges that the ICC had not directed that sound accounting principles be followed by the railroads. In response to the hearings, the ICC in 1957 made revisions to its system of accounts to eliminate certain disparities cited by the Committee.

March 9, 1976, the CAB had eliminated self-insurance reserves from its forms to comply with the requirements of FASB Statement No. 5 concerning accounting for contingencies.

Finally and quite recently, the CAB, like the ICC, announced its intention to incorporate the provisions of FASB Statement No. 13 into its regulations for lease transactions.

CONCLUSION

As documented in this Statement of Position and its supporting Exhibits, the FASB acts with integrity, independence and objectivity in establishing meaningful and useful financial accounting and reporting standards. This, and the Board's procedures for broad public participation, its breadth of support and the acceptance of its pronouncements within the private and public sectors, and the SEC's continuing review and participation, are assurances that the FASB's financial accounting standards serve the public interest and are responsive to needs of financial statement users.

The task of setting accounting standards is complex and demanding, and the effort, and risks, in developing and launching a new and untried system without widespread support and cooperation would be substantial and disruptive of progress now being made. The FAF and FASB are confident that the Subcommittee, on review of a complete, accurate and balanced record, will agree that the existing structure with the FASB as the standard-setting body provides the best assurance for continued progress and improved financial accounting and reporting, to the benefit of the public and the Government alike.

For all the reasons discussed and as further documented in Exhibits A through E, the FAF and the FASB respectfully urge the Subcommittee:

1. To reject the Study's recommendation that the Federal Government directly establish financial accounting standards for publicly-owned corporations; and
2. To reject any similar recommendation which might have the effect of replacing the FASB as the authoritative accounting standard-setting body, or reducing its status to that of an advisory or consulting body to others.

FURTHER INFORMATION

The FAF and FASB would be pleased to supplement or elaborate on the matters set forth in this Statement of Position or any of its supporting Exhibits, as may be requested by the Subcommittee in the exercise of its oversight responsibilities.