Remarks Of

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Environmental Liability Disclosure, Litigation Reform, and Accounting Matters of Interest

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*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

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I. Introduction

I am honored to participate once again in a conference of the National Association of Manufacturers ("NAM"). I wish to encourage the members of the NAM to remain involved in the legislative and regulatory process, particularly insofar as issues involving our capital formation system are concerned. I have enjoyed working with your staff and look forward to the continuation of the dialogue that has been established between us. While differences in approach may be advocated from time to time, I know that I share with the NAM the goal of fair and efficient capital markets, free from unnecessary governmental regulation.

It is my intention today to address briefly several issues that I believe are of interest to the NAM: environmental liability disclosure, securities litigation reform, the FASB's stock option valuation project, the Financial Fraud Detection and Disclosure Act sponsored by Congressman Wyden, and the AICPA's plan for public reporting on internal controls.

II. Environmental Liability Disclosure Development

As an initial matter, I wish to begin by mentioning one development which has occurred recently in the environmental liability disclosure area and that development is Staff Accounting Bulletin No. 92 ("SAB") which was issued by Commission staff in June. Commission staff have been concerned for some time with environmental liability accounting practice, particularly in view of the potentially enormous environmental liability costs looming on the horizon. The SAB is intended to address some of the deficiencies in the current accounting practice.

The SAB, which sets forth the staff's interpretation of GAAP regarding contingent liabilities, will affect in particular those issuers that may have incurred environmental liabilities. The SAB's guidance is intended to promote timely recognition of contingent losses and to address the diversity in practice with respect to the accounting and disclosures in this area. Hopefully, publication of the SAB will improve environmental liability accounting practice.

Specifically, the SAB presents the view of Commission staff regarding: (1) the manner in which a contingent and any related asset representing claims for recovery should be displayed in the financial statements (offsetting); (2) the appropriate discount rate to be used for recognition of a contingent liability presented at its present value to reflect the time value of money (discounting); and (3) the disclosures that are likely to be of particular significance to investors in their assessment of these contingencies. The most controversial aspect of the SAB is likely to be the view of Commission staff that for the vast majority of situations, contingent liabilities should be displayed on the face of the balance sheet separately from amounts of claims for recovery from insurance carriers or other third parties.[1]

Since offsetting is probably the most controversial aspect of the SAB, I wish to discuss that particular issue in a little more detail.

Rather than recognize and display separately the liability representing the likely settlement amount of a contingent liability and the asset representing the amount likely to be recovered from the insurance carrier, many issuers recognize the liability net of the insurance claim. This practice is equivalent to "offsetting" the insurance receivable against the contingent liability.

Current requirements permit liabilities to be offset by probable insurance recoveries. However, most insurance claims are heavily litigated, and no litigation

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1 The exception being that offsetting is permissible when the conditions of FIN 39 are met. See infra note 2. This will probably be a rare circumstance.

outcome pattern has yet been established. Thus, in most of these situations, the recovery is not probable of realization.

In the view of Commission staff, presentation in the balance sheet of the gross, rather than net, amount of the liability most fairly presents the potential consequences of the contingent claim on the issuer's resources. For example, the issuer's liquidity may be affected materially if cash settlement of the liability must be made prior to receipt of insurance proceeds, even if the insurance recovery is indeed probable of realization. Separate display of the gross liability and the amount probable of recovery highlights the different factors that affect these two estimated outcomes and the related cash flows. Offsetting the two components may leave investors unaware of the magnitude of the liability and may lull them into a less rigorous consideration of the legal sufficiency of the issuer's claims for recovery and the creditworthiness of the party from whom recovery is anticipated.[2] Separate display would not affect the measurement of income or stockholders' equity.

Separate display of the claim for recovery is expected to lead to more rigorous

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2 The accounting literature generally proscribes the offsetting of assets and liabilities except where a right of setoff exists. Accounting Principles Board Opinion No. 10, "Omnibus Opinion --1966" ("APB 10"), states that "[i]t is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists." This general proscription was strengthened by the FASB in a recently issued interpretation, Financial Accounting Standards Board Interpretation No. 39, "Offsetting of Amounts Relating to Certain Contracts" ("FIN 39"). FIN 39 indicates that the prohibition on setoff in the balance sheet should be applied more comprehensively than it may have previously been in practice.

Paragraph 5 of FIN 39 states that a right of setoff exists when all of the following conditions are met:

a. Each of the two parties owes the other determinable amounts.
b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
c. The reporting party intends to set off.
d. The right of setoff is enforceable at law.

consideration of the uncertainties affecting realization of that claim. The SAB's limitation on offsetting is consistent with the notion that financial statement preparers must evaluate separately the circumstances under which the amount deemed recoverable from an insurance carrier or other third party may qualify for recognition as an asset. In my opinion, the SAB is also consistent with current accounting literature, in particular APB 10 and the FASB's recent interpretation regarding setoffs as contained in FIN 39.[3]

I know there are many issuers that presently recognize contingent liabilities reduced by an undisclosed setoff of claims for recovery which are probable of realization. The SAB indicates that Commission staff will not object if an issuer continues to account for a claim for recovery that is probable of realization as an offset against the contingent liability, rather than display it within total assets, until the effective date of FIN 39. I understand that the FIN 39 standard is effective for financial statements for periods beginning after December 15, 1993, which for most issuers will mean the first quarter 1994 form 10-Q. In the interim, however, issuers are advised to disclose in a note to the financial statements the gross amount of probable recoveries that is netted against the contingent liability.

While the SAB is not a rule or interpretation of the Commission but represents the interpretations and practices followed by the Commission's Division of Corporation Finance and the Office of the Chief Accountant, generally, I agree with the staff positions set forth in the SAB, I know that the NAM has expressed concerns about the feasibility of the SAB. My guess is that these concerns pertain more to the environmental laws and regulations than to disclosure matters such as the SAB. I am of the opinion that publication of the SAB will assist practitioners in the environmental

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3 See supra note 2.

liability accounting area. I strongly recommend that interested parties in this area carefully review the SAB and let me know of your thoughts on this matter.

III. Securities Litigation Reform

On the legislative front, securities litigation reform remains a controversial topic of interest. Legislation on the subject has been reintroduced in the House by Congressman Tauzin, and Senator Dodd recently held a hearing on the subject in the Senate.[4]

While I do believe that meritless securities litigation is a problem, I am not a supporter of the current legislative attempts to achieve securities litigation reform. I prefer the reform that apparently is already taking place judicially. For example, in a decision with national implications, the California Supreme Court recently held that investors who sue for fraud cannot collect punitive damages unless they prove that they actually relied on corporate misrepresent- ations in making their investment decisions.[5] For another example, I understand that Rule 11 sanctions are now beginning to be levelled by courts against both plaintiffs and defendants for taking meritless positions. Further, if certain amendments to the federal rules of civil procedure are adopted as recommended by the federal judiciary, Rule 11 will probably be invoked even more frequently. Moreover, the Supreme Court earlier this year narrowed the application of the civil liability provisions of RICO[6] and has affirmed the right of defendants to seek contribution from persons who were jointly responsible with them for securities law

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4 See Testimony of William R. McLucas, Director, Division of Enforcement, SEC, Concerning Private Litigation under the Federal Securities Laws, Before the Subcommittee on Securities of the Senate Banking, Housing, and Urban Affairs Committee (June 17, 1993)("McLucas Testimony").

55 See Dolan, "Ruling Limits Investors Rights in Fraud Cases," Los Angeles Times (Sept. 10, 1993), at 1.

6 Reves v. Ernst & Young, 61 U.S.L.W. 4207 (U.S. March 3, 1993).

violations.[7]

These reforms, already taking place within the parameters of our existing litigation system, make a lot more sense to me than the well-intentioned but misguided legislative vehicles currently being bounced around.

Notwithstanding the foregoing, there could be compiled a legislative reform package that I would consider supporting, in addition to the judicial reforms underway. I will mention briefly some of the components of such a package.

A. RICO Reform

For a number of years, the Commission has supported legislative efforts to eliminate the overlap between private remedies under the Racketeer Influenced and Corrupt Organizations Act ("RICO") and those available under the federal securities laws.[8] This position has been taken because the securities laws generally provide effective remedies for the victims of securities fraud. The civil liability provisions of RICO, however, permit plaintiffs to seek extraordinary remedies, such as treble damages and the recovery of costs and attorneys fees. Exposing issuers and other market participants to the threat of such extraordinary remedies has a coercive effect that tends to impede capital formation and to place inappropriate financial burdens on commercial defendants.

As I mentioned earlier, the Supreme Court's recent decision in Reves v. Ernst & Young[9] has narrowed substantially the exposure of accountants and other professional

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7 Musick, Peeler & Garrett v. Employers Insurance of Wausau, 61 U.S.L.W. 4520 (U.S. June 1, 1993).

8 See, e.g., Testimony of Mary L. Schapiro, Commissioner, SEC, "Concerning H.R. 1717, the RICO Amendments Act of 1991," Before the Subcommittee on Intellectual Property and Judiciary Administration of the House Judiciary Committee (Apr. 25, 1991).

9 See supra note 6.

advisers to RICO liability. However, although the Reves decision may diminish the exposure of professional advisers to liability under RICO, it is not likely to affect cases against issuers and broker-dealers. Accordingly, legislation to eliminate the application of RICO's civil liability provisions in private securities law actions continues to be appropriate.

B. Class Action Reform

The Commission historically has also expressed general support for certain measures designed to curb abuses in private securities cases brought as class actions under the federal rules of civil procedure.[10] These included measures that would prohibit the payment of additional compensation to a class representative, the payment of referral fees by class counsel, and service as class counsel by an attorney who has beneficial interest in the securities that are the subject of the litigation. The Commission further has supported a prohibition against the payment of attorneys' fees from funds disgorged in a Commission action. All of these measures are worth pursuing and merit support in my judgment.

C. Contribution

Further, as a less problematic alternative to proportionate liability legislation, I would prefer to focus on issues related to the equitable doctrine of contribution. Under this doctrine, which is closely related to the concept of proportionate liability, a defendant against whom judgment has been rendered may seek reimbursement from other persons who are jointly liable for payments made in excess of the defendant's share of the liability. Earlier this month, as I previously mentioned, the Supreme Court held that a right of contribution is available in private actions under Section 10(b) and Rule 10b-5, a result urged by the Commission in an amicus curiae brief filed

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10 See McLucas Testimony, supra note 4.

with the Court.[11] The Court has not resolved, however, a conflict among the circuits concerning how contribution should operate, particularly where there is a partial settlement of a multiparty action.

Legislation in the area of contribution would be useful in my view because, like the determination of an appropriate statute of limitations, it involves striking the right balance among competing policy concerns. Legislation in this area also would eliminate the current uncertainty regarding the manner in which contribution rights should be implemented. At the same time, because such legislation would not limit the ability of investors to be fully compensated for their losses, it would not be as controversial as other proposals that may have that impact.

In any event, I could foresee a legislative package being compiled which could provide some additional impetus for securities litigation reform that I would support.

IV. Stock Option Valuation

Moving on to the subject of executive compensation, it appears to me that the new executive compensation disclosure requirements have enabled the marketplace to discern the compensation policy and practices of issuers. This was not possible before as a practical matter.

I recognize that compliance with these new requirements proved painful for companies this year. Hopefully, this pain is a one time occurrence and that once adjusted to the new requirements, compliance will be easier to achieve and much smoother next year. The Commission issued an interpretive release on the subject this summer which was designed to facilitate such compliance in the future, and I believe that the release will be successful in that regard.

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11 See supra note 7.

The new executive compensation disclosure rules contain a requirement to disclose the value of employee stock options either on the basis of an assumed increase in stock price, or through valuation using a model such as Black-Scholes. This provision was not especially popular with the corporate community at the time, but such unhappiness was slight compared to the current unhappiness with the Financial Accounting Standards Board's ("FASB") project to require a valuation of employee stock options either on the date granted or on the date vested. Once this value is determined, it would be required to appear as a compensation expense on the company's income statement.

The FASB's proposed accounting treatment would be quite a departure from the present day accounting treatment required by APB 25. Under the current accounting treatment, I understand that nothing needs to be expensed unless, at the time of grant, the option exercise price is lower than the present market price of the underlying common stock.

Supporters of the FASB proposal argue that the present treatment of option awards is inconsistent with the treatment of stock awards, which are expensed. They further argue that options have inherent value as of grant date and are given to executives as a replacement for cash bonuses, which would require expensing. Although these are valid points, experts probably could debate the best option value methodology until the turn of the century without reaching a consensus. The Commission had a not so pleasant taste of this controversy in its own executive compensation disclosure project.

Further, while the impact of the FASB project with respect to most companies would be minimal, it arguably could prevent a small growth company from going public. It would be unfortunate if a valuation accounting project, which may only marginally improve the quality of a financial statement, hindered the rise of even one future star company. Such an occurrence would be most negative for our capital formation system. Moreover, FASB's stock option valuation proposal may run counter to the policy of encouraging employees to be owners. If a choice must be made between the two, I prefer the policy of encouraging employees to be owners rather than at best incrementally improving the quality of a company's financial statement.

In any event, it appears that the supporters of the FASB proposal have won, at least for the moment. An Exposure Draft has been issued for a new accounting standard which would require: (1) an accounting expense for the "fair value" of stock options and other equity-based instruments granted to employees after December 31, 1996, and (2) disclosure in the footnotes to the financial statements of the "fair value" of such grants made after December 31, 1993. Thus, starting next year, all stock option grants will need to be valued and disclosed in a footnote to the financial statements.

While I support the footnote disclosure requirement, I question whether an expense requirement is necessary. I would argue that the true cost to shareholders of a stock option is the dilution experienced with the issuance of new shares, which can be described adequately through disclosure. Unless I receive some indication that the FASB is considering reversing its initial decision, or some strong indication of widespread disapproval such as congressional action, though, I intend to respect the FASB's decision.

Congress has conferred on the Commission statutory responsibility for defining the content of accounting principles for companies filing with the Commission or making public offerings of securities. Since the inception of the FASB, however, the Commission has looked to the private sector to establish and to improve accounting principles. I believe that this historical relationship should be maintained, even when the decision by the FASB is an unpopular one, unless there is a very strong public signal otherwise, such as an indication of disapproval from Congress.

While I would not be inclined to support legislation designed to overrule the FASB, passage of a sense of the Senate resolution, for example, may be a different matter. Passage of such a resolution would be a clear signal, at least to me, that the FASB decision should be reevaluated, historical relationship notwithstanding.

It is my hope, however, that the FASB will consider eliminating for now the expensing implementation date. There should first occur some experience with the new disclosure period before expense recognition is required. Disclosure period experience is particularly warranted in this instance in my view since there appears to be no consensus existing yet for any one option valuation methodology. I believe it is important that there exists a high degree of confidence that the option valuation method or methods selected would in fact improve the quality of financial statements. In addition to accuracy, it is also important that the method or methods selected provide comparability. I am not sure that the present valuation models satisfy these conditions. Therefore, I encourage the FASB to move prudently and cautiously when selecting an option-pricing model. This evaluation process should be designed to achieve validity and reliability rather than implementation.

V. Other Accounting Matters

There are a couple of other accounting matters that I wish to discuss briefly with you today. The first is Congressman Wyden's legislation, H.R. 574, and the second is the American Institute of Certified Public Accountants' ("AICPA") plan for public reporting on corporate internal controls.

For some time now, Congressman Wyden has sponsored the Financial Fraud Detection and Disclosure Act which would place a greater burden on independent auditors to inform top corporate management, and, in some cases, the Commission, of illegalities discovered during audits. There apparently exists substantial support for this legislation in the House, and similar legislation has been introduced in the Senate by Senator Kerry.

As I understand, H.R. 574 would require each audit under the Exchange Act to include in accordance with generally accepted auditing standards as may be modified or supplemented from time to time by the Commission:

- procedures for the detection of illegal acts,
- procedures to identify related party transactions, and
- an evaluation of the issuer's ability to continue as a going concern

The bill also would require auditors to report detected illegal acts directly to the board of directors if:

- the illegal act is material to the financial statements,
- management and the board have failed to correct the illegal act, and
- the auditor reasonably expects to qualify its report or resign due to the illegal act.

The issuer would have one business day to notify the Commission that the auditor has given the board such a report. If the issuer does not so notify the Commission, then the auditor has to furnish the Commission with a copy of the report within the next business day.

Generally, I support H.R. 574. At the same time, I recognize that the one business day Commission notification requirement contained therein may prove difficult to comply with and that some parts of the bill may be unnecessary since the Commission already has the authority to set auditing standards and since some of the audit procedures in the bill already are required under GAAS. However, on balance, I do believe that the legislation would provide important new protections against financial fraud.

Concerning the internal reporting requirements called for by both the AICPA and the Public Oversight Board, I am inclined to agree with the negative statements made by the Commission's distinguished Chief Accountant, Walter Schuetze, on this subject in July. As Walter stated:

> Unfortunately, the truth is that even companies with good internal controls make mistakes. Internal controls related to financial reporting typically relate to the recording of transactions, the authorization of transactions, and the safeguarding of assets. No amount of internal controls will keep banks from making loans that later go bad, prevent managements from entering into contracts that become loss contracts, or make each decision to fund research and development pay off. Investors will be disappointed. And, in their disappointment, investors and others may point to the "clean" audit report on the effectiveness of the issuer's internal controls and ask, "How could this happen?"
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> Proponents of auditor reporting on internal controls should make sure that there is an obvious and readily understandable answer to this question before asking the staff of the Commission to consider the imposition of more, costly reporting requirements on public companies.
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> I believe that auditor reporting on internal controls will not stop the crooks of the world who are going to make the financial statements say what they want them to say regardless of the facts, and that auditor reporting on internal controls will not solve the more pervasive and more important problem of managements pushing pliable accounting standards.[12]

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12 "Reporting by Independent Auditors on Internal Controls over Financial Reporting," Remarks delivered by Walter P. Schuetze, Chief Accountant, SEC, at a Symposium Sponsored by the CPA Journal, Washington, D.C. (July 15, 1993).

I believe that Walter is right, and I am inclined to be of the view that the AICPA's proposal for auditor reporting on internal controls does not pass muster under the proverbial cost-benefit test.

VI. Conclusion

Since I suspect that my time has more than expired, I will conclude. I have enjoyed participating in this conference. I look forward to working with the NAM during the remainder of my Commission tenure, which unfortunately grows shorter.

Communication solves a great many problems, and I intend to continue the dialogue that I have established with the NAM. I believe that we share a common interest in maintaining a fair and efficient capital formation system. We can and should work together toward achieving that objective.