

TESTIMONY OF
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
NEW YORK, NEW YORK

ON HR. 15481
BEFORE THE
SUBCOMMITTEE ON CONSUMER PROTECTION
AND FINANCE
OF THE
COMMITTEE ON INTERSTATE AND
FOREIGN COMMERCE
U.S. HOUSE OF REPRESENTATIVES

SEPTEMBER 22, 1976

Mr. Chairman and Members of the Subcommittee, my name is Thomas L. Holton. I am a CPA and a partner in the firm of Peat, Marwick, Mitchell & Co. in New York. I also serve as chairman of the Committee on SEC Regulations of the American Institute of Certified Public Accountants. With me this morning is Mr. Theodore C. Barreaux, Vice President of the Institute's Washington office.

I am speaking in behalf of the American Institute of Certified Public Accountants, which is the national professional organization representing more than 120,000 CPAs throughout the country. We welcome this opportunity to testify on the proposed legislation to amend the Securities Exchange Act of 1934 to strengthen corporate accountability and to prohibit certain questionable corporate payments.

In particular, we will direct our comments to Section 1 of HR 15481, which would require every issuer having a class of securities registered under Section 12 of the Securities Exchange Act of 1934 and every issuer which is required to file reports pursuant to Section 15(d) of the 1934 Act to maintain its financial records accurately in order to fairly reflect transactions and dispositions of assets, as well as to devise and maintain an adequate system of internal accounting controls.

In addition, Section 1 of HR 15481 would make it unlawful for any person, directly or indirectly, to falsify or cause to be falsified, any book or record made or required to be made for any accounting purpose. HR 15481 would also add a new Section 13(b)4 making it unlawful for any person, directly or indirectly, to make or cause to be made a materially false or misleading statement to an accountant, or to omit to state any material fact to an accountant in connection with any examination or audit of a company.

We have no doubt that this is well-intentioned legislation and we are in agreement with what appear to be the objectives of Section 1 of HR 15481 dealing with corporate records, internal

control and representations to auditors. The July 2, 1976 report (No. 94-1031) of the Senate Committee on Banking, Housing and Urban Affairs that accompanied S. 3664 stated on page 8:

The Committee expects that the requirement to maintain accurate books, records, and management controls and the prohibition against falsifying such records or deceiving an auditor, will go a long way towards eliminating improper payments, which - - almost by definition - - require concealment.

In some respects we agree that this portion of the proposed legislation would help in attaining the stated objective, but in other respects we do not agree. Also, we find several deficiencies in Section 1 in its present form that in our opinion can be remedied to make the legislation more effective.

Internal Accounting Control

Our first major area of concern relates to the requirement that certain publicly held companies be required to devise and maintain "adequate" systems of internal accounting controls which are sufficient to provide reasonable assurances with respect to certain management and accounting safeguards. The drafter of this portion of the legislation was obviously under the impression that "inadequate" systems of internal accounting control have been a significant contributing factor in the more than 100 cases of varying types of illegal or questionable corporate payments that have received publicity because of SEC filings or otherwise. A careful analysis of those cases will show that this simply is not the case. All of those cases involved companies that had systems of internal accounting controls. In fact, many people would say that most of them had very good systems. There is no indication that it was the lack of adequate systems of internal accounting controls of these companies that resulted in the abuses and prevented their detection and disclosure. Instead, the abuses usually involved circumvention of internal accounting controls.

The published reports of the incidents of illegal or questionable corporate payments in most instances make reference to “off-book” accounts or other techniques indicating that the internal accounting controls of the companies involved were circumvented. Adequacy of controls was not the issue. The May 12, 1976 “Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices,” submitted to the Senate Banking, Housing and Urban Affairs Committee, makes the following observation:

Many of the defects and evasions of the system of financial accountability represented intentional attempts to conceal certain activities. Not surprisingly, corporate officials are unlikely to engage in questionable or illegal conduct and simultaneously reflect it accurately on corporate books and records.

We believe it is critically important to additionally recognize that illegal or improper corporate activities can and will occur regardless of the strength of internal controls because no system has yet been devised that can withstand collusive behavior or circumvention by corporate officials.

Accordingly, our first concern with the legislative mandate to have adequate systems of internal accounting controls is that such a requirement would not accomplish the objective sought. Furthermore, making it illegal not to have an adequate system would be counterproductive. There are no definitive standards against which to judge what is or is not an adequate system and there are widely varying opinions among accountants, both accounting officers of companies and independent auditors, about what would constitute an “adequate” system. The term “adequate” as applied to systems of internal accounting control has not been defined.

“Adequacy” is much like “beauty” - - for the most part, it is only in the eyes of the beholder. This fact of life raises two questions. First, would it be fair for anyone to be subject to

conviction for a federal criminal offense dealing with something so highly judgmental? We think not. Second, would such a legislative mandate be counterproductive? We believe it would. Because of the risks involved, it seems obvious that lawyers would advise their clients to discontinue, or at least strictly curtail, the normal practice of obtaining criticisms (i.e., suggestions for improvement) from internal auditors, outside consultants, independent auditors and others. The Senate Committee Report that accompanied S. 3664 stated on page 12:

The Committee recognizes that no system of internal controls is perfect and that there will always be room for improvement. Auditors' comments and suggestions to management on possible improvements are to be encouraged.

We agree that such comments and suggestions should be encouraged, not only from independent auditors, but also from internal auditors and others. There can be little doubt, however, that the proposed legislation in its present form would in fact discourage such comments and suggestions.

The Senate Committee Report that accompanied S. 3664 commented that "Requiring companies to devise, establish, and maintain an adequate system of internal accounting controls is not a panacea." We agree entirely, and when this fact is considered along with the subjectivity and impracticability of enforcement of the related proposal in HR 15481, we reach an inescapable conclusion that the proposal does not belong in this very important piece of legislation.

It is our recommendation, then, that the intended purposes of HR 15481 will be better served by requiring that the books and records of a corporate issuer registered with the SEC appropriately reflect transactions and by making it unlawful for officers, directors and employees to falsify such records or to circumvent internal accounting controls.

Falsifying Books and Records; Representations to Auditors

Our second major area of concern with the legislation relates to the prohibitions in subsection 13(b) 3 and 4 of “any person” from directly or indirectly causing any book, record or document to be falsified and from making materially false or misleading statements or omitting to state material facts necessary to be stated to an accountant in connection with any audit or examination of an issuer. Although at first blush the thrust of these provisions appears to be desirable by protecting the integrity of books and records and by giving accountants greater assurance in relying on statements made to them, there are some serious pitfalls that need to be examined most carefully.

First, we note the total absence from these subsections of any language such as “deceit” and “contrivance” as used in Section 10(b) of the Securities Exchange Act of 1934 from which the Supreme Court in Ernst & Ernst v. Hochfelder found a statutory requirement of an “intent to deceive” for even civil liability. Thus, as presently drafted, HR 15481 appears broad enough to permit a court to hold that a negligent mistake in a book or record or a negligently made misstatement is a criminal violation. Therefore, to put it as simply as we can, an honest mistake might land you in jail. I also note that, whereas proposed subsection (b) (4) includes the concept of materiality, subsection (b) (3) applies to any book, record or document, no matter how insignificant. Because of the thousands of documents prepared by employees of a large corporation which are for an accounting purpose, it would be unwise to extend criminal liability to those which are not significant.

We also point out that auditors in the normal course of their audits discuss matters affecting clients’ financial statements with many people of diverse backgrounds and training. Some of these individuals are very well informed and sophisticated, while others are not. By encouraging an attitude of free and candid discussion, the auditor is more likely to be able to ferret out information that is important to the audit. Improving the truthfulness and completeness of

information received from client personnel and third parties clearly benefits the audit process. However, situations may arise in which statements may later become the basis of criminal prosecution, and as a result, people are going to be far more reluctant to discuss matters with an auditor if they believe their every statement will be judged within a framework of potential criminal liability. Clearly, if this bill is passed in its present form, lawyers would advise corporate officials not to pursue conversations with an auditor without a lawyer monitoring what was being said. The stilted nature of such conversations would be detrimental to the audit process that relies in large measure on a candid give and take between the auditor and his client. The public would be the loser in such a process that results in less effective audits.

Undoubtedly, misunderstandings will occur, and imposing a concept of responsibility relating to oral statements is not desirable and would be quite difficult to enforce. Such difficulties, though, would not nearly approach the same magnitude in the case of written representations. It should also be noted that in the audit process, representations would normally be reduced to writing when the subject matter is of material consequence to the accountant's audit.

Therefore, we propose restricting the application of subsection (b) (4) to written representations where adequate attention can be devoted to reduce the risk of unintentional errors that could result in misleading the auditor. Also, we suggest restricting liability in both subsections (b) (3) and (b) (4) to directors, officers and employees of the company. Extending the liability under (b) (4) to third party respondents who in most cases provide useful information on a voluntary basis will in fact be counterproductive to the objectives of this legislation. Bankers, customers, suppliers, and other third persons will be advised by their lawyers to simply refuse to respond to audit inquiries in the light of increased legal exposure. The same reasoning would apply to lawyers themselves, who are important sources of audit information in many cases.

Unquestionably, though, information from such third parties is useful to an auditor (and, indeed, is often required by professional standards), and any reduction in the willingness of such

individuals to respond, although they are not required to do so, would adversely affect the current level of information available to an auditor and decrease the effectiveness of audits.

“Accurate” Books and Records

We are also concerned about the requirement in HR 15481 that books and records “accurately and fairly” reflect transactions, etc. This connotes a concept of exactitude that is simply not obtainable, and there is no standard against which achievement of that precision can be measured. The Senate Committee Report that accompanied S. 3664 stated on page 11:

The term “accurately” in the bill does not mean exact precision as measured by some abstract principle. Rather, it means that an issuer’s records should reflect transactions in conformity with accepted methods of recording economic events.

We do not understand why the word “accurately” is used if, as the Committee report suggests, that was not the intent of the Committee. The intent would be far better expressed if the word “appropriately” were used instead of the words “accurately and fairly”. As a minimum, the words “accurately and” should be deleted.

Conclusion

To assist the Subcommittee, we will be preparing certain amendments to Section 1 of HR 15481 incorporating our recommendations.

We urge the Committee to study these proposals carefully as we sincerely believe they will result in a more workable and effective law and enable us, as auditors, to assist in achieving the objectives of this legislation.

We believe this legislation, as it relates to corporate accountability, will be better served by requiring the maintenance of accounting records that appropriately reflect transactions and dispositions of assets and by prohibiting circumvention of internal accounting controls, falsification of the records, and written misrepresentations. We also hope that the Subcommittee shares our enthusiasm for the many positive measures already underway in the business community today in this area. I would like to particularly make note of three such developments:

- Many companies have already developed, or are in the process of developing, strong and clear corporate policy statements to guide officers and employees in their business conduct in the future. These policies have been communicated to company employees at all levels, and monitoring and enforcement mechanisms are being established.
- A significant expansion is underway as to the responsibilities and functions of independent audit committees and outside directors. Increasingly, included in these responsibilities are matters relating to establishment, monitoring and enforcement of corporate policy statements, as well as matters relating to systems of internal accounting control.
- There has become an increased sensitivity to these problems by the accounting and legal professions. In that regard, we particularly call your attention to the recent efforts by the accounting profession to prepare auditors for circumstances in which illegal acts by clients or irregularities are involved. The Auditing Standards Division of the AICPA has exposed for public comment two drafts of Statements on Auditing Standards entitled “The Independent Auditor’s Responsibility for the Detection of Errors or Irregularities” and “Illegal Act by Clients”.

We are most appreciative of the opportunity to present our views on this important legislation, and are prepared to assist you in any way possible in your consideration of the significant issues involved.