"THE GUARDIANS OF FINANCIAL TRUTH"

REMARKS BY

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U.S. SECURITIES AND EXCHANGE COMMISSION

SEC AND FINANCIAL REPORTING INSTITUTE
UNIVERSITY OF SOUTHERN CALIFORNIA
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I'm here today to speak out on behalf of one of the most underappreciated groups in American society -- certified public accountants.

I've noticed an alarming trend in the way our society allocates fame: It seems that the further removed you are from reality, the more famous you become.

Think about it: Who are the best-known people in America today?

Without a doubt, actors -- who owe their celebrity not so much to who they are, but to their portrayal of people they are not.

Running a close second are professional athletes -- but they, too, are only playing a game -- as difficult as it may be for some Lakers fans to believe.

CPAs, on the contrary, perform a very real function, without which our economy would be crippled.

But I can't recall a CPA ever making the cover of People magazine.

Oprah has probably never done a show on "Auditors who have discovered major discrepancies."

And while millions tune in to the Academy Awards every year, the AICPA's Gold Medal Awards aren't even carried on one of those do-it-yourself cable channels.

It seems safe to conclude that accountants have not captured the popular imagination. That is all the more remarkable in light of what it is accountants really do. They are highly sophisticated, knowledgeable professionals. And they serve one of the most valuable functions in a capitalist society.

Their stock in trade is neither numbers, nor pencils, nor columns, nor spreadsheets, but TRUTH. Accountants are the people who protect the truth.

Can there be a more important role, or a greater responsibility? The livelihood of every American depends in a meaningful way on how well accountants do their job. Economic decisions are no better than the information on which they are based -- if the numbers are wrong, the decisions are wrong, and our economic future is imperiled.

Accountants are the guardians of financial truth. But the truth, as Oscar Wilde famously noted, is rarely pure, and never simple. In any society, people have different ideas about what constitutes the truth; and at any time, a different definition might prevail.

Accountants are not immune to the ebb and flow of custom. But they are bound to defend the terrain of their truth. And we, the beneficiaries of their work, are bound to support them.

Popular culture aside, the laws of our nation have long recognized the pivotal role played by accountants, and the huge public interest in keeping them independent. The responsibility for setting accounting standards for public companies was entrusted to the SEC more than 60 years ago.

The SEC has looked to the private sector for leadership in setting standards and improving financial reporting.

At the same time, the Commission has worked to keep the standard-setters independent, because public faith in our markets requires it. Accounting standards must be perceived as being above political concerns, special interests, or bureaucratic convenience.

The members of the Financial Accounting Standards Board are the standard-setters; as you know, they are appointed and supported by their parent organization, the Financial Accounting Foundation. But while the FASB is generally acknowledged to be independent, the structure of the FAF opens a door to potential conflicts of interest, and that's what I want to talk to you about today.

We're concerned about the potential conflict between those who prepare financial statements -- that is, corporations and governments with an interest in presenting themselves in the most favorable light possible -- and those who use financial statements -- including investors, creditors, analysts, and members of the public. Put simply, the FASB sets standards for preparers, in order to protect the interests of users and the public.

Almost from the moment it came into the world, the FASB and its pronouncements have been criticized by corporate interests. There's nothing wrong with criticism -- it's <u>expected</u> -- indeed, it's what I used to do when I was on the corporate side. A frank dialogue between those who make the rules and those who must abide by them is healthy.

But earlier this year, healthy criticism turned into withering attack. The FEI, a financial officers' group, issued a series of recommendations that would have put FASB in the corporate equivalent of leg irons. Among other things, they would have reduced the number of Board members, made them part-time, diminished the size of the staff, and given control of the agenda-setting process to an external corporate body -- an idea so over the top that it taxes the imagination: What corporation in America would ever let an external body set its agenda?

The same group tried to tar the FASB as "anti-business" -- a ludicrous notion. Calling the FASB "anti-business" is like calling the College of Cardinals "anti-Catholic." Faith in the integrity of FASB's rules is what enables capital to flow so freely in our markets. Still more extreme was a recommendation that would have required 4 out of a possible 5 votes for approval, giving corporate interests an effective veto on accounting rules.

Despite some words of reconciliation, the pressure has continued. We've witnessed a barrage of public statements against FASB, along with a series of initiatives that would eviscerate it.

But as harsh as the rhetoric has been, more disturbing yet have been the silences. I was very disturbed that the FAF did not rise to defend the FASB.

The FASB is charged to create the most hallowed rules of accounting, and the FAF is charged to protect the rulemakers. And yet, throughout this one-sided war of words, the Trustees of the Foundation have largely remained silent.

I met with the CEOs of the Big Six accounting firms and the Trustees of the FAF and urged them to speak up in support of the FASB. Not long ago, we worked together to gain much-needed relief for the profession from frivolous lawsuits. We should also work together to preserve the independence of FASB. Unfortunately, every new assault on the FASB was met with silence.

One reason for this lies in the fairly obscure details of how the standard-setting process is governed: Though operating ostensibly in the public interest, the FAF has been dominated by private interests. Its governance structure has not featured the balance and strong independent representation that I believe are critical to any self-regulatory effort.

The FAF raises funds for the FASB's operations, and selects its members. But FAF membership has been allocated by formula, principally to constituent groups most affected by FASB's rules. One need not hold a degree in public policy to realize that such an arrangement opens the door to conflicts of interest. The system was created 25 years ago, but the world was far less complicated then; it is more difficult today to avoid the conflicts inherent in the system. The time has come to change it.

In April, I asked the FAF to change the composition of its Board to achieve a better balance between constituent and public representation. The FAF needed more people with a strong track record of independence and public service -- free of conflicts, and committed to the interests of investors.

I'm pleased to say that, in recent days, the SEC and the FAF have made some progress toward resolving our differences. And I'm optimistic that we will move toward a solution.

There should not be the slightest doubt about the Commission's goal in these negotiations. We know something about hostile takeovers, and this is not one of them.

It's our aim to keep the standard-setting process in the private sector, while strengthening it. I would hope that we can reconstitute the FAF's Board to achieve a balance between those who do and those who do not have a stake in the outcome of how accounting standards are set.

I would hope that we can reduce the number of constituent representatives, and simultaneously increase the number of public representatives.

I would hope that we can reach a similar balance on the FAF's nominating committees, which will select the next chairman of the FASB.

And, finally, I would hope that the FAF and the SEC can work together to establish selection criteria for new, independent members of the Board.

Independent oversight is not a unique need of those who set accounting standards. Over the years, the Commission has worked to broaden public representation among several bodies with public or quasi-public responsibilities, from the New York Stock Exchange in 1938 to the NASD in 1996. It's time the FAF modernized its structure as well.

If anyone doubts the need for independent governance of standard-setters, consider the huge difference that accounting standards can make. In 1993, Daimler-Benz became the first German company to register securities in the US. Under German accounting standards, Daimler had reported a profit of 168 million Deutschmarks for its 1993 fiscal year; under US GAAP, the company reported a loss of almost a billion Deutschmarks for the same time period.

Closer to home, in 1992, the FASB required companies to record retirement health benefits as liabilities. As a result, the balance sheets of General Motors, for example, showed a "new" liability of $36 billion for retirees' health care costs. Without the new standard, total shareholder equity would have shown up as $42 billion; with the new standard, shareholder equity was actually shown to be $6 billion -- a huge difference in value.

The controversy over marking securities to market provides perhaps the most dramatic example of how accounting standards can make a difference. Prior to 1993, securities often were carried on balance sheets at their historical cost, regardless of their current value. That's like keeping your watch set to the time you first bought it -- it doesn't help you figure anything out. Under this standard, for example, American S&Ls showed a positive net worth of $36.2 billion in 1980, when Congress was considering deregulating the thrift industry.

S&L assets consisted more of bad loans than devalued securities. But had those assets been marked to market, the <u>real</u> net worth of S&Ls would have been evident -- somewhere between minus $78 billion and minus $118 billion. I cannot say whether Congress would still have deregulated the industry, had these figures been widely known. I <u>can</u> say that we would have had a better chance of averting the S&L crisis.

I said earlier that accountants are the guardians of financial truth, and I think these examples demonstrate that. The profession's credibility and dedication to the public interest have been well established among investors.

But recent developments in the profession threaten to diminish that trust -- and not just the onslaught against the standard-setters, but also the more general changes in accounting practice as we approach the millennium. If I may digress for a moment: I'm deeply concerned that "independence" and "objectivity" are increasingly regarded by some as quaint notions.

I see a profession that is seeking to expand its business interests far beyond traditional services, into such activities as investment banking, franchising the use of the auditor's name, and providing "outsourcing" for a variety of services.

There are those who say that increasing competition puts pressure on accountants to branch out and try new ways of generating profits. I caution the industry, if I may borrow a Biblical phrase, not to "gain the whole world, and lose [its] own soul."

In contrast with other businesses, the auditing profession bears the burden of being, at all times, objective and independent, and of appearing, at all times, objective and independent. That is a very strong public expectation, and it is one that this Commission demands. If the profession loses its reputation for independence in the search for greater profits, I fear that it will be gravely difficult to regain.

That's all I'll say today about auditor independence, which deserves its own speech. Let me return to the broader issue of the independence of those who set standards for the profession.

As I noted, a certain amount of tension between standard-setters and the corporate community is inevitable, and healthy. I'm all for maintaining that tension; the corporate community's proposals from earlier this year would have effectively eliminated it.

Farsighted business leaders over six decades have supported the independence of the process and accepted even those standards that may have worked against their short-term interests. The positive economic consequences of a visibly independent and well-protected FASB far outweigh any potential dislocations and temporary discomforts it may cause.

More than 20 years ago, as the FASB was being inaugurated, Reginald Jones, then Chairman of General Electric, said, "We must recognize that with its *first* decision the new Board is going to gore somebody's ox -- and *that* will be the time for us to pull together -- not splinter apart." Those words are still relevant today.

Clearly, any organization, including the FASB, can refine and improve its processes. A twelve-year turnaround time -- even for a group of judicious CPAs -- seems a tad on the long side. I'm all for due process, but a colleague recently described the situation at FASB with the phrase, "undue due process." The Board has considered a three-year turnaround time for new rules; I would support any effort to speed the process up.

The FASB is not immune to criticism and change. But there is a world of difference between constructive advice and intimidation. Changes that would help make the Board more responsive to critical issues are absolutely welcome; changes that would undermine FASB's independence are not. And the first change, even before we approach changes in FASB procedures, must be to reconstitute the FAF with a balance between independent and affiliated trustees.

We ought to get this done quickly and painlessly. I believe we are near an agreement now. There are so many challenges on the accounting horizon that we need to put this conflict behind us and move forward. Mergers and acquisitions are occurring in record numbers. Derivatives and similar instruments are becoming increasingly sophisticated. The public utility and communications industries are being deregulated. Advances in technology raise fundamental questions about what the model of financial reporting should be as we approach the millennium.

Finally, there is the vital question of international accounting standards. As capital markets around the world continue to develop, companies seeking capital will look for the best markets irrespective of national borders. Investors providing capital will need to make comparisons of investment opportunities so that they can make informed investment decisions.

We are facing a future in which capital flows across borders will continue to grow at an extraordinary rate. There will be increasing recognition of the value of higher quality financial reporting and a more level disclosure playing field.

The SEC and its fellow regulators are working toward this high-quality, level field through the July 1995 agreement between the International Organization of Securities Commissions and the International Accounting Standards Committee.

Regulators internationally are urging the International Accounting Standards Committee to develop a core set of standards as soon as possible. The IASC is accelerating its process in response.

The FASB has a key role to play in this process, not only in establishing accounting principles for domestic and foreign issuers seeking capital in US markets, but also in contributing to IASC efforts to develop international standards of the quality and integrity that US investors expect. I want to be clear on one critical point -- as my two immediate predecessors and I have consistently stated, the Commission will accept only those standards that provide the transparency that characterizes US standards.

The FASB is quite capable of playing this and all of its roles -- but only if given the support it needs.

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I hope that in the course of these remarks, I've made my position clear.

The problem is not a question of accounting -- it's a question of <u>governance</u>.

To be acceptable and credible, the FAF must be balanced --

it must represent the users, the investors and public for whose benefit financial statements exist, as well as preparers, who are most directly affected by the disciplines and constraints that the standard-setting process imposes.

The underlying philosophy of private sector self-regulation is that special interest voluntarily yields to public interest. That requires true commitment and leadership from the private sector participants, to set aside short-term self-interest in the pursuit of long-term common goals -- in this case, the quality and credibility of the financial information that nourishes our capital markets.

Our capital markets are among our nation's most spectacular achievements -- they're the envy of the world. They've raised more than capital: they've raised the quality of life.

Those markets are a rich legacy we have inherited, but do not own. They are a national asset we hold in trust for America.

You are the guardians of that vital trust -- that the markets of our nation; that the integrity of the process; that the confidence of investors will not be compromised.

We owe it to those who will come after us to leave those markets stronger, sturdier, more productive, and more prolific than we found them. And, if we ensure the independence of the standard-setting process, I have no doubt that we will. Thank you.

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