Speaker

SECURITIES AND EXCHANGE COMMISSION

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THE ACCOUNTING PROFESSION AND THE SEC: A PARTNERSHIP UNDER ATTACK

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Four years ago, Sandy Burton, the SEC's most recent Chief Accountant, described the relationship between the SEC and the accounting profession by stating that:

> For nearly forty years the Securities and Exchange Commission and the accounting profession have constituted a highly effective partnership for progress in improving the quality of public information about the economic activities of corporations who came to the capital markets of the United States for financial resources.

The events of the intervening years, particularly some which have transpired during the past twelve months, have raised serious questions regarding the effectiveness and stability of this partnership and the prospects for its continuation.

During the past year, one major accounting firm instituted legal action against the Commission because of the way the Commission had "injected itself into the area of accounting principles." Equally dramatic, two reports, one issued by Congressman Moss' Subcommittee on Oversight and Investigations, and the other by the staff of Senator Metcalf's Subcommittee on Reports, Accounting and Management, have been critical of the accounting profession, the various private accounting organizations and the Commission's policy with respect to the standard setting processes for both accounting and auditing. Senator Metcalf's Subcommittee staff stated:

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> To an astounding degree, the SEC has permitted, and even insisted upon, establishment of accounting standards which have substantial impact on the Federal Government and the public by self interested private accounting organizations. The result has been an extraordinary delegation of public authority and responsibility to narrow private interests.
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> A review of the SEC's record on accounting and reporting matters shows clearly that it has seriously failed to protect the public interest and fulfill its Congressional mandate.

Published responses to this unusually strong indictment of the relationship that has been maintained between the SEC and the accounting profession have included such epithets as "pure junk," "nonsense," and "incompetently researched and grossly biased." While such responses might accurately describe one's opinion of the report, they are not very helpful in re-examining the important, fundamental question of whether the relationship between the SEC and the accounting profession is appropriate and in the public interest. I believe the stature of professions and government agencies, like that of individuals, can be measured by how they respond to criticism. If the relationship of the SEC and the accounting profession cannot be strengthened and tempered by the heat of criticism, then perhaps basic structural changes are warranted.

Before the Securities Act was enacted in 1933, there was an intense debate in the halls of Congress and elsewhere about the appropriate degree of governmental intervention in the capital formation process. Some individuals urged that the proposed legislation embody an approach whereby an issuer of securities would be required to disclose relevant data to investors who would fend for themselves in making their investment decisions. Others advocated an approach, similar to some "blue sky" laws, whereby a governmental agency would evaluate the fairness of an issuer's proposed offering. Indeed, the original bill introduced into Congress specifically provided for revocation of an issuer's securities registration upon an administrative finding that "the enterprise or business of the issuer or the security is not based upon sound principles, and that the revocation is in the interest of public welfare." Quite obviously, the disclosure philosophy, with its genesis in the English Companies Act, was adopted.

As a facet of the basic philosophical debate, consideration was given to the advisability and feasibility of a statutory requirement that companies proposing to sell securities be audited by a corps of Federal auditors. That approach was rejected, apparently in response to testimony from the accounting profession that adequate protections would be provided to the investing public by requiring that

financial statements be audited and reported on by independent accountants.

As enacted, the Securities Act of 1933 necessitates the joint involvement of both the Commission and the accounting profession by requiring the inclusion in prospectuses of balance sheets and profit and loss data "certified by an independent public or certified accountant" and presented "in such detail and such form as the Commission shall prescribe." In addition, the Act authorizes the Commission to prescribe:

> the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, the appraisal or evaluation 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 consolidated balance sheets or income accounts of any person directly or indirectly controlling or controlled by the issuer, or any person with a direct or indirect common control with the issuer.

Similar authority was granted to the Commission in the Securities Exchange Act of 1934.

In my opinion, the Congress did not mandate the SEC's adoption of accounting principles, nor did it direct the SEC to defer to accepted principles of the accounting profession. Unlike the various Companies Acts, which generally define required financial statements in considerable

detail, the Securities Act granted the SEC extensive discretionary authority to establish accounting requirements and deal with evolving accounting issues.

Having been granted this broad discretionary authority, one of the threshold questions was the Commission's proper role with respect to accounting standards. Serious consideration was given to the establishment of a uniform system of accounting standards by the Commission. On the basis of staff studies, the Commission was advised that such an approach was impracticable.

The first Chief Accountant of the SEC, Carman Blough, argued that the development of accounting principles should be left to the accounting profession. He recognized that practicing accountants faced accounting and auditing problems on a daily basis and thus should be responsible for their resolution. At the 50th Anniversary of the American Institute of Accountants in 1937, he stated the following:

> As a matter of fact I think I have emphasized at numerous times that the policy of the Securities and Exchange Commission was to encourage the accountants to develop uniformity of procedure themselves, in which case we would follow. We expected to be able to follow the better thought in the profession and only as a last resort would the Commission feel the necessity to step in.

In April of 1938, the Commission publicly endorsed the views of its Chief Accountant. By a vote of three to

two, Accounting Series Release No. 4 announced the Commission's policy that financial statements which were prepared in accordance with accounting principles for which there was no substantial authoritative support would be presumed to be misleading notwithstanding disclosure. If there was a difference between the registrant and the Commission regarding the proper accounting, the Commission would accept disclosure in lieu of a change in the financial statements only when there was substantial authoritative support for the proposed accounting principle and the Commission had not expressed a contrary view in an official release.

This important decision was not made lightly, but on the basis of several year's experience. The evolution of the Commission's position was outlined in its Annual Report for 1939 which stated:

> Until recently, the Commission's interest in accounting has been directed toward the improvement of corporate reporting of financial data and the standardization of accounting principles. At the time when the Securities Act of 1933 and the Securities Exchange Act of 1934 became law, accounting had developed to such a point that it was believed feasible to prescribe forms that in large part asked only for disclosure of some of the more significant principles upon which the financial statements were based and for disclosure of a certain amount of information believed to be of particular

> importance to investors. The form of presentation, the method of description, the inclusion of information beyond the minimum, and the fundamental responsibility for the quality of the statements were problems left on the shoulders of the issuer and its officers. In addition, it was required that independent accountants make a review and express their opinion of the accounting principles followed and the statements presented. However, at the same time the Commission established a policy of administrative review of financial statements filed which led to discussions of accounting problems with issuers and their accountants, to the preparation of memoranda of deficiencies observed, and in some cases to the issuance of stop order, delisting, or accounting opinions. Experience gained in this way has demonstrated a considerable diversity of views on matters of accounting principle. The Commission first endeavored to overcome this situation by enlisting the cooperation of numerous organizations interested in accounting, by conducting research, and by consulting with registrants. In addition, on some accounting matters the Commission has taken a positive position in published opinions or its rules governing financial statements required to be filed. More recently, steps have been taken to enforce the observance of generally accepted accounting principles by adopting a policy of presuming financial statements to be misleading in cases in which such statements are prepared in accordance with accounting principles for which there is no substantial authoritative support despite disclosure of the matters involved in the accountant's certificate or in footnotes to the statements.

The establishment and improvement of accounting principles within the accounting profession has been the responsibility of a single body within the profession since 1939. From 1939 until 1953, the Commission on Accounting

Procedure, appointed by the American Institute of Certified Public Accountants, issued 51 accounting research bulletins. The focus in these documents was the identification of accepted practices, including alternatives. From 1959 until 1973, the AICPA's Accounting Principles Board, whose members served on a part-time basis and without compensation, had the responsibility of establishing and approving accounting principles.

The increasingly complex business transactions of the late 1960's, particularly problems associated with the conglomerate movement, placed a severe strain on the accounting profession and the principles board. In 1971, partially in response to mounting criticism, the AICPA authorized a study of how accounting principles should be established. A committee chaired by former SEC Commissioner Frank Wheat recommended the establishment of a Financial Accounting Standards Board. The committee's report was well received and, at the urging of many, including the SEC, the FASB was established as the first full-time standard setting body for accounting principles and began operation in April of 1973.

With the establishment of the FASB, the Commission believed that it should publicly reaffirm its historic policy of relying on the private sector to develop generally accepted accounting principles. In December of 1973, the Commission

issued Accounting Series Release No. 150 in which it recognized the FASB as the private accounting sector's standard setting body by stating that standards promulgated by the FASB would be presumed to have substantial authoritative support, and those which had been considered by the FASB and rejected would be presumed to have no such substantial authoritative support.

The Commission's administrative posture should not be misunderstood. As one who participated in the approval of Accounting Series Release No. 150, I can assure you that it was not an abdication of Commission responsibilities or a delegation of its powers. We stated that: "the Commission intends to continue its policy of looking to the private sector for leadership in establishing and improving accounting principles and standards through the FASB with the expectation that the body's conclusions will promote the interests of investors." We also clearly stated that "the Commission has the responsibility to assure that investors are provided adequate information" and that the "Commission will continue to identify areas where investor information needs exist and will determine the appropriate methods of disclosure to meet these needs." Moreover, the Commission noted that if it were necessary to depart from statements specified in the release as those presumed to have substantial authoritative support

in order to prevent misleading financial statements, the Commission might require the use of other principles.

It is this Commission policy--looking to the private sector for leadership in the establishment of accounting principles--about which the Moss Report and the Metcalf Report are so critical. The Moss Committee Report states that "the results of the Commission's 1938 decision, by a three-to-two vote, to rely primarily on the private accounting profession to establish accounting principles has been disappointing at best." As I previously mentioned, the Metcalf Report is more blunt in concluding that the SEC has "failed" by deferring to the private sector. With respect to the FASB itself, the Moss Report concludes that it "has accomplished virtually nothing toward resolving fundamental accounting problems."

In my opinion, these criticisms are not supported by the facts. Without debating the achievements of the past standard setting bodies, and realizing that there have been problems since its formation in 1973, the FASB has issued 13 discussion memoranda, conducted 14 public hearings, and adopted 14 new statements of accounting principles, a number of which, such as leasing, business segments, translation of foreign currency, and research and development costs, deal with controversial and complex issues. In addition, eighteen interpretations of accounting principles have been issued.

Currently under consideration are such matters as the conceptual framework of financial statements, mergers and acquisitions, and accounting in the extractive industries, all of which are projects of enormous breadth.

In any event, the implicit assumption or explicit statement in a report that the SEC has delegated its public authority or always deferred to the FASB or its predecessors in the establishment of accounting principles cannot be supported. One need only examine the background of matters such as the SEC's Regulation S-X amendments relating to the disclosure of financial leases and their impact on income, or the FASB's Statement No. 4 on Reporting Gains and Losses from Extinguishment of Debt--issued only after the Commission indicated that it was prepared to take action--to realize that the Commission has not abdicated either its authority or responsibility.

Another recent example of the SEC's action, reflecting a divergence of views between the SEC and the FASB, is in the area of replacement cost accounting. In late 1974, because of the distortive effect inflation was having upon financial statements prepared on the basis of historical cost, the Commission's staff was requested to recommend an appropriate method for the disclosure of inflation's impact upon such financial statements.

About that same time, the FASB issued an exposure draft calling for the supplemental disclosure of general price level adjusted financial statements. Under the general price level approach, historical cost financial statements would be prepared using an index which reflected the decline in the general purchasing power of the dollar from period to period. This is certainly not an invalid concept, but it would fail to portray the impact of inflation on an individual company because all companies would use the same index, and there is persuasive evidence that inflation does not impact all companies equally.

The Commission was of the opinion that investors should have information which would indicate the impact of changing prices upon particular companies. Therefore, in 1975 we issued a proposal for the disclosure of certain replacement cost information. After considerable study and evaluation of the numerous comment letters, this proposal was adopted. Without attempting to debate the merits of the replacement cost regulation vis-a-vis the general price level proposal, I would suggest that the SEC's adoption of the replacement cost regulation does represent an important example of an SEC accounting initiative substantially different than that proposed by the private sector. We are just now seeing the first wave of replacement cost disclosures and are carefully monitoring the results. Incidentally, I was pleased

that in his confirmation hearings last Wednesday, Harold Williams, the incoming Chairman of the SEC characterized the Commission's efforts in inflation accounting as a "very important move."

While the SEC and FASB have had disagreements, we have generally worked together in close cooperation and coordination in dealing with many complex accounting issues. This relationship has worked well in the past and I am hopeful it will continue to work in the future. In 1975, the Congress adopted the Energy Policy Conservation Act. Section 503 of that Act required that the SEC take such steps as may be necessary to assure the development of accounting practices to be followed by all persons engaged in the production of crude oil or natural gas. Recognizing the Commission's historic policy of allowing the private sector to take the lead in establishing accounting practices, Congress specifically provided that the SEC could meet its responsibilities by relying on standards adopted by the FASB if the Commission believes that such practices will be observed as if they were adopted by the SEC as rules. The FASB has issued a lengthy discussion memorandum, conducted public hearings, and expects to meet the December deadline. Unquestionably the Congress has imposed a tight time schedule. However, I am confident that the FASB will complete its work within the prescribed time frame and that the combined efforts

of the SEC and the FASB will demonstrate the vitality of the partnership between the accounting profession and the Commission.

Another accounting topic with which the SEC is currently concerned is betterment accounting. Historically, the SEC has had very limited jurisdiction over the reporting of financial results to shareholders by railroads and certain other regulated enterprises. In 1976, the Congress granted the Commission considerable responsibilities for the reporting of these enterprises. For many years railroads have recorded the initial cost of track structures (usually ties, rails and ballast) as a nondepreciable asset and have subsequently expensed replacements except to the extent they constitute a betterment, such as an increase in the size of the rails. Many believe that this method of accounting, which is quite unlike the method of depreciation accounting used by most commercial enterprises for their fixed properties, can lead to significantly distorted financial results, particularly when a railroad allows the physical condition of its track to deteriorate. I expect the Commission to issue a release in the near future requesting comments from interested persons on whether the Commission should continue to accept financial statements prepared employing betterment accounting. Although this is a relatively narrow accounting subject, it does impact a significant industry. Before concluding that we should

undertake this study, we asked if the FASB would be prepared to complete such a project by the end of 1977. We were advised that the Board would not be able to meet this schedule and that if the Commission believed the project should be completed by the end of 1977, the Board understood the need for the Commission to initiate its own rulemaking proceedings. To me, this response indicates the strength and flexibility of the partnership between the SEC and the FASB.

Along with the criticism with respect to the formulation of accounting standards, the process for establishing auditing standards has also been under severe attack. I would be less than candid if I did not tell you that I am concerned over the auditing profession's failure to be responsive to public demands because of its fear of potential litigation. In 1975, the Commission adopted a regulation requiring that auditors perform a limited review, but not an audit, of the quarterly information that companies provide shareholders. Auditors have been somewhat reluctant to undertake such reviews as a result of their anxiety over liabilities that might attach to their failure to detect errors in the unaudited quarterly information. The reports auditors are willing to render on such reviews are guarded, technical and, in my opinion, fail to communicate the degree of effort the auditor has employed in conducting the reviews. In fact, Clarence Sampson, our Acting Chief Accountant, was told

recently that companies are not publishing these reports on limited reviews because they are negative and meaningless. I find that to be most unfortunate.

As another example, in 1975 we adopted a regulation which requires that in order for a company to change from one generally accepted accounting principle to another, the change must be accompanied by a letter from the registrant's auditors stating whether or not in the auditor's opinion the change is to a preferable accounting principle in the circumstances. If a change does not result in an improvement in financial reporting, it is not to a preferable method and, therefore, will not be allowed by the Commission. The Commission believes that generally accepted accounting principles require consistency unless a change results in improved financial reporting. About this there is no debate. The debate is over how to determine whether the change results in improved financial reporting.

Some auditors claim that they are incapable of arriving at an opinion as to whether changes in accounting principles are or are not preferable in the circumstances. Only management can make this decision. If a company's management is required to justify a change in an accounting principle on the basis that the change will result in improved financial reporting, its justification should be sufficiently persuasive to bring the auditor to the same conclusion. In other words, if a company can make this

judgment, so can its auditors, and only when the auditors can do so, from their independent vantage point, should the company be allowed to make a change. I might note that in its tentative conclusions, the Commission on Auditor's Responsibilities, the so-called Cohen Commission, has gone beyond the SEC's position which is limited to changes in accounting principles. Its Report stated that, except in certain limited circumstances, an auditor should be required to satisfy himself in all instances that all principles utilized are the most appropriate.

Auditing standards are presently set by the Auditing Standards Executive Committee, the senior technical committee of the AICPA. In the last few years, I have noticed a defensive trend in the publications of this body, a trend which seems to be designed to demonstrate to the courts that auditors have only limited responsibility. In some instances only the threat of SEC action has resulted in the adoption of adequate standards. These rather defensive documents may well be playing into the hands of the auditing profession's critics. It is not uncommon to hear the view expressed that if the auditing profession continues to issue such negative documents then the SEC should not continue to rely upon the auditing profession to establish auditing standards.

The Metcalf staff report raised a number of other very important issues for the auditing profession, such as auditors performing management consulting services for their clients, and whether auditors should be engaged in management recruiting or offer expert testimony on their client's behalf. Those who think auditors should not be performing such services believe that they can impair the auditor's independence from his client. Auditors argue that such problems are perceived and are not substantive. Nonetheless, even if the problems are only perceived, it is my view that they should be fully explored and debated.

Because of the many unanswered questions regarding the role and responsibilities of auditors, in October 1974 the AICPA established the Commission on Auditor's Responsibilities, to which I have already referred. In its recent Report of Tentative Conclusions, that Commission made forty recommendations which are intended, among other things, to:

--improve reporting on significant uncertainties in financial presentation;

--clarify an auditor's responsibility for the detection of fraud by adopting a standard of "due professional care";

--establish a framework for auditor participation in the corporate accountability system with respect to the detection and cessation of illegal

or questionable acts regardless of their materiality;

--expand the audit function from being oriented to periodic financial statements to include such things as a more comprehensive study and evaluation of the controls over the accounting system;

--reform the auditor's method of communicating with users of financial information to clarify the auditor's role vis-a-vis management's role;

--improve the education, training and development of auditors;

--require internal re-examination and public disclosure of management advisory services by auditors for their clients to assure the auditors' complete independence;

--create a full-time auditing standards board; and

--remove secrecy from professional disciplinary proceedings.

Although it would be premature for me to have any final views on these broad ranging recommendations, it is clear that the Report is a professional and responsible work product.

I believe the auditing profession must bridge the gap between the performance of auditors and the expectations

of the users of financial statements by being responsive to the challenges of the Cohen Commission. I suspect that almost everyone will agree with the general approach and philosophy of the Report as well as with such conclusions as improving the education, training and development of auditors. The measure of the auditing profession will be taken, however, by the way it responds to the tentative conclusions relating to such topics as preferability and internal controls.

Members of the SEC, including myself, have not been completely satisfied with the performance of the accounting profession and private standard setting bodies. There have also been instances in which, I believe, the Commission has not responded as quickly as we should have. We know our judgments have not been perfect and that there have been and are problems that need to be resolved, but that doesn't mean that the partnership between the accounting profession and the SEC should be dissolved or that the government has the ability and should dictate all accounting principles and auditing standards.

There were and are important policy reasons for the SEC to look to the private accounting profession for leadership in establishing and improving accounting principles and auditing standards. I believe that the enviable reputation the SEC has gained is in part a result of our regulatory philosophy of looking to those on the firing line in the

private sector, whether they be broker-dealers, securities exchanges, accountants or other professionals, for self-discipline and appropriate professional standards. We supplement those efforts through rules, regulations and enforcement actions which are intended to encourage or induce private organizations to seek to fulfill the investor protection and public interest purposes of the securities acts which we administer.

How the accounting profession responds to our initiatives, the recommendations of the Cohen Commission, and responsible criticism and recommendations from other sources will determine whether the partnership is strengthened or destroyed. While no system can provide a guarantee against fraud and misrepresentation, investors and the public must have confidence that all reasonable steps are being taken to assure that financial information on public corporations is fair, accurate, and meaningful. We can continue to rely on the private sector only as long as it fulfills its part of that responsibility. I urge you to rededicate your efforts to meet this challenge because if you do not, both the public and the accounting profession will be the losers.