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Evolution of U.S. Regulation and the Standard-Setting Process for Financial Reporting: 1930s to the Present

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Evolution of U.S. Regulation and the Standard-Setting Process for Financial Reporting: 1930s to the Present

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ABSTRACT

Since the 1930s, successive private-sector accounting standard setters in the United States have established, under the oversight of the Securities and Exchange Commission (SEC), "generally accepted accounting principles" for use by public companies. In the early decades, when the standard setter was a committee or board of the American Institute of Certified Public Accountants, and was a part-time body with a slender staff, the SEC intervened actively in its deliberations and in the formulation of its recommended practices. With the coming of the independent, full-time, well-resourced Financial Accounting Standards Board (FASB) in 1973, the SEC's regard for the standard setter increased, and a climate of mutual respect and consultation prevailed. But beginning in the 1990s, companies and banks strongly opposing the Board's standards already issued or in prospect increasingly turned to members of Congress for relief, hoping to force the FASB to back down.

This article is a recounting and explanation of the series of episodes from the 1930s to the present on the evolution of the

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U.S. regulatory and standard-setting process for financial reporting by companies in the private sector. By gathering together all of these events and developments in a single article, it is hoped that researchers will come to appreciate the historical antecedents that have shaped today's institutional reality for both the SEC and the FASB. An extensive list of references to books, articles, press reports, and other documents has been provided to enable readers to obtain a fuller story of this evolution. An appendix completes the article, containing the first published list of the SEC Chief Accountants from 1935 to the present.

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1

Introduction and the Formation of the SEC

The collaborative system for regulating and setting standards for the norms of financial reporting in the United States has evolved in stages since the early 1930s. On various occasions, its sustainability has been threatened by challenges from powerful lobbying groups representing parties aggrieved by a proposed, or already approved, accounting standard. The regulator has been a federal government agency, the Securities and Exchange Commission (SEC), while the standard setter has been a body in the private sector, currently the Financial Accounting Standards Board (FASB). On occasion, members of the federal Congress, which oversees and funds the SEC, have also intervened in the regulatory and standard-setting processes.

The aim of this article is to survey and attempt to explain the evolution of the stream of events and developments in the regulation and standard setting that have set the requirements for companies' financial reporting in the U.S. capital market. Particular attention is given to instances in which the SEC, as regulator, has either been in disagreement with the private-sector accounting standard setter, or where they both have partnered in a solution. Attention is also given to some of the more celebrated attempts by self-interested parties,

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particularly the company sector, to interpose themselves forcefully into the standard-setting process. The interventions from members of Congress on behalf of the company sector are also the object of study. Inevitably, the selection of events and developments to review over the span of some 90 years is a personal one, and other researchers would certainly make different choices. In this rendering of the evolution, the author has endeavored to provide extensive references to the published literature to enable readers to study the events and developments in greater depth.

Members of the private-sector standard setter have sometimes chafed at the unequal relationship between it and the federal regulator. Professor Charles T. Horngren (1972, 39), who served for five years as a member of the part-time Accounting Principles Board (APB), the immediate predecessor of the FASB, complained that the relationship between the SEC and the APB was that of top management and lower management. He wrote that lower-level management (the APB) "does an enormous amount of work for no salary and has just enough freedom to want to continue the arrangement. . . . however, the Board has been unjustifiably criticized for timidity or vacillation on several occasions when the basic explanation for the Board's behavior has been no assurance of support from the SEC." John C. (Sandy) Burton, then the SEC Chief Accountant, disputed that characterization. In an interview, he said, "I feel that, as Chairman Casey said, we are in partnership and that our best interests are served in an atmosphere of mutual nonsurprise" (Pacter and Nolan, 1973, 26). Subsequently he said, "The relationship is a legitimate partnership, not a superior-subordinate relationship" (Burton, 1974, 273).[1]

Leonard M. Savoie, the AICPA's Executive Vice President who oversaw the APB, had a similar view as Horngren's. In 1974, he wrote, "we can expect the SEC to continue to use the private sector body, soon to be the FASB, for doing the research and detailed rule-making within the parameters set by the SEC. This is a convenient arrangement for the SEC. It permits the SEC to function with a small accounting staff while

[1] For a view on the SEC-FASB relationship during the post-Burton years, see Sprouse (1987). Robert T. Sprouse was Vice Chair of the FASB from 1975 to 1985.

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enjoying the extensive expert services of the private sector Board. This arrangement also diverts almost all criticism and some pressures to the Board. The SEC has good reason to want to continue this arrangement" (1974, 324). Miller *et al.* (1998, 158–159) concur with Savoie.

In his replies to Horngren, Sandy Burton may well have been thinking of the SEC's relationship with the full-time, independent, heavily resourced FASB, which had just come into existence, not with the APB. As will be seen below, the SEC came to regard the FASB as a much more professional standard setter which was worthy of the Commission's respect.

1.1 Professional Accountancy Body Responds to the New York Stock Exchange, 1932–1934

The story of the evolution of U.S. regulation and the standard-setting process for financial reporting begins in 1932, even before Congressional passage of the Securities Acts of 1933–1934. Prior to then, the New York Stock Exchange (NYSE) had appointed J. M. B. Hoxsey as the full-time executive assistant to the Committee on Stock List in 1926, and the Exchange had been urging its listed companies to secure annual audits and to publish more informative annual and even quarterly financial statements. This was at a time when there was no federal government body that regulated the financial reporting by publicly traded companies, and the states' corporation laws did not, with rare exceptions, require companies to furnish their shareholders with audited financial statements, or to adopt GAAP (generally accepted accounting principles) when they did (Siegel, 1986). The oversight by the states' securities commissions was easily circumvented by companies engaging in the interstate trading of shares (Seligman, 2003, 45).

In the mid-1920s, William Z. Ripley, a Harvard University economist, criticized corporations for their deficient financial reporting, first in a widely noticed article, "Stop, Look, Listen! The Shareholder's Right to Adequate Information," in the September 1926 issue of *The Atlantic Monthly*, and then in a book, *Main Street and Wall Street* (1927), which caused a public stir (Chatov, 1975, 18–20).[2] In the article and again in

[2] For more on Ripley, see Miranti (1990, 136–137).

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the book, he called on the Federal Trade Commission to "address itself vigorously to the matter of adequate and intelligent corporate publicity" (Ripley, 1926, 399; 1927, 228). George O. May, the English-bred senior partner of Price, Waterhouse & Co., feared a government takeover of accounting and took steps to head it off (May, 1926, 42; Zeff, 1984, 451). In 1926, his firm offered to be the NYSE's accounting adviser, with May as its representative, and the Exchange agreed. He then persuaded the American Institute of Accountants, one of the two major national accountancy bodies, to offer to collaborate with the Exchange in order to improve company reporting, but the Exchange declined. Yet May persevered, and, following the Stock Market Crash in October 1929, the Exchange was more receptive. In 1930, spurred by its concern over the multiple accounting methods used for the same kind of transaction by different companies, the Exchange's Hoxsey said that he welcomed the collaboration with the Institute (Zeff, 1972, 119–122).

In 1930–1931, the Institute formed a blue-ribbon committee, the Special Committee on Co-operation with Stock Exchanges, composed of the senior partners of the six largest audit firms, with May as the chair. It seems that May, who was a dominant figure in the profession, drafted all of the committee's communications to the Exchange. After an exchange of correspondence in 1931 and early 1932 between the committee and Hoxsey on specific questions, on September 22, 1932 the committee wrote a 15-page letter to the NYSE's Committee on Stock List in which it proposed that the Exchange "make universal the acceptance by listed corporations of certain broad principles of accounting which have won fairly general acceptance." The committee then appended five such "broad principles of accounting," which included some practices that were intended to correct accounting abuses during the 1920s. The committee's general proposition was that the Exchange should require listed corporations to make available to shareholders "on request and upon payment, if desired," a list of the accounting methods which the corporation employs in its financial statements, together with an assurance that it will follow those methods consistently from year to year (*Audits of Corporate Accounts*, 1934, 12–14). May himself was opposed to the imposition of uniform accounting methods across corporations, yet the Exchange, or at least Hoxsey, was concerned about

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the undisciplined diversity of practice from one listed corporation to the next. May's thinking was expressed in the following sentence in the committee's letter:

> Within quite wide limits, it is relatively unimportant to the investor what precise rules or conventions are adopted by a corporation in reporting its earnings if he knows what method is being followed and is assured that it is followed consistently from year to year.
>
> (*Audits of Corporate Accounts*, 1934, 9)

In the end, the Exchange did not implement the committee's proposition (Carey, 1969, 160–180; Grady, P., ed., 1962, Chap. 6; Seligman, 2003, 46–49; Storey, 1964, 9–15; Zeff, 1972, 121–126; Zeff, 1984, 450–452).

The committee's most important and enduring recommendation was for auditors to affirm in their certificate that companies' balance sheets and statements of income and surplus "fairly present, in accordance with accepted principles of accounting" their position and results of operations. In January 1934, the Stock Exchange approved this new form of certificate (Form of Certificate, 1934; Zeff and Moonitz, 1984, 118).

1.2 Passage of the Securities Acts of 1933–1934 and Formation of the SEC

By the time the committee's series of communications with the Exchange ended in 1934, its efforts were overtaken by Congressional passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, and formation of the Securities and Exchange Commission[3] (SEC) (de Bedts, 1964; Doron, 2015; Hawkins, 1986, Chap. 8; Landis, 1959; Parrish,

[3] The SEC and the Securities Acts have not been without their detractors. Professor George J. Benston was one of the leading critics. He has written that "The accounting information that the SEC requires is, on the whole, not relevant for investors [and] . . . the accounting disclosure requirements of the securities acts are an unwarranted imposition on corporations and investors, despite the good intentions of legislators and honest and conscientious administration by the commission" (1969, 73, 76). Professor Homer Kripke (1979), another critic, has argued that the SEC needs to modernize its approach to regulating corporate disclosure.

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1970, Seligman, 2003, Chaps. 2 and 3). The Securities Act, which was approved on May 27, 1933, stipulated that registration statements (in initial public offerings) must include a balance sheet and profit and loss statement, and it charged the Federal Trade Commission with assuring that such information was "fully adequate for the protection of investors" (Section 7) and "not misleading" (Section 8(d)). Schedule A of the Act provided that the balance sheet and profit and loss statement, to be included in the registration statement, shall be prepared "in such detail and in such form as the Commission shall prescribe" (paragraphs 25 and 26).

The Securities Exchange Act, which was approved on June 6, 1934, created the SEC and said in a section entitled "Periodical and Other Reports" as follows:

> The Commission may prescribe, in regard to reports made pursuant to this title, the form or forms in which the required information shall be set forth, the items or details to be shown in the balance sheet and the earning statement, and the methods to be followed in the preparation of reports, in the appraisal or valuation of assets and liabilities, in the determination of depreciation and depletion, in the differentiation of recurring and nonrecurring income, in the differentiation of investment and operating income, and in the preparation, where the Commission deems it necessary or desirable, of separate and/or consolidated balance sheets or income accounts. . . . (Section 13(b)).

The SEC inherited the duties assigned to the Federal Trade Commission in the Securities Act of 1933. The SEC was also charged with overseeing the rules and operations of the New York Stock Exchange and other exchanges.

These Acts for the first time established federal government control over the financial reporting by publicly traded corporations (Pines, 1965, 727–729). The SEC has a Chair and four Commissioners who are chosen

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by the President with the advice and consent of the Senate. It has a sizable staff which is organized into divisions and offices.[4]

In December 1935, the SEC established the position of Chief Accountant, and Chair James M. Landis chose Carman G. Blough, a CPA who had been on the Commission's staff for the past year, as the first occupant of that office. The Chief Accountant, who eventually became head of the Office of the Chief Accountant, is the principal adviser to the Commission, and to the various divisions and offices, on matters related to accounting and auditing. He is responsible for these matters in the Commission's administration of the federal securities laws, particularly with respect to the form and content of financial statements to be filed with the Commission.[5] Thus far, the Commission has had 18 Chief Accountants, all men. The first four and the sixth and seventh (Blough, William W. Werntz, Earle C. King, Andrew Barr, A. Clarence Sampson, and Edmund Coulson) were career civil servants, while the others were typically recruited from the private sector and usually remained in office for two to three years. All were CPAs but Werntz and King; Werntz was a lawyer.[6] That only one Chair and two Commissioners in the SEC's more than 85 years have been CPAs suggests that the Commission has been heavily dependent on the Chief Accountant for accounting and auditing advice.[7] A list of the 18 Chief Accountants and their terms of office is shown in the appendix.

[4]For more about the SEC and its activities related to financial reporting, see Hamlen (2018) and Zeff (1995).

[5]This characterization of the scope of the Chief Accountant's responsibilities has been adapted from the SEC's website. Beginning in the Commission's 1939 annual report to Congress, it included a section entitled "Activities of the Commission in the Field of Accounting and Auditing." These sections from 1939 to 1953 may be found in Zeff and M. Moonitz, eds. (1984). The Commission's full annual reports may be found on the website of the Securities and Exchange Commission Historical Society (http://www.sechistorical.org/).

[6]For more on the successive Chief Accountants, see Previts (1978), Sack (1988), and Previts *et al.* (2003).

[7]The Chair was Donald C. Cook (1952–1953), who was also a lawyer, and the Commissioners were Edward T. McCormick (1949–1951) and James J. Needham (1969–1972). Of the three, Needham was the only accounting practitioner; he was a partner in A. M. Pullen & Company. The vast majority of the Chairs and Commissioners have been lawyers.

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The SEC's Division of Corporation Finance (CorpFin) regularly reviews the financial statements in filings for compliance with GAAP, and it corresponds with registrants on any questionable accounting and disclosure practices, occasionally leading to conferences at the SEC's offices between the company, the partner in charge of its audit engagement, and the staff of CorpFin. During such meetings, the SEC representatives are sometimes heard to say that the SEC interprets GAAP in a way that was previously not publicly known. In this way, SEC staff creates "silent GAAP," but they also have revealed their interpretations of GAAP in speeches and articles, even though these utterances are always prefaced with the caveat that the views being expressed are not necessarily those of the Commission (Zeff, 1972, 151–152). Hence, not all of GAAP can be found in the pronouncements of the standard setters and in SEC publications.

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