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THE PARTNERSHIP BETWEEN THE ACCOUNTING PROFESSION AND THE SEC.

by

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It is a particular pleasure to have the opportunity to address the annual meeting of the American Institute of CPA's, since in talking to this group I am speaking to the representatives of a profession which is very much in partnership with the SEC. This partnership was formed by the Congressional decision made almost 40 years ago to refrain from any effort to establish a Federal corps of auditors to verify corporate reports but rather to rely on the independent audits made by independent accountants. Although this relationship has never been formalized as self-regulation by business and the accounting profession, that is what it is in a very real sense. The investing public and the Commission rely on the work of the accounting profession to achieve responsibility and reliability in financial reporting in much the same way reliance is placed on the stock exchanges and the National Association of Securities Dealers to achieve and maintain fair practices and financial responsibility in the sale of securities and in taking care of the funds and securities of investors.

Let me suggest some of the dimensions of our partnership and point out some of the things which I believe are required if we are to meet the test which we cannot avoid -- that of fulfilling public expectations.

First, we must look at some of the requirements faced on a profession-wide basis. The one which has received the greatest attention is the establishment of standards of reporting which satisfy the information needs of the investing public. There are two parts to this problem: The establishment of principles of measurement to be followed and the determination as to the extent of disclosure of information that is required. In both these areas, Congress assigned to the Commission the authority to act.

In the case of establishing principles, for nearly 40 years the Commission has chosen to exercise this authority by encouraging and cooperating with the accounting profession to improve accounting practices rather than to attempt itself to prescribe the detailed rules.

The basic question before us is whether that approach is good enough. I'd like to make clear at the outset that it

is my personal preference to keep the formulation of accounting principles and standards and their implementation in the hands of the profession, subject to the oversight of the Commission. But as I look back at the record and the progress in improving accounting standards to deal with the growing complexity of business and the proliferating requirements of users of financial statements, I find myself virtually forced to the view that the Commission should exercise more vigorous oversight and undertake to force the pace at which the profession meets the multiplicity of demands made upon it and generates reports which are more comparable, more revealing and more meaningful.

Now, I want you to understand that I move toward this conclusion with great respect, great admiration and great hope for what your profession has done and will do for the effort and resources you have committed, for the work of the Wheat and Trueblood Committees, and for the intensified research and rule-making apparatus now being generated by the Financial Accounting Foundation. I also want to assure you that we have no intention of jumping in like the proverbial bull in a china shop to try to write rules for your profession. We do not

intend to place our judgment in matters of accounting principle above that of the Board; we feel this function should remain in the private sector. But we will feel the responsibility to call upon the Financial Accounting Standards Board to give attention to problems on a timely basis and we expect to work cooperatively with it as we have with its predecessor, the Accounting Principles Board. Our recent Accounting Series Release on "Pooling-of-Interests Accounting" is an example of this cooperation. In this case, we identified a problem area from a particular situation which came before us and we promptly discussed the problem with representatives of the Accounting Principles Board. The Board authorized its staff to issue an interpretation which we endorsed and publicized in the Accounting Series Release, together with some guidelines to assist registrants in its application to subsequent filings with the Commission. We believe that in the proceedings of the Standards Board all interested parties should have ample opportunity to make their views known to the Board. We are confident that out of our cooperative effort will come more meaningful standards of measurement which will meet the test

of reason and usability and move away from reliance on detailed rules to be followed without thinking.

In the area of disclosure policies, we will look in part to the Financial Accounting Standards Board, but I expect that the Commission will play a more active role. We hope that the Board will establish disclosure standards, but we feel in this area that we can identify problem areas rapidly and require disclosure that in many cases will go beyond the financial statements alone. A recent example was last Friday's release in which we proposed rules which would require substantial additional disclosure in regard to material unusual charges or credits to income. At the present time we are studying the adequacy of line-of-business disclosure and considering possible changes in our requirements to improve disclosure of the liquidity position of corporations.

We will be devoting more resources to the problems of accounting and reporting. We will increase the staff of the Office of the Chief Accountant and that of the new financial analysis group in the Division of Corporation Finance. We will be developing programs to increase personnel interchanges

between profession and Commission. I hope we get your cooperation in this. A Presidential Exchange Executive from one accounting firm is now working at the Commission for 12-18 months.

In addition to improved reporting standards, there is a pressing need for improved two-way communication between accountants and the users of their statements. It may be every bit as important to create public and investor understanding of what accounting is as it is to redefine its goals and upgrade its methods. It seems vital to me that you correct the impression that accounting is something which produces exact measurements -- that it is a scale on which a business can be weighed to get an exact and precise answer as to its performance and the degree of its progress in any particular period and its value. It seems to me that there is a need for greater public understanding that the accounting process relies on and produces estimates.

Accountants have encouraged the public to think of accounting as an exact science by producing a single number result and limiting accountants' responsibility to a single, segregated section of reports to shareholders, when the essence of the accrual system of accounting is estimation and prediction of future events.

On the other side of the coin, accountants must also recognize that in developing accounting principles, they must pay considerable attention to the perceptions of users of financial statements. If statements are to be useful, they must communicate: They must mean what informed people think they mean. Formulas cannot be used blindly which produce results which defy common sense and fail to present a fair picture. Form cannot triumph over substance.

A third profession-wide requirement which must be fulfilled if our reporting partnership is to be a success is an increased recognition of the need for innovation in financial reporting. This may take the form of revisions of the traditional accounting methodology or it may

be seen in changing patterns of disclosure. . . Examples of the former might be a revision of the single-valued net income measure in recognition of situations where risk is so great that no single number can adequately describe the results of a year's operations, or a revision of traditional income statement classifications, to reflect distinctions between business activities which are readily repeatable and, hence, should be included in a measurement of the continuing earning power of the enterprise and those which were evidence of a single thrust of activity which can only be repeated by expending totally new business effort.

Disclosure innovation might take the form of future oriented data, or information as to the sensitivity of results to important events. Improved analysis of variations occurring in reported results over time would be a wholesome contribution.

If such disclosure would unduly complicate the financial statements or the annual report, it may be that the necessary information should be presented in the form of supplemental material made available to all those who require it for detailed analysis of corporate activities.

While I cannot guarantee that the Commission will view every innovation as an advance, we do encourage you to try us out in situations where you feel that traditional patterns of reporting and disclosure do not tell the corporate story satisfactorily. If the profession and the Commission are not willing to innovate, both run the risk of being left to perform an unneeded ritual while the real world passes by.

Any discussion of innovation leads inevitably to a discussion of responsibility and liability. While I have great sympathy for the liability problems of the profession, I am troubled by the approach that some members of the profession are taking to reduce them. Liability can be either an incentive or a constraint. To a point, liability enforces responsibility. At some further point unpredictable liability can generate a flight from responsibility. It is rare, however, that flight accomplishes its purpose. As Joe Louis once said about an opponent, "he can run but he can't hide."

My own view, and a strong one, is that one gets better protection from liability by moving forward to broaden the

area of responsibility rather than by trying to narrow or restrict it. Attempts to narrow liability run the risk that a court will force it on you unexpectedly in a hard fact situation. It is apparent that the courts today are not willing to take a narrow view of the role of the accountant. In *Continental Vending*, the court established that it is not enough to merely adhere to rules, even if they are generally accepted principles or standards. Rather a critical test is whether the financial statement, as a whole, fairly presents the position of the company and accurately reports its operation for the period it purports to cover. To meet this test and establish good faith, an accounting report has to reflect pertinent information which those who prepare it have, or in due diligence, should obtain, whether or not the disclosure of that information is required by specific generally accepted principles or standards. In the *Yale Express* case, the courts established that the accountant had a duty to assure that users of financial statements on which he reported were informed when he acquired information that the financial statements were false. That

duty would require that the accountant make such disclosures if the company failed to do so.

The message seems to me to be clear. The accountant must be willing to meet the enlarged expectations of a critical public. I believe he should seek and take responsibility for appraisals of internal control, the content of annual reports and perhaps even future oriented data. If he does this with professionalism and with good faith I believe the threat of liability will become less rather more capricious and dangerous.

Finally, it seems to me that an important profession-wide requirement for the accounting profession is the establishment of an improved professional quality control system. Membership in the national professional organization of accountants should represent more than a license and paying dues. It should represent more even than agreement to a code of ethics as vital and necessary as that is.

It seems to me that several steps should be taken in this connection. First, there should be a more active articulation of standards of supervision and control to

assure responsibility at all levels in the work of the profession.

Second, efforts should be made to assure the continuing qualification of members. Continuing education requirements, which I understand are being made prerequisite for continued licensing in a few states, are a major step in the right direction. Various other techniques might be used, but whatever the means, the AICPA should have the responsibility for assuring that its members maintain an adequate level of competence.

Finally, it might be that a more formal mandatory self-policing system should be established so that every professional practice is reviewed periodically by other professionals. In the self-regulation of the securities industry, a comprehensive annual inspection is called for. The situation is not exactly analagous and such a comprehensive inspection may not be necessary on an annual basis in your work. However, if your organization is to be a truly responsible self-regulatory body, some self-policing effort seems called for.

In addition to profession-wide requirements, there are some elements which can only be fulfilled by individual firms in their audits of individual clients. No profession-wide standards or quality control can substitute for superior professional performance in dealing with clients. Every firm must feel the impact of these requirements on every audit engagement.

The primary requirements in this area are a willingness to insist on reporting which makes sense and on disclosure which adequately sets forth all information which is needed by investors. Minimum acceptable practice under a series of specific rules is not sufficient. Least common denominator accounting, where one corporation gets away with slightly sub-par disclosure on accounting and many entities then seek to use this as a precedent for sinking to the same level, is not acceptable to the courts, the Commission or the public.

This requirement also means that the registration and his auditor must consider the overall impact of financial statements. The end result cannot be simply the accumulation of individual transactions without regard to the total effect which they produce.

Another important requirement that must be met in each individual case is that the auditor must feel a sense of responsibility for continuing participation in all phases of public reporting by his client. A once-a-year appearance on the scene to bless an annual audit report does not conform to public expectations of the auditor's role.

In my view, an auditor must carry a responsibility for knowing what is going on at his client, what the fundamental business situation is and whether the public reports being prepared adequately reflect these things. In this connection, I would expect him to review interim reports before they are issued to the public and to consult with his client on reporting problems as they arise.

In short, the auditor must recognize that he is the only independent, public representative immediately involved in the reporting process with the ability to take timely action where necessary to protect both management and investors from misleading reports. No enforcement proceeding after the fact can possibly have the same impact.

In recognition of the need for strengthening the independence and continuing responsibility of auditors, the Commission has taken a number of actions in the past year. First, we imposed a requirement that any auditor change be reported promptly on Form 8-K and that if the change resulted from a disagreement that might have caused the auditor to issue a qualified report, that fact be reported together with a confirming letter from the auditor involved. During the first ten months that this requirement has been in effect, we have received 118 reports of auditor changes. Of these, 15 have indicated differences of opinion on accounting matters. The Commission's staff normally follows up all such reports of differences with request for additional information from the company and careful inspection of subsequent filings to ascertain whether the differences of opinion led to financial statements which might be misleading to investors. We are currently working on a study of auditor change reports and plan to make our findings public later in the year.

Second, we issued Accounting Series Release 123 recommending that corporations establish audit committees

composed of outside directors so as to create a direct channel of communication between auditors and Board and by so doing give added assurance to investors as to the objectivity of financial statements.

Most recently, just last Friday, we issued a release which among other things proposed that auditors report in a timely fashion on the fairness of material unusual charges or credits reported to the Commission on Form 8-K. This reduces the possibility that auditors will be called in after the fact and increases the reliability of the report filed with the Commission.

While it may appear that I have suggested a rather long set of requirements for a partner to follow, all seem to me to be necessary elements in the continuing development of our partnership. If these requirements are met both by the accounting profession and by individual auditors, as I expect that they will be, the continuing partnership of the SEC and the profession will be a long and profitable one and, most importantly, one which well serves the public interest.