

1-1982

Acknowledging The SEC As Standard Setter: Heresy, or Accounting Realism?

William J. Radig

Roland L. Madison

Follow this and additional works at: <https://egrove.olemiss.edu/wcpa>



Part of the [Accounting Commons](#), and the [Women's Studies Commons](#)

Recommended Citation

Radig, William J. and Madison, Roland L. (1982) "Acknowledging The SEC As Standard Setter: Heresy, or Accounting Realism?," *Woman C.P.A.*: Vol. 44 : Iss. 1 , Article 5.

Available at: <https://egrove.olemiss.edu/wcpa/vol44/iss1/5>

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Woman C.P.A. by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.

Acknowledging The SEC As Standard Setter

Heresy, or Accounting Realism?

By William J. Radig and Roland L. Madison

Much has been written recently about who should establish financial reporting and accounting standards.¹ Many authors are proponents of the traditional private sector view of establishing accounting principles and offer many arguments to support this position. Others have utilized survey techniques in an attempt to determine what the popular preference is in this matter.²

In a previous article in *The Woman CPA*,³ the authors discussed the logical advantages for public sector leadership of the accounting profession and attempted to allay the fears many held of the change that has occurred. Unfortunately, it became evident that the fear of public sector leadership was so great that the reality of the situation was not comprehended.

The time is past for a further polemic designed to convince accountants that public sector leadership may be in the best interest of the profession as well as the public. The purpose of this article is to show that the transition to public sector leadership of the profession by the Securities and Exchange Commission (SEC) is nearly complete and lacks only formalized acceptance.

A previous article attempted to dispel some of the irrational fear of the SEC being formally and publicly

named as the U.S. standard setting body. It was assumed that only the most misinformed would argue against the point that the SEC has, during at least the last ten years, become the true and active master of the U.S. accounting profession in the establishment of financial accounting and reporting standards.

Attention should be turned now to the gradual and subtle assumption of the standard setting function by the SEC. Then the authors will present the logical directions that the standard setting quest may take in the future.

The SEC vs. The Accounting Principles Board

One of the earliest examples of the SEC's power to veto accounting standards established in the private sector was the 1964 SEC position on accounting for the Investment Tax Credit (ITC). The Accounting Principles Board (APB) issued Opinion No. 2 calling for the "asset reduction," and "deferred" recognition of ITC benefits. The SEC favored the "flow through" method whereby the full benefit of the credit is recognized in the current period as a reduction of income taxes. The APB was forced to reconsider its position and accept either accounting treatment of the

credit, thus acknowledging its defeat by the public sector in APB Opinion No. 4. This action by the SEC put the APB on notice that it not only had the authority to establish accounting standards, but that it would use this authority when deemed necessary. Some years later, when the then suspended ITC was reinstated, the U.S. Congress specifically stated that no standard setting body (including the SEC) could specify a single accounting treatment for this tax credit.

With the issuance of two very controversial pronouncements⁶ in the early 1970's, many scholars felt that the APB virtually determined its fate and set the stage for the SEC as the next truly authoritative body to establish accounting and reporting standards in the United States.

While the Trueblood and Wheat Committees labored to develop a solution to insure the retention of the standard setting function in the private sector, the APB hurriedly issued several authoritative pronouncements (1971-1973) as a reaction to SEC stimulus. An interesting point is that while the APB issued a total of thirty-one opinions in nearly fourteen years, seventeen of these opinions came in the last four years of its existence. Some may feel that coincidentally all of the eggs (opinions) hatched at once — others would observe that the SEC, with John Burton as its aggressive chief accountant, just turned up the heat!

One topic that was brought to a boil during this time was leases. Leases as a means of acquiring the right to use property proliferated markedly throughout the postwar period. However, it was the decade of the 1960's that saw the greatest expansion, not only in the volume of leasing transactions, but also in the variety of application and degree of sophistication of the techniques employed.⁷

Unfortunately, the APB rejected the conceptually sound recommendations in Accounting Research Study No. 4 (1962), authored by Professor John H. Myers, and issued two opinions which permitted the lessor and lessee to utilize inconsistent accounting treatments.⁸

The APB acknowledged that certain questions remained in connection with Opinions 5 and 7. Instead of solving the problems, the APB

The FASB has not fared extremely well in the evolution and development of accounting standards.

decided to deal only with additional disclosure requirements by the lessee and let the soon-to-be-formed Financial Accounting Standards Board (FASB) study the conceptual problem of leases.

Here again, the private sector failed to act on its own initiative, requiring motivation by the SEC before taking partial action only. In late 1972, the SEC announced its intent to establish a disclosure standard for leases. When the APB reacted with an exposure draft in January 1973, the SEC suspended action to watch for progress. Instead, the exposure draft was recalled and tabled by the APB in April of that year. At this point, the SEC moved ahead in June of the same year with a proposal to amend Regulation S-X to require substantial disclosures by the lessee. Thus, when it became apparent that the SEC was not going to tolerate further delays, the APB issued Opinion No. 31 "Disclosure of Lease Commitments by Lessees"⁹ in late June 1973. The SEC, however, did not retract its proposal, but pressed on and issued Accounting Series Release (ASR) No. 147 in October 1973. This pronouncement imposed essentially the same disclosure requirements with respect to total rental expense and minimum rental commitments as APB Opinion 31. However, it made mandatory the disclosure of the present value of certain lease commitments and required disclosure of the impact on net income had the "financing" leases been capitalized.

The FASB: How Has It Fared?

Shortly after the lease disclosure confrontation the Financial Account-

ing Standards Board (FASB) was formed as a result of the Wheat Committee Report. This was soon followed by the controversial Trueblood Committee Report entitled "The Objectives of Financial Statements" (1973). The report signaled the formal beginning of the important and crucial conceptual framework study. Still incomplete, the study purportedly will develop a coherent conceptual basis from which the FASB could develop and issue conceptually sound financial reporting standards, which would enable the accounting profession to retain the standard setting function in the private sector.

Unfortunately, the FASB has not fared extremely well in leading the profession toward the evolution and development of accounting and financial reporting standards. An observation from a study¹⁰ that was chaired by the distinguished scholar Yuji Ijiri may be quite valuable in understanding the recent aggressive actions taken by the SEC in the establishment of accounting standards. The study implies that the early FASB standards were based upon research and sound conceptual reasoning while several of the later standards were not so supported. Thus, they were subject to more criticism and second-guessing, causing certain standards to require interpretation and others to be superseded and reissued by the FASB. Other standards were either issued or revised under pressure from the SEC.

The reality of the public sector's influence and dominance in each area should be apparent after the following accounting areas are considered.

Leases Revisited

The FASB had to issue two exposure drafts on leases (August 1975 and July 1976) before it released FASB Statement No. 13, "Accounting for Leases" (November, 1976). Since its release, that Statement has been amended and interpreted so many times (13 to be exact), that the FASB has issued a codification of the lease pronouncement.¹¹ When considering these numerous changes, it should be noted that the Research Impact Committee Report stated: "Very little research was cited in either the discussion

memorandum or the final standard."¹² Instead of applying the conceptual approach, as taken by J.H. Myers' Accounting Research Study No. 4 (1962), the FASB "appeared to be aiming at simply reconciling extant pronouncements on lease accounting."¹³

Inflation Accounting

By issuance of ASR No. 190 in March, 1976, the SEC began applying very real pressure for an authoritative pronouncement on inflation accounting from the private sector. This pronouncement requires the disclosure of certain replacement cost information for inventories and depreciable assets. In an August 1979 speech, Harold Williams, Chairman of the SEC, told nearly 3,000 members of the profession to look to other countries for inflation accounting proposals — and then move quickly — or else the public sector would act.¹⁴

In response to a question from Professor Madison, Clarence Sampson, Chief Accountant of the SEC, stated that ASR No. 190 would probably be withdrawn if the current FASB exposure draft "dealing with the inflation accounting problem" was adopted.¹⁵ After certain revisions, this exposure draft was adopted as SFAS No. 33 "Financial Reporting and Changing Prices" (September, 1979) and the SEC then withdrew ASR No. 190. Logic would, therefore, dictate that if the FASB had not acted, the SEC would have actually set a standard in this area.

Oil and Gas Accounting

In contrast to SFAS No. 13 (leases), the FASB appears to have made a conscious effort to apply logical reasoning in their choice of alternatives in SFAS No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies," (December, 1977). This standard makes substantial use of relevant literature, conceptual as well as empirical. SFAS No. 19 required the use of the "successful efforts" method of accounting for exploration costs. The SEC, however, acting under its powers and interpretations of the Energy Policy and Conservation Act (EPCA) of December, 1975, rejected SFAS No. 19 as inadequate. The SEC preferred to develop a combined current- and present-value method

called "Reserve Recognition Accounting." The SEC mandated a three year development and implementation period for this new method. Accordingly, the FASB issued Statement No. 25 (December, 1978) which suspended certain SFAS No. 19 requirements in order to resolve the conflict with the SEC.

Foreign Currency Translation

Since 1975, the financial and industrial sectors have objected to the volatile earnings pattern caused by the SFAS No. 8 requirement that adjustments from translations of foreign currency financial statements should pass through the income statement.

Recently, the FASB tentatively proposed that these adjustments should not be a determinate of current income, but should be reported "as a separate component of stockholders' equity."¹⁶ The FASB, like the earlier APB is subject to pressures from the industrial community, as well as from the SEC.

Report on Internal Control

In the area of auditing standards, the SEC recently withdrew¹⁷ a proposal (SEC Release No. 34-15772) dated April 30, 1979, to require auditors to report in published financial statements their opinion on the adequacy of internal accounting controls maintained by management. The proposed Accounting Series Release was withdrawn only after the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) issued an exposure draft,¹⁸ which moved substantially in the direction of the SEC proposal. Again, the profession was forced to react rather than act on its own initiative.

Other Issues

Other areas of SEC influence upon standard setting include:

Segmental reporting by diversified companies (SFAS No. 14, 1976).

Prior Period Adjustments (SFAS No. 16, 1977)

Auditor's Responsibility for the Detection of Errors or Irregularities (SAS No. 16, 1977)¹⁹

Illegal Acts by Clients (SAS No. 17, 1977)
Required Communication of Material Weaknesses in Internal Accounting Control (SAS No. 20, 1977)

The Future: Private or Public Sector?

The literature abounds with the

opinions of many noted writers concerning the establishment of financial reporting standards. Two quotations have been selected which convey the feelings of many accountants with respect to the present dilemma.

A.A. Sommer, Jr., former SEC Commissioner said:

As one reads this history (of the profession), and then looks at the continuing problem with adequate financial reporting, one is tempted to conclude that indeed the Commission should undertake a full exercise of its statutory powers and through its own efforts, bring forth a sufficient, workable set of accounting principles. ("The SEC and the FASB: Their Roles" Speech at the University of Washington, Seattle, Washington, January 21, 1974).

Leonard M. Savoie, former Executive Vice President of AICPA, has stated:

For sentimental reasons I still prefer to see accounting standards set in the private sector, but I can no longer advocate this position with great conviction. My reasons are that standards are now being determined largely in the public sector, and inevitably the function will be taken over completely by the public sector. The SEC occupies a dominant position in determining accounting standards and the APB a subordinate one. The FASB will have the identical relationship with the SEC . . . that is, the SEC will be dominant and the FASB will be subordinate. ("Accounting Attitudes" Financial Executive, October, 1973, pp. 78-80.)

It is apparent that the evidence presented herein gives a great deal of validity to Mr. Savoie's 1973 statement with one small adjustment due to the seven year time differential. The SEC is dominant and the FASB is now subordinate.

Both an earlier article and this one have been written with the thought by the authors that the profession could offer an "offensive surrender."

One potential action would be to force the SEC to formally and publicly accept complete responsibility for accounting and reporting standards and allow the accounting profession to serve primarily in a statutory audit function. Such is the case in several European accounting organizations.

If responsibility were transferred it would significantly reduce the veil of "safe harbor" under which the SEC has operated for many years. With the accounting profession removed

Coalition of the accounting profession and the private industrial sector would be a powerful deterrent to SEC intrusion.

as the proverbial scapegoat, the SEC would have to assume the major responsibility for any failure to establish proper accounting standards and disclosure requirements. Due to several factors, many of which are prevalent on the continent, it is quite possible that auditing fees for corporations and the public could be reduced. These factors include providing businesses with a government approved list of statutory auditors, the requirement that the fee structure to be based upon "turnover" or total assets, and the imposition of severe civil and criminal penalties for noncompliance with statutory requirements. Auditor rotation would probably be quite minimal since some of the motives presently responsible for changing auditors in the United States, i.e., shopping for fees, interpretative accounting disclosures and audit differences, would be greatly reduced.

Of course the SEC may simply refuse to assume complete responsibility for the development of accounting and financial reporting standards. When offered this responsibility, the SEC may prefer to return to the position of being a strong cooperative supporter and ally of the accounting profession and the major stock exchanges (circa 1935-1960).

Although such a move is possible, it is not very probable given the recent aggressive actions of the SEC in the last ten years. A more probable event (means to an end, actually) is that the accounting profession and the private industrial sector

would form a joint effort to repel a very demanding intruder that is common to each. There is, in fact, some evidence that this action may have already begun.

The Foreign Corrupt Practices Act (FCPA) of 1977 had been widely criticized by both corporate management and accounting firms. The Act has two parts. The "antibribery" portion is administered by the criminal division of the Justice Department while the "accounting standards" portion is enforced by the SEC. The Justice Department indicated it would review either past or future "questionable payments" presented to it voluntarily and give its opinion as to their legality under the FCPA. Originally the SEC opposed such a review and stated that it would not be bound by a decision of the Justice Department not to prosecute an entity or person under the anti-bribery provision.²⁰

Much of the confusion experienced²¹ by corporate executives and accountants over provisions and interpretations of the Act may soon be eliminated. Senator John Chafee, charging that international trade has suffered "a chilling effect" from the ambiguities in the FCPA, has introduced the Business Accounting and Foreign Trade Simplification Act to amend and clarify the FCPA.²² The proposal would remove the SEC as the interpreter and enforcer of the FCPA and designate the Justice Department as the principal enforcer of the FCPA. It would also establish a review procedure to determine compliance and establish a materiality standard for the accounting standards section of the ACT.

A study released by the Financial Executives Research Foundation (FERF) indicated that business executives were confused and displeased with FCPA. Subsequent to the release of this study and senator Chafee's proposal to amend the FCPA, the SEC indicated they would abide by the Justice Department's enforcement determination on proposed foreign payments. Accordingly the commission agreed not to prosecute companies that received clearance from the Justice Department before May 31, 1981.²³

Based upon the developments above, it is most difficult to speculate how far or how close a unity might

develop between private industry and the accounting profession.

The following recent events are noteworthy. The SEC has discontinued its efforts to adopt Reserve Recognition Accounting (RRA) for the primary financial statements of oil and gas companies.²⁴ The action closely followed the issuance of SFAS No. 39 "Financial Reporting and Changing Prices: Specialized Assets — Mining and Oil and Gas." This statement expanded the inflation accounting disclosures of SFAS No. 33 to such specialized industries. The SEC will continue to mandate supplemental disclosures of RRA data and has asked the FASB to undertake the task of adopting standards for those disclosures. This methodology is consistent with previous SEC actions in bringing stimulative pressure upon the private sector in establishing financial reporting standards.

Another significant event concerns the proposed changes in SEC staff, budget, and directional objectives. Advisors to President Reagan have proposed a 30 percent budget reduction for the agency for the year ending September 30, 1983. They have also proposed staff reductions from 200 to 50 persons at the Washington headquarters of the powerful enforcement division. Overall, nearly a 50 percent reduction in the SECs staff has been recommended. More importantly, the advisors' report says the focus of SEC policy would be on tearing down barriers to raising money. " 'Regulation of the financial activities of corporations and financial institutions should be limited to insuring that capital formulation is facilitated and encouraged in an orderly process and with appropriate investor safeguards.' "²⁵

It should be remembered that the proposed staff reductions and budgetary cuts will effect a "model government agency" with a "deserved reputation for integrity and efficiency" according to the report. These changes in a "model government agency" must first be approved by Congress. If this does occur, however, the accounting profession may have a golden — and perhaps final — opportunity to regain, or retain, the lead in establishing financial accounting and reporting standards in the private sector.

NOTES

¹Thomas A. Maddox, "Accounting Orthodoxy: Standards From the Private Sector," *The Woman CPA*, October, 1979, pp. 9-11. Also, see Wallace E. Olson, "The Accounting Profession in the 1980's," *Journal of Accountancy*, July, 1979, pp. 54-55; 58-60.

²J. Ronen and M. Schiff, "The Setting of Financial Accounting Standards — Private or Public?" *The Journal of Accountancy*, March, 1978, p. 70.

³Roland L. Madison and William J. Radig, "Accounting Heresy: The SEC as Standard Setting Body," *The Woman CPA*, October, 1979, pp. 12-15.

⁴Michael Chatfield, *A History of Accounting Thought* (New York: Holt, Rinehart, and Winston, Inc., 1974).

⁵For a brief review of these and other foreign systems: American Institute of Certified Public Accountants, *Professional Accounting in 30 Countries*, (New York: AICPA, 1975).

⁶APB Opinion No. 15 "Earnings Per Share," (EPS) created a nonexistent security called "Common Stock Equivalents" and used extremely subjective materiality standards and assumptions "as if" certain events had oc-



William J. Radig, CPA, is an assistant professor of accounting at Marshall University. He is a member of the West Virginia Society of CPAs and AICPA, and holds an MBA from the University of Scranton. He has published several articles in professional literature.



Roland L. Madison, CPA, Ph.D. is an associate professor of accounting at Marshall University. He holds membership in the West Virginia Society of CPAs, AICPA, AAA, and the Ohio Valley Accountants Association. He is a previous contributor to *The Woman CPA*.

curred to compute EPS. This Opinion was adopted with only ten unqualified affirmative votes from the eighteen member board. *APB Opinion No. 16*, "Business Combinations" virtually eliminated the popular "Pooling of Interest" method of accounting for business combinations.

⁷FASB Discussion Memorandum "Accounting for Leases," (Stamford, Connecticut: FASB, July, 1974).

⁸*Accounting Principles Board Opinion No. 5*, "Reporting of Leases in Financial Statements of Lessee," (New York: AICPA, September, 1964), and *Accounting Principles Board Opinion No. 7*, "Accounting for Leases in Financial Statements of Lessors," (New York: AICPA, May, 1966).

⁹*Accounting Principles Board Opinion No. 31*, "Disclosure of Lease Commitments by Lessees," (New York: AICPA, June, 1973).

¹⁰"Report of the Committee on Research Impact," American Accounting Association, July, 1978.

¹¹Financial Accounting Standards Board, FASB Statement No. 13, "Accounting for Leases," as amended and interpreted through May, 1980.

¹²"Report of the Committee on Research Impact," p. 11.

¹³*Ibid.*, p. 11.

¹⁴Harold Williams, "The Accounting Profession and Self-Regulation: Plans and Progress," speech before the American Accounting Association, August 22, 1978, Denver, Colorado.

¹⁵American Accounting Association Mid-Atlantic Regional Meeting (University of Maryland: April, 1979).

¹⁶Financial Accounting Standards Board, "Exposure Draft" (Revised), Foreign Currency Translation," (Stamford Conn.: FASB, June 30, 1981), para. 11, 13.

¹⁷"SEC Withdraws Internal Control Reporting Proposal" (Deloitte Haskins and Sells, TWIR, May 30, 1980).

¹⁸Exposure Draft: Proposed Statement on Auditing Standards, "Reporting on Internal Accounting Control," (New York: AICPA, December 31, 1979); adopted July, 1980, as SAS No. 30, "Reporting on Internal Control." Also, see Auditing Standards Board, "Statement on Auditing Standards No. 30: Reporting on Internal Accounting Control," (New York: AICPA, July, 1980).

¹⁹Roland L. Madison and Wayne A. Ross, "Responsibility for Fraud Detection Requires Immediate Clarification," *The Practical Accountant*, April-May, 1980, pp. 38-39.

²⁰"Justice Department offers advice on whether payments are illegal," *Journal of Accountancy* (May, 1980), 14.

²¹*Internal Control in U.S. Corporations: The State of the Art.* (New York: Financial Executives Research Foundation, 1980).

²²"Legislation Introduced to amend the FCPA," *The CPA Letter*, June 23, 1980.

²³"SEC will abide by Justice's Enforcement Determination on Proposed Foreign Payments," *Journal of Accountancy* (October, 1980), pp. 10, 12.

²⁴*Corporate Accounting Reporter*, March 1, 1981, p. 2.

²⁵"Reagan Team Urges New Direction For SEC," *The Wall Street Journal*, January 22, 1981, p. 27.

Accounting For The Vernacular

By Anita Hunter

Our community college recently offered a potpourri of "outreach" classes, and after debating over the merits of aerobic dance versus a creative writers' roundtable, I settled on Accounting 101. My previous experience was limited to balancing the household budget, and frantically gathering assorted slips of paper each year when I tackled the income tax. Perhaps I would at last become financially organized, and even, with a little application, a fount of wit and wisdom in the realm of numbers.

My first day of class held an inkling of the eye openers ahead, with new meanings at every turn of the textbook pages. There was *equity*, which I had always thought was a group to which actors belonged. Then there were *liabilities*, which were what we were currently paying an arm and a leg for in our car and home insurance policies. *Assets* were no longer curly hair and straightened teeth. *Principles* and *concepts* were more than just what you stand on and think of. The *realization principle* seemed symbolic of the concept that I was in over my head. But I was determined to conquer this challenge to my brainpower, and to discover what made CPAs and writers of yearly corporation reports tick.

Soon our class was *recording transactions* — not to be confused with paying for a Linda Ronstadt label. I knew right off that *debit* was not what courting frogs said, and that *credit* was not what you gave someone for having enough sense to avoid trouble. Speaking of the latter, we soon learned to *locate* our numerous *errors and how to correct* them.

Trial balances were yes and no — a trial, yes, balanced, no. There was a great deal of adjusting. Our instructor threw us encouragement by pointing out a recent multi-million dollar embezzlement scheme that worked for months because the per-

petrator knew how to manipulate the numbers, and got caught only because he went on vacation and someone else looked at the *accounts*. Actually, I had not really planned to use my newfound knowledge in so crass a manner.

The chapter in the text on *work sheets* was of the utmost importance, and to think, before my enlightenment, those words might have indicated denim bed linens. I hope the teacher never finds out that the nearest I had previously been to *closing entries* was locking the front and back doors of our house. An *income statement* was when someone said, "I'm broke!"

Looking ahead in the textbook, I can see that I will have to rearrange my preconceived notions that *code numbers* are only for secret agents, the telephone company, the post office, and the grocery store. Obviously, *reducing posting labor*, does not mean making it easier to ride horseback, and of course I know that *columns* were not used by Greeks to hold up their buildings, but are also the very backbone of bookkeeping.

Perpetual inventories (sounds like those cans of soup on the top shelf of my pantry) and *allocating depreciation* may throw me yet, but it is upward and onward, making sure the *bottom line* is double. Next term, Accounting 102.Ω



Anita Hunter is a free lance writer with a degree in Home Economics. She encountered accounting at Los Angeles Harbor College.