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Before The
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C.

Financial Accounting Foundation
Financial Accounting Standards Board

STATEMENT OF POSITION

Submitted to
Securities and Exchange Commission
Pursuant to Solicitation of Public Comments in
Accounting Series Release No. 193 (July 27, 1976)
"Request by Arthur Andersen & Co.—Partial Response
and Solicitation of Comments on Certain Questions"

(Relating to Petition of Arthur Andersen & Co., June 15, 1976,
"Request for Action by Commission with Respect to Certain
Rules and Pronouncements Relating to Accounting Principles")

August 27, 1976

Financial Accounting Foundation
Financial Accounting Standards Board
HIGH RIDGE PARK, STAMFORD, CONNECTICUT 06905

August 27, 1976

Securities and Exchange Commission
500 North Capitol Street, N.W.
Washington, D.C. 20549

Attention: George A. Fitzsimmons, Secretary
File Reference: S7-647

Statement of Position Submitted Pursuant to Solicitation of Public Comments in Accounting Series Release No. 193, "Request by Arthur Andersen & Co.—Partial Response and Solicitation of Comments on Certain Questions" (July 27, 1976)

Dear Sirs:

The Financial Accounting Foundation (the "Foundation") and the Financial Accounting Standards Board (the "FASB") are pleased to submit this Statement of Position to the Securities and Exchange Commission (the "Commission"), pursuant to the Commission's solicitation of public comments in Accounting Series Release ("ASR") 193 on the following issues:

1. Should the Commission continue its policy of recognizing the pronouncements of the FASB as providing a frame of reference for publicly held companies to satisfy their statutory disclosure obligations?
2. Should the Commission further define the phrase "substantial authoritative support" for purposes of its administrative practice and policies in ASRs 4 and 150?
3. Should the Commission further define the phrase "accounting principles and practices" used in Rule 2-02(c) of its Regulation S-X?

As the Commission states in ASR 193, these "fundamental issues of importance" have been raised by two actions requested in the petition of Arthur Andersen & Co. ("Andersen") to the Commission dated June 15, 1976 (the "Petition"):

1. That the Commission revoke ASR 150; and

2. That the Commission define "substantial authoritative support" as used in ASR 4 as it relates to accounting standards, principles and practices reflected in audited financial statements filed under the federal securities laws, or, alternatively, to revoke ASR 4.

The Commission characterizes Andersen's Petition in ASR 193 as requesting the Commission to withdraw its administrative policies which have governed the manner by which the Commission has determined whether financial statements meet the requirements of the federal securities laws.

The Foundation and the FASB point out, additionally, that Andersen's Petition, which it followed with its legal action against the Commission,[1] has come to be widely regarded within the accounting profession and broad segments of the financial and business community and general public as directly challenging whether the FASB, notwithstanding its resources, output and broad support in the private sector and through its sponsoring organizations,[2] should continue to establish and improve accounting principles, standards and practices.

The FASB is the authoritative body in the private sector designated by the governing Council of the American Institute of Certified Public Accountants (the "AICPA") to establish accounting principles.[3] The formation of the FASB in 1972 was widely endorsed by the accounting profession, the financial and business community and accounting educators, all of which have continued their substantial support. The Commission also endorsed establishment of the FASB as an institutional framework within which, following consideration of varying points of view, prompt and responsible action in financial accounting and reporting matters would result. The Commission has continued its support by recognizing and accepting FASB Statements and Interpretations as establishing generally accepted accounting principles and, more recently, by amending and rescinding certain of its own rules and guidelines in order to conform its requirements to subsequently issued FASB Statements.[4]

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[1] *Arthur Andersen & Co.* v. *Securities and Exchange Commission*, Civil Action No. 76 C 2832 (N.D.Ill. July 29, 1976).

[2] American Accounting Association, American Institute of Certified Public Accountants, Financial Analysts Federation, Financial Executives Institute and National Association of Accountants. Effective October 1, 1976, the Securities Industry Association will become the sixth sponsoring organization.

[3] The formation, operations and organization of the FASB, its output of authoritative accounting and reporting pronouncements, exposure drafts and discussion memoranda, and its current agenda of technical projects, are discussed in Appendix A. The schedules to Appendix A list the members and identify the affiliations of the Foundation's Board of Trustees and the FASB's advisory body, the Financial Accounting Standards Advisory Council, as well as the members of the FASB and their former affiliations.

[4] See ASR 172 (June 13, 1975), ASR 178 (October 9, 1975), ASR 181 (November 10, 1975) and ASR 184 (November 26, 1975). These and other expressions recognizing the role of the accounting profession and more recently the FASB in establishing and improving accounting principles, standards and practices are discussed more fully in Appendix B.

The Foundation and the FASB believe this support and recognition confirm the prediction in 1972, on the formation of the FASB, that a private standards-setting body,

—supported by the accounting profession, the business and financial community and other concerned groups in the private sector,

—possessing independence and objectivity in fact and appearance, and

—issuing pronouncements after following comprehensive public procedures that insure an opportunity for all interested parties to be heard and their views considered,

offers the greatest potential for progress in financial accounting and reporting.[5]

The Foundation and the FASB also are firmly committed to the belief that the continued and effective involvement of the private sector through the FASB in establishing and improving accounting principles and standards is in the best interests of public investors, the accounting profession, and the business and financial community. This principle—long unchallenged in the private sector—and the obvious and continuing need to consider thoroughly and resolve many significant financial accounting and reporting issues, make it urgent that the issues posed in ASR 193 be resolved promptly.

Accordingly, the Foundation and the FASB urge the Commission:

1. To avoid taking action which could jeopardize, or might be viewed as jeopardizing, the continued authority and responsibilities of the FASB as an authoritative standards-setting body, whether by revocation or significant modification of its administrative practice and policies described in ASR 193, by instituting "substantive rule-making" for FASB pronouncements, or otherwise; and
2. To reaffirm, promptly and unequivocally, by appropriate official release that:
   a. The Commission will continue its historic administrative practice and policies of looking to the FASB, as the standards-setting body designated by the accounting profession, to provide leadership in establishing and improving accounting principles, standards and practices, and
   b. FASB Statements and Interpretations and effective APB Opinions and Accounting Research Bulletins ("ARBs") provide a frame of reference for publicly held companies to satisfy their statutory disclosure obligations, and constitute accounting principles, standards and practices with "substantial authoritative support" for purposes of the Commission's administrative practice and policies in carrying out its responsibilities under the federal securities laws; and
3. If the Commission should determine to further define the phrase "substantial authoritative support" or the phrase "accounting principles and practices" as used in Rule 2-02(c) of Regulation S-X (which, as discussed below, the Foundation and the FASB do not believe is necessary), to state that FASB

[5] See Report of the Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards*, page 24.

Statements and Interpretations and effective APB Opinions and ARBs are the authoritative sources of generally accepted accounting principles in the areas covered, unless the Commission determines otherwise in particular circumstances.

In ASR 193 the Commission has separated consideration of Instruction H(f) to Form 10-Q on "preferability" from the issues on which it has solicited comments. The Foundation and the FASB urge the Commission to continue that separation so as not to confuse the issue of preferability with its consideration of the issues concerning the Commission's administrative practice and policies in ASR 4 and ASR 150, the concept of "substantial authoritative support," the phrase "accounting principles and practices" as used in Rule 2-02(c), or indeed the role of the FASB and the private sector in establishing and improving accounting principles, standards and practices.

I. ACCOUNTING SERIES RELEASES NO. 4 AND 150: THE COMMISSION'S POLICY OF RECOGNIZING FASB PRONOUNCEMENTS AS PROVIDING A FRAME OF REFERENCE FOR PUBLICLY HELD COMPANIES TO SATISFY THEIR DISCLOSURE OBLIGATIONS

A. The Significance of Existing Commission Policy

Continued and effective leadership by the FASB in establishing and improving accounting principles, standards and practices through its procedures for insuring maximum public participation and consideration of all points of view [6] depends on the quality and persuasiveness of its Statements and Interpretations, their status as generally accepted accounting principles with presumptive weight under Rule 203 of the AICPA's Code of Professional Ethics,[7] and the Commission's long-standing administrative practice and policies as expressed in ASR 4 and ASR 150.

Discontinuance by the Commission of its policy of recognizing FASB pronouncements as providing a frame of reference for publicly held companies to satisfy their statutory disclosure obligations, or other Commission action diminishing the status of the FASB or its pronouncements for purposes of filings under the federal securities laws, could seriously and adversely affect the FASB's effectiveness as a standards-setting body.

Such action would inevitably be viewed within the accounting profession and the business and financial community as signifying (i) a lack of confidence on the part of the Commission in the resources, ability and resolve of the FASB to perform its standards-setting function, and (ii) a Commission determination that the federal government should assume pervasive, direct control over financial accounting and reporting.

In adopting the Securities Act of 1933, Congress determined that independent public accountants should make the required examinations of financial statements rather than government accountants and auditors. Congress also granted the Commission authority

[6] See Appendix A, pages A-3 through A-7.

[7] See the discussion, *infra*, at pages 6 and 13, and in Appendix D, pages D-3 through D-5.

to prescribe the form and content of financial statements filed with it and to specify methods to be followed in their preparation. From the beginning, however, the Commission has encouraged the accounting profession to take the lead, reserving for the Commission the role of overseer and day-to-day administrator of the federal securities laws, and only occasionally superseding the profession's pronouncements with rules, regulations and releases of its own.

This partnership between the private and public sectors has worked effectively and continuously for over 40 years to produce significant advances in financial accounting and reporting. Without abdicating or delegating its statutory responsibilities, the Commission has long relied to a significant degree on the resources and expertise in the accounting profession to provide leadership. Beginning in 1973 the FASB has supplied this leadership with the support and participation of the accounting profession, the business and financial community and other concerned private sector groups. The Commission first expressed its policy in 1938 in ASR 4, explicitly reaffirmed it in 1973 in ASR 150, and characterized it in 1976 in ASR 193 as the administrative practice by which it carries out its responsibilities under the federal securities laws and the manner by which it determines whether financial statements filed with it meet the requirements of those laws.[8] All would agree that public investors are far better informed today than ever before.

Substantial benefits have resulted from the FASB's work over the past three years. Thus,

1. Accounting principles, standards and practices are established objectively by a full-time board, independent of professional and business affiliations.
2. Accounting principles, standards and practices are established under comprehensive and effective operating procedures calculated to maximize public participation and thoughtful consideration of the views of all, at all stages up to the issuance of final Statements and Interpretations.
3. There is significant support for the FASB and its operating procedures within the accounting profession, the business and financial community and the general public, and interested persons and groups within the private sector have actively participated in the work of the FASB.
4. Through Rule 203 of the AICPA's Code of Professional Ethics, members of the AICPA are bound to the FASB's Statements and Interpretations when expressing an opinion on the fair presentation of financial statements in conformity with generally accepted accounting principles.
5. As set forth in Appendix A, pages A-9 through A-11, the range of the FASB's Statements and Interpretations, exposure drafts and discussion memoranda, and its agenda of technical projects reflects its commitment to its responsibilities.

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[8] Additional examples of the Commission's recognition of the role of the accounting profession and the FASB in establishing and improving accounting principles, standards and practices are contained in Appendix B.

The Commission's long-standing administrative practice and policy, first expressed in ASR 4 and reaffirmed in ASR 150, benefits public investors by providing a framework for the preparation of financial statements filed under the federal securities laws.

In ASR 150, the Commission confirmed, for purposes of its administrative practice and policy, that it would accord the same recognition to the FASB and the same weight and effect to its Statements and Interpretations (and effective APB Opinions and ARBs) as the AICPA had accorded earlier in 1973. Rule 203 of the AICPA's Code of Professional Ethics (adopted in March 1973) and the AICPA Council action in May 1973 combined to establish FASB Statements and Interpretations and effective APB Opinions and ARBs as presumptively binding generally accepted accounting principles except in unusual circumstances where other accounting principles are required to prevent the financial statements from being misleading. In stating in ASR 150 that it would consider principles, standards and practices in those pronouncements as having substantial authoritative support and contrary ones as not having such support, the Commission referred to Rule 203 and also indicated the necessity of continuing to retain its prerogatives to meet its responsibilities mandated by Congress in the federal securities laws. ASR 150 thus provides, as does Rule 203, for the exercise of judgment by registrants and auditors alike, and permits the degree of flexibility permitted under that Rule. By reflecting, as Commission policy, the authority accorded by the accounting profession to the FASB, its Statements and Interpretations, and effective APB Opinions and ARBs, ASR 150 contributes to certainty and consistency in the preparation of financial statements and thus benefits the investing public.

With this background, the Foundation and the FASB are firmly of the belief that Commission action to revoke or modify ASR 150 or ASR 4, so as to discontinue or qualify its administrative practice and policy of support and reliance on the FASB and its pronouncements, would quickly reduce the FASB from a recognized standards-setting body widely supported within the accounting profession and the business and financial community, to an advisory group with diminishing prospects for survival and support.

—Such action, unaccompanied by a Commission determination to continue FASB Statements and Interpretations as presumptive generally accepted accounting principles for purposes of financial statements filed under the federal securities laws, would leave FASB pronouncements, as well as existing APB Opinions and ARBs, in limbo as to weight and acceptability under those laws.

—Such action would have an immediate, substantial and irreparable effect on the ability of the Foundation to attract and retain outstanding persons as members of the FASB and of the Financial Accounting Standards Advisory Council (the "Advisory Council"). The FASB would be similarly affected in its efforts to attract and retain competent persons to its technical staff. Over time it seems clear that the FASB's significant financial support would diminish and in some quarters would probably disappear entirely. As foreseen in the 1972 Report of the Study on Establishment of

Accounting Principles,[9] a further effect could well be a lessening commitment by the leaders of the accounting profession to the continuing process of improving financial accounting and reporting.

—Such action would effectively signal the end of the involvement and participation of the business and financial community and others in the private sector through the FASB in establishing and improving accounting principles, standards and practices.

The final result can only be accounting principles, standards and practices set through rule-making by the federal government.

The question of the best way to set accounting standards, and the related question of whether the task should continue as a responsibility of the private sector or be taken over by federal rule-making, was considered and discussed at length by the distinguished Wheat study group in its 1972 Report of the Study on Establishment of Accounting Principles.[10] In concluding that "a continuing, dynamic relationship between a private standard-setting board and the SEC [offered] the greatest potential for future progress in financial accounting" (page 24), the study group discussed a number of "distinct disadvantages to transferring the standard-setting function to the public sector" (pages 23 and 24):

1. Governmental agencies might be more susceptible to political pressures, leading to accounting standards designed to accomplish self-serving objectives for private interest groups, rather than meeting the needs of those who use financial statements in making economic decisions.
2. Where governmental agencies had become directly involved in accounting, the result had too often been a tendency towards inflexibility and a lack of responsiveness to the needs of investors.
3. Transferring standards-setting to a governmental agency would "inevitably sap the vitality of the accounting profession" (page 23). Noting that the leaders of the profession had increasingly given unstintingly of their time and talent in the search for better accounting standards, the study group concluded that it is doubtful that such men would be willing to continue contributing if the basic responsibility for accounting were shifted to government:

   "It seems likely that practicing public accountants might be largely reduced to the role of advocates on behalf of their clients. This would constitute a serious loss to the public at large."
4. If the task were assumed by the Commission, or should the Commission be forced to take it, it would involve extension of the Commission's present powers to companies not now regulated or to the possible coexistence of two or more sets of accounting standards for regulated and nonregulated companies, respectively.

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9 See discussion below.

10 See pages A-1 through A-3 of Appendix A for information as to the members of the study group, its mission, and its conclusions and recommendations leading to the formation of the FASB.

The Foundation and the FASB are committed to the belief that these disadvantages and the conclusions of the Wheat study group are as relevant and persuasive today as they were in 1972.

B. Formal Rule-making

FASB Statements and Interpretations

A theoretical alternative to the Commission's existing administrative practice and policy would be formal Commission rule-making for each FASB Statement and Interpretation at the time issued, and, following public comment, their adoption by the Commission in proposed or amended form as "substantive rules," or their rejection.

However, this is not a practicable alternative if the authority of the FASB as a standards-setting body and the authoritative character of its pronouncements is to be retained, for rule-making, too, would reduce the FASB from a standards-setting body to an advisor without authority. In short, the problems for the FASB are no different, in nature or degree, whether the SEC elevates FASB Statements and Interpretations to the status of "rules," or discontinues its current administrative support for and acceptance of the FASB and its pronouncements.

First, FASB Statements and Interpretations would be placed in limbo in both cases and, notwithstanding Rule 203 of the AICPA's Code of Professional Ethics, would not, as a practical matter, be accorded full presumptive weight within the accounting profession and the business and financial community during the Commission's public comment period and during its deliberations on the comments received, alternative proposals, and the FASB's pronouncements as exposed. Second, the FASB's resulting advisory status would immediately affect hiring and retention of highly qualified FASB members and competent professional personnel. The Foundation is also concerned that this would endanger continuing financial support. Finally, it can be expected that during periods spent on duplicative consideration, drafting, exposure, reconsideration and re-drafting,[11] case-by-case review of *ad hoc* determinations by individual registrants would consume more and more of the Commission's time and resources.

The dangers in formal rule-making were also foreseen and discussed at some length by the Wheat study group in its 1972 Report (pages 66 and 67):

> "Even if formal rule-making were practicable in the area of financial accounting standards, however, we would be troubled by its potential impact. It can be assumed that if the APB or its successor should adopt an opinion after much study and debate, and thereafter that opinion should be published for comment by the Commission as a proposed rule, the outcome of the process could be quite different from the initial opinion. Repetition of all of the elements which went into the making of the original opinion would necessarily be involved, including preparation of an exposure draft,

[11] See Appendix A, pages A-3 through A-7.

receipt of comments and alternative proposals, debate upon the form and substance of the opinion, decision, and final drafting. In this process, unless the subject matter is entirely noncontroversial, substantial change is probable. It is not change as such that concerns us, but the fact that when men of high ability and experience have labored on the form and substance of an opinion, only to see it revised or rejected by a separate authority, they will necessarily view their roles as downgraded. We see a clear danger that this may lead to a lessening of commitment by those leaders of the accounting profession who have, to date, been willing to devote themselves wholeheartedly to the service of the [APB].

"Another consequence of the suggested procedure which troubles us is the inevitable delay which it would interject into the standard-setting process.

"On balance, therefore, the Study believes that it would be unwise, as it is unnecessary, to attempt to institute an arrangement by which opinions of the APB (or its successor) would be proposed for adoption as formal rules of the SEC."

Apart from the foregoing, formal rule-making is not necessary, due to ASR 150's reservation of authority by the Commission to issue its own rules, regulations and official releases and to continue to make case-by-case determinations, as required, to meet its responsibilities under the federal securities laws. Further, there are persuasive impracticalities, both from the standpoint of the standards-setting body and the accounting profession, in attempting to resolve authoritative effect and enforceability of standards, on a piecemeal *ad hoc* basis, after pronouncements have been issued. It is simply not feasible to withhold authority from a standards-setting body's pronouncements and at the same time expect that body to operate effectively with dedication to resolve complex and pervasive questions on an independent, objective and timely basis.

These considerations against formal rule-making have been long recognized in the case of accounting and auditing matters. The accounting profession's governing and rule-making bodies have consistently avoided this approach, deciding instead to designate a standards-setting body with authority, as opposed to piecemeal consideration of individual pronouncements once issued.

For example, in its 1964 resolution strengthening the authority of APB Opinions, the AICPA's Council defined "generally accepted accounting principles" in terms of "substantial authoritative support" and provided that Opinions of the Accounting Principles Board, then or thereafter issued, would constitute such support.

Similarly, Rule 203 of the AICPA's Code of Professional Ethics, effective since March 1973, and the related AICPA Council action in May 1973, take the same approach by presumptively binding members of the AICPA to apply FASB Statements and Interpretations in the absence of unusual circumstances requiring departure to avoid misleading financial statements. The FASB had not issued any pronouncements at all when the profession took this significant step. Additionally, Rule 202 of the AICPA's Code proceeds on the same basis in its references to Statements on Auditing Standards, present and future, as interpretations of generally accepted auditing standards.

Finally, in ASR 150, the Commission recognized the FASB as the designated standards- setting body under Rule 203 and accorded its Statements and Interpretations correlative weight and effect. Nothing has occurred since which demonstrates formal rule-making as either necessary or preferable, or as a practical alternative.

At best, therefore, formal rule-making would be an unnecessary duplication of the FASB's comprehensive and effective procedures, resulting in unnecessary and undesirable delays in authoritative resolution of important accounting questions to the detriment of public investors.

At worst, on the other hand, formal rule-making could spell the end of the FASB as a standards-setting body, just as surely and as quickly as the Commission could by revoking its administrative practice and policy and withdrawing its support of the FASB and its pronouncements.

ASR 150

Another alternative to the Commission's existing administrative practice and policy through ASR 150 might be readoption of ASR 150 in its present form as a "substantive rule."[12]

In both ASR 4 and 150, the Commission made it clear that it would continue to meet its responsibilities under the federal securities laws to issue such rules, regulations and other pronouncements as it deemed necessary for the protection of investors. Referring to Rule 203 of the AICPA's Code of Professional Ethics, the Commission also reserved its prerogative to determine in individual instances, in its day-to-day administration of the federal securities laws, that financial statements might be misleading even though they reflected the application of FASB or APB pronouncements or other principles for which there was substantial authoritative support. There is the possibility, therefore, that transforming policy into a rigid rule could, in some circumstances, restrict the Commission in issuing rules, regulations and releases, and its staff in their review and determinations with respect to the financial statements and accounting problems of individual registrants.

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12 Andersen's Petition and Complaint characterize ASR 150 as a "rule" and contend that it was adopted "in direct violation of the Administrative Procedure Act." However, both by its title and by its text, ASR 150 is a "statement of policy"; its stated intention is to guide, but not inflexibly to control, "the Commission staff . . . [in] tak[ing] such action on a day-to-day basis as may be appropriate to resolve specific problems of accounting and reporting under the particular factual circumstances involved in filings and reports of individual registrants." As a statement of policy which is not finally determinative as to the selection or application of accounting principles or of the acceptability of individual filings and reports, and which by necessity reflects the Commission's Congressionally imposed responsibilities and recognizes and refers to Rule 203 of the AICPA Code of Professional Ethics, ASR 150 does not appear to constitute a "rule." Moreover, the Commission has not delegated any of its authority, or given up its right to reject FASB pronouncements through its own rule-making procedures.

On balance, the Foundation and the FASB believe the Commission's existing administrative practice and policy in ASR 150 preferable to a rule. On the other hand, the most important consideration is the Commission's continued acceptance of the FASB's Statements and Interpretations as authoritative and presumptively binding pronouncements of accounting principles, standards and practices. Accordingly, the Foundation and the FASB join with the AICPA[13] in urging the Commission to take such action as may be appropriate in the circumstances (if any should be necessary) to maintain and continue its administrative practice and policy reflected in ASR 150 and to avoid formal rule-making for FASB pronouncements.

C. Exercise of Professional Judgment

Andersen has asserted that ASR 150 "restricts" and makes it "not possible" for an auditor to carry out his responsibilities properly, in terms of his judgments as to whether financial statements have been presented fairly. (Petition at 12 and 13)

There is no basis for any claim that ASR 150 restricts or prohibits responsible action or creates confusion for independent auditors. FASB Statements and Interpretations, and effective APB Opinions and ARBs, are binding and presumptively not misleading under Rule 203 of the AICPA's Code of Professional Ethics. By virtue of ASR 150, the same pronouncements have been carried forward as binding and presumptively not misleading for purposes of the Commission's administrative practice and policy. ASR 150 therefore benefits public investors by providing a framework for the preparation of financial statements filed under the federal securities laws, parallel to that imposed on auditors by the AICPA's membership through Rule 203 and related AICPA Council action. By recognizing and accepting this private-sector framework, ASR 150 clearly does not impose new or unusual burdens on registrants and accountants in making judgments and in meeting their responsibilities and obligations. To the contrary, as a reaffirmation of ASR 4 and as a reflection of current administrative practice and policy, ASR 150 contributes significantly to certainty and consistency in the preparation of financial statements.

Similarly, there is no conflict in considering FASB Statements and Interpretations, APB Opinions and ARBs as having substantial authoritative support, as ASR 150 states, and at the same time recognizing the requirement that financial statements present fairly an enterprise's financial position and results of operations. By ASR 150's reference to Rule 203 (which recognizes that a departure from an accounting principle promulgated by the FASB may be necessary if "due to unusual circumstances the financial statements would otherwise [be] misleading"), the Commission recognized as policy what the AICPA's membership had concluded nine months previously as a matter of professional ethics—that literal compliance with authoritatively established accounting principles did

[13] Letter dated July 8, 1976 to Chairman Hills. (See Appendix C.)

not always insure fairness of presentation.[14] The Commission also reserved its prerogatives in ASR 150 to issue rules, regulations and official releases and "to take such action on a day-to-day basis as may be appropriate to resolve specific problems of accounting and reporting under the particular facts and circumstances involved in filings and reports of individual registrants," thereby confirming its Congressional mandate applied for over 40 years and a duality of responsibility that is recognized and accepted within the accounting profession.

II. SUBSTANTIAL AUTHORITATIVE SUPPORT

Members of the accounting profession have long been bound, by action taken in self-regulation through the AICPA's governing Council and senior technical committees, to the concept of "substantial authoritative support" as the basis for selection and application of accounting principles, despite the absence of an explicit, all-inclusive definition of that concept. The concept "substantial authoritative support" is not attributable to or dependent upon ASR 150, for that Release merely confirmed that, for purposes of financial statements filed under the federal securities laws, the Commission as a matter of administrative policy would give presumptive weight to the standard of support imposed by the profession on its members.

Development within the accounting profession of the concept of "substantial authoritative support" and its relationship to "generally accepted accounting principles" is discussed in detail in Appendix D. A consistent thread throughout the development of this concept has been the profession's avoidance of an all-inclusive, explicit definition, in favor of providing guidance as to how auditors can *find* and *evaluate* sources of support for accounting principles. Given the dynamic and evolutionary characteristics of accounting and changing forms of business transactions and new regulatory and legislative requirements, it is not difficult to see why the profession has followed this course.

Significant actions within the accounting profession regarding "substantial authoritative support" are summarized briefly in the following paragraphs.

In October 1964, without definition of "substantial authoritative support," the AICPA's governing Council issued a Special Bulletin (see APB Opinion No. 6, Appendix A) announcing its unanimous adoption of the following propositions:

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[14] In July 1975, the requirement of fair presentation in relation to the selection and application of generally accepted accounting principles was emphasized and developed further in Statement on Auditing Standards No. 5 ("SAS-5"), "The Meaning of 'Present Fairly in Conformity with Generally Accepted Accounting Principles' in the Independent Auditor's Report," issued by the AICPA's Auditing Standards Executive Committee. SAS-5 superseded certain sections in Statement on Auditing Standards No. 1 which had required independent auditors to judge only whether accounting principles had general acceptance; and, in substitution, related the judgment required of the independent auditor to fairness of the overall presentation of financial statements, with that judgment being applied within the framework of generally accepted accounting principles as a uniform standard for judging presentation. For a more detailed discussion of SAS-5, see pages D-5 and D-6 of Appendix D.

1. "Generally accepted accounting principles" are those principles which have substantial authoritative support.
2. APB Opinions and ARBs constitute "substantial authoritative support."
3. "Substantial authoritative support" can exist where accounting principles differ from ARBs and APB Opinions.

In 1965, AICPA Council recommended to the Accounting Principles Board that, among other things, the Board define "generally accepted accounting principles" and "substantial authoritative support." After lengthy study, the APB, in its Statement No. 4, decided *against* adopting an all-inclusive definition of "substantial authoritative support," electing instead to provide guidance as to *how* individual auditors could *find* and *evaluate* support for accounting principles. While APB Opinions and ARBs were characterized as the most authoritative sources of generally accepted accounting principles, Statement No. 4 acknowledged that APB Opinions and ARBs were not an exclusive or comprehensive listing.

Effective March 1, 1973, the profession adopted Rule 203 of its Code of Professional Ethics. Rule 203 provides that an AICPA member may not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain a departure from an official pronouncement, *unless* the member can demonstrate that due to unusual circumstances the financial statements would otherwise be *misleading*. In May 1973, a resolution of AICPA Council designated the FASB as the body to establish accounting principles under Rule 203 and stated that APB Opinions and ARBs would have the same status as FASB pronouncements.

In July 1975, the AICPA's Auditing Standards Executive Committee issued SAS-5. Adopting the approach of the APB in its Statement No. 4, SAS-5 referred to FASB Statements and Interpretations and other authoritative pronouncements under Rule 203, and continued in paragraph 6:

> "In the absence of pronouncements comprehended by Rule 203, the auditor should consider other possible sources of established accounting principles, such as AICPA accounting interpretations, AICPA industry audit guides and accounting guides, and industry accounting practices . . . APB statements, AICPA statements of position, pronouncements of other professional associations and regulatory agencies, such as the Securities and Exchange Commission, and accounting textbooks and articles (see paragraphs 205 and 206 of Statement No. 4 of the APB). Independent auditors should be alert to pronouncements that change accounting principles . . . and to changes that become acceptable as a result of common usage in business, rather than as a result of pronouncements."

In recognition of the foregoing, the Foundation and the FASB believe that it is not necessary for the Commission now, in 1976, to attempt to define "substantial authoritative support." However, should the Commission conclude to the contrary, the Foundation and the FASB believe it important to the continuing authority of the FASB for the Commission to state that FASB Statements and Interpretations and APB Opinions and ARBs (except to the extent altered, amended, supplemented, revoked or superseded by one or more FASB

Statements) are the authoritative sources of generally accepted accounting principles in the areas covered, unless the Commission determines otherwise in particular circumstances.

III. RULE 2-02(c) OF REGULATION S-X

For reasons similar to those discussed above, the Foundation and the FASB also believe it unnecessary for the Commission to further define the term "accounting principles and practices" as used in its Rule 2-02(c). Should the Commission conclude to do so, however, the Foundation and the FASB urge that its definition be consistent with the concept of "substantial authoritative support" and the authority accorded FASB Statements and Interpretations and effective APB Opinions and ARBs under that concept and AICPA Rule 203.

Rule 2-02(c) sets forth the Commission's requirements as to the opinions to be expressed in accountants' reports on financial statements filed under the federal securities laws. Specifically, the report must indicate clearly, among other things, the opinion as to the financial statements covered and the accounting principles and practices reflected therein, and the consistency of application of those principles. These requirements have existed without noticeable change since Regulation S-X was originally adopted in ASR 12 (February 21, 1940). Rule 2-02(c) is the Commission's version of those requirements the accounting profession has long imposed on itself.

The justification for an auditor expressing an opinion on financial statements rests on his having conformed with generally accepted *auditing* standards and on his findings. Generally accepted auditing standards, in turn, include four standards of reporting as set forth in Statement on Auditing Standards No. 1, Section 150.02: (i) the report shall state whether the financial statements are presented in accordance with generally accepted *accounting* principles; (ii) the report shall state whether such principles have been consistently observed; (iii) unless otherwise stated in the report, informative disclosures in financial statements are to be regarded as reasonably adequate; and (iv) the report shall express the auditor's opinion regarding the financial statements taken as a whole or disclaim that the auditor has such an opinion.

The AICPA's Auditing Standards Executive Committee recently amended SAS-1 with respect to the first standard of reporting by issuing SAS-5, in July 1975. In addressing whether financial statements are presented in conformity with generally accepted accounting principles, SAS-5 sets forth in detail those areas in which the auditor, in rendering his opinion, must exercise judgment, and provides guidance for the selection and evaluation of accounting principles.[15]

Similarly, Rule 2-02(c), adopted two years after ASR 4, reflects the Commission's policy in that Release to regard financial statements as presumptively misleading if they are prepared in accordance with accounting principles for which there is no substantial

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[15] SAS-5 is discussed, *supra*, on page 12 (footnote 14) and page 13, and in more detail in Appendix D, pages D-5 and D-6.

authoritative support, and its determination to accept only financial statements prepared in accordance with practices for which there is substantial authoritative support. ASR 150 builds on ASR 4 by stating the Commission's policy of considering FASB Statements and Interpretations and effective APB Opinions and ARBs as constituting substantial authoritative support for purposes of ASR 4, unless the Commission determines otherwise in particular circumstances, and SAS-5 requires the exercise of judgment in selection and evaluation of accounting principles.

In short, Rule 2-02(c), ASR 4, AICPA Rule 203, ASR 150 and SAS-5 are consistent. Taken together, they provide a framework for registrants and their independent auditors in meeting their responsibilities and obligations, and guidance in reaching their judgments.

The Foundation and the FASB believe, therefore, that little could be gained by the Commission, after 36 years of Rule 2-02(c), now taking steps to define *how* and *by whom* accounting principles and practices are to be evaluated and applied.

CONCLUSION

The Foundation and the FASB urge the Commission to take appropriate action, promptly and unequivocally, to reaffirm the authority of the FASB and the intent of the Commission to continue its historic administrative practice and policy of looking to the FASB, as the designated standards-setting body, to provide leadership within the private sector in establishing and improving accounting principles, standards and practices.

Unless such action is taken promptly, doubt concerning the existing body of authoritative accounting literature and the continuing role of the private sector through the FASB in establishing accounting principles, standards and practices inevitably will give rise to confusion and uncertainty, thus working to the detriment of preparers, auditors, and users of financial information, and ultimately the public interest.

Respectfully submitted,

FINANCIAL ACCOUNTING FOUNDATION

By /s/ Ralph E. Kent
Ralph E. Kent, President

FINANCIAL ACCOUNTING STANDARDS BOARD

By /s/ Marshall S. Armstrong
Marshall S. Armstrong, Chairman

cc: Chairman Roderick M. Hills
and other Members of the
Securities and Exchange Commission