

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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PROGRESS TOWARD PROFESSIONAL SELF-GOVERNANCE: AN UPDATE  
An Address by Harold M. Williams, Chairman

The AICPA Council  
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(edited text)

The accounting profession is in the midst of fundamental and far-reaching changes, both in its structure and in its governance. If you believe, as I do, that a profession which remains under essentially private direction is, in the long run, the most effective answer to the questions which are being raised today concerning accounting and accountants, then I think you must conclude that communication and cooperation between the Commission and the profession are vital. Accordingly, I would like to use the opportunity to speak to you this morning to continue the dialogue with the profession which I began last January in Washington in my address to the Institute's Fifth National Conference on Current SEC Developments. In that address, I sketched an interim report on the profession's progress toward meeting the goals and challenges which it faces. Today, I will update that report, and touch on my conception of the role which Congress sees the Commission playing in that process.

At the outset, one point bears emphasis. As most of you are aware, on July 1 -- about eight weeks from now -- the Commission will issue a formal report to Congress on the accounting profession. I believe that that report will provide Congress and the profession with both a useful

measuring stick to determine how far accountants have progressed and with guidance as to how you should proceed in responding to the difficult issues which the profession faces. It is critical, however, that accountants not expect that document to be in any sense the termination of the process begun by Senator Metcalf's committee and others in and out of Congress who have directed attention at the profession. On the contrary, the challenge of demonstrating that accountants themselves, rather than government, should retain the primary authority to insure auditor independence, to develop and maintain a viable self-regulatory structure for the profession, and to formulate appropriate accounting and auditing standards is one which will demand the profession's commitment and resolve for many years to come.

#### The Congressional Focus on Accountants

Before I turn to specifics, I think it is useful to offer some historical perspective. A year ago, a Senate subcommittee chaired by the late Lee Metcalf held public hearings concerning the profession. Those hearings, the staff study which preceded them and the committee report which followed, are part of a broad and continuing public examination of accounting and accountants. That examination has served to highlight the in-

creasing public and congressional interest and concern over the important role in our economic life of a profession which, until recently, has enjoyed relative obscurity. Much could and has been said about particular substantive issues aired before the Metcalf committee. The testimony of witnesses raised concepts such as mandatory rotation of firms, federal licensing of accountants, direct governmental involvement in the formulation of both accounting and auditing standards, and other steps which would radically alter the autonomy of the profession as we know it today. While the committee's report did not propose any of the more extreme measures some recommended, the key point is that -- apart from the merits of the various substantive issues that were discussed -- the Metcalf hearings conveyed one very definite and clear message: There is a sense of expectation and urgency for the profession, and, as necessary for government, to build the public's confidence in the independence of accountants and in their resolve and ability to engage in meaningful self-discipline. The hearings also conveyed a second message -- that many people in and out of Congress are critical of the Commission for what it is or is not doing with respect to the auditing and financial reporting of public corporations and for not being aggressive enough in the discharge of its oversight role.

I have very little desire to preside during my five years as the Commission's Chairman over increased regulation of the accounting profession. Similarly, I have no wish to see the enactment of legislation that would place the responsibility on the Commission, or on any other government body, to regulate accountants. But all of us would be shortsighted indeed if we failed to recognize that the Metcalf committee's work is a clear signal that time is running out on the opportunity for voluntary initiatives.

In February of this year, and again in March, Congressman John Moss, who chairs the House Interstate and Foreign Commerce Committee's Subcommittee on Oversight and Investigations, held hearings during which the Commission testified on the accounting profession's efforts to develop a selfregulatory program. In my testimony during both sessions of those hearings, I reiterated the Commission's belief that the profession should be afforded an opportunity to develop a mechanism for self-regulation. Congressman Moss was, to a degree, critical of the profession's efforts and of what he characterized as the Commission's unconstrained "wait and see" attitude. He indicated that he would be introducing legislation to correct some of the defects which he perceived in the AICPA's SEC Practice Section.

Similarly, Senator Metcalf's recent and unexpected death has not lessened the Senate's interest in the accounting profession. The accounting-related responsibilities of Senator Metcalf's subcommittee have been transferred to a new subcommittee chaired by Senator Thomas Eagleton. Senator Eagleton has informed me that, as Chairman of this Subcommittee, he intends to continue the work begun under Senator Metcalf's direction and to expand it to include various other areas of concern. He concluded a recent letter to me by stating,

"Appropriate Committees of Congress have recently spent substantial time and effort developing sound public policies for improving the accountability of publicly-owned corporations and their auditors. We are serious about seeing them implemented. I look forward to working with the SEC toward meeting that objective in a timely manner."

At a recent appropriations hearing on the Commission's budget, Senator Eagleton demonstrated that he means to implement this philosophy. He raised questions at that hearing concerning the permissible scope of auditors' services to their clients, the auditor's response to discovery of illegal client activity, and the proper scope of auditor liability. It is, I think, obvious that Senator Eagleton is committed to continuing Senator Metcalf's work. And I have little doubt -- although the order of succession is not quite as obvious -- that there will be someone on the House side

equally ready and willing to pick up the baton from Congressman Moss, who has announced that he plans to retire at the end of this year.

At the same time that this congressional scrutiny has focused on accountants -- and in response to it -- the profession has been making progress. You are, of course, all well-aware of the formation of the AICPA's Division of CPA Firms and of the structure of that Division's SEC Practice Section. To date, four of the five members of the Section's Public Oversight Board have been selected. That Board has had two meetings and has begun to consider how it will carry out its oversight of the Section's self-regulatory program. The Executive Committee and the Peer Review Committee of the SEC Practice Section have been at work exploring various avenues to resolve key issues including the scope and mechanics of peer reviews and the scope of services which auditors perform for their clients. However, much is still left to be done.

#### Objectives of Self-Regulation

With that chronology in mind, I will devote the balance of my remarks this morning to the future rather than the past. But it is important for each of you to recognize the improvements the profession has achieved to date in order to evaluate

how these improvements compare with congressional expectations and with the work that remains. Hopefully, some of that remaining work will be done in time to be included in the Commission's July 1 report to Congress. If voluntary initiatives are to succeed, timely results are essential.

As I see them and as I have stated several times before, the issues on which the accounting profession's progress will be evaluated are three: independence; self-regulation, including quality control and self-discipline; and the accounting and auditing standard-setting process. I want to examine the objectives the profession must meet in each of these three areas.

A. Independence

The issue of independence is the key one. It is the key because everything else fits with it. In many ways, the public has expectations of the profession and of what the auditor's report means that exceed reality. To the extent, however, that the public views the auditing process as a wholly unbiased review of management's presentation of the corporate financial posture, I believe the expectations are fully justified. Independence is your most valuable attribute. If the profession cannot satisfy its obligation to maintain both the appearance and the fact of independence, ultimately

the political process -- even at the risk of paying a heavy price in other areas -- will compel changes in the profession to satisfy the expectation of independence. Thus, the objective of both the profession and the Commission should be to institute measures which enhance and reinforce independence, whether in the audit process, through standard-setting, or through disciplinary actions.

The most obvious factor which erodes independence, or at least its appearance, is the fact that, as a practical matter, the auditor's compensation and the continued utilization of his services are often dependent upon the wishes of the client's management -- the same group towards which the auditor is expected to be independent. The ultimate issues concerning independence are the amount of pressure that management can bring to bear on the auditor as a result of that built-in leverage and the ability of the auditor to withstand that pressure.

I do not believe that we should try to address directly the principle that the client is the source of the auditor's compensation. But there is much that can be done to strengthen independence. Let me give you an example. If the profession is to remain credible, and to respond to the Commission's expectations and those of Congress, the services which auditors render to their publicly-held audit clients must be limited

to those that are appropriately related to the profession's primary responsibility -- the audit itself. A proposed amendment to the organizational document of the SEC Practice Section treats the relationship between the scope of auditor services and independence. After a review of the proposal, however, I have doubts concerning whether certain of the services which the proposal would permit are consistent with that goal. Accordingly, I believe it incumbent on the profession to examine carefully the specifics of the proposed amendments in light of their impact on both the fact and appearance of independence. That task is one for which the Public Oversight Board should have responsibility.

The Commission's decision whether to propose rules concerning scope of services will be affected by the extent to which the profession adopts specific proposals of its own which are consistent with the basic policy goal. I note in that context Senator Metcalf's admonition that:

"the most simple and direct method for enhancing independence and preventing unfair competition would be to prohibit accounting firms from providing any management services to publicly-held corporations who are their audit clients."

I do not believe that we must necessarily do anything that extreme, but Senator Metcalf's comment indicates one end of the

spectrum as far as the congressional view is concerned, and the philosophy it embodies cannot be ignored.

A second example of what the profession should do to stimulate confidence in its own independence relates to audit committees. Most of you have probably heard my views on the subject of audit committees by now. I believe that audit committees, composed of independent corporate directors, are one important avenue available to strengthen auditor independence. In companies where the auditors report to an independent audit committee, a potentially important buffer insulates accountants from inordinate management pressures and strengthens the auditor in his relationship with management. Stated differently, the absence of an audit committee may invite questions concerning the ability of an auditor to be independent. Determining, as a legal matter, the independence of an auditor can be a cloudy issue at times, and the lack of an audit committee tends to make the independence determination that much cloudier. It certainly is a negative factor in arriving at the ultimate judgment. Of course, not all audit committees will function effectively. Many will -- particularly if auditors recognize the critical role they can play in helping make the audit committee meaningful and effective.

The Commission will watch with great interest the outcome of the work of the AICPA special committee which has published an issues paper on audit committees and which will hold hearings at the end of this month. The Commission believes that the profession can and should move forward in this important area. The profession must take whatever steps are reasonably available to it -- such as formally requiring that publicly-owned clients maintain audit committees -- to enhance and insure its independence. If the profession is reluctant to take such steps voluntarily and of its own accord, the Commission will need to understand the reasons and how that reluctance can be reconciled with a profession which desires to maintain the initiative for self-regulation. The Commission has the authority to promulgate rules which would alter the standards for auditor independence. If it proves necessary for us to act, we will do so, but it is far preferable for the profession to exercise the primary responsibility to police its own independence.

B. Self-regulation

The second criterion against which the profession's efforts will be assessed is its progress toward effective self-regulation and self-discipline. Indeed, in the field of self-regulation, possibly more than any other, there is a

sense of expectation and urgency to achieve progress. I recognize the very substantial strides that the profession made in the few months following Senator Metcalf's hearings to develop the AICPA Division of CPA Firms as a framework for such a program. But we need to be realistic about what is likely to succeed and to be acceptable as a self-regulatory mechanism.

The key to achieving a meaningful self-regulatory program lies in the Public Oversight Board and in whether it can function effectively without the backing of legislatively created authority. Increasingly -- and we see this throughout many aspects of our society -- society is demanding that power be accountable and subject to checks beyond the good intentions of those who exercise that power. This is certainly true in government, but it is no less true in the private sphere. We see this reflected, for example, in a number of the state licensing bodies where nonprofessionals are coming on to licensing boards, and we see it in existing self-regulatory organizations, such as the New York Stock Exchange, which has a large number of so-called public board members who come from outside the exchanges.

By contrast, the governing body of the SEC Practice Section, the Executive Committee, is composed solely of members

of the accounting profession. The Public Oversight Board, on the other hand, made up primarily, if not exclusively, of distinguished nonaccountants, will, if the Board functions properly, serve in large measure as an independent overseer of the Section's activities. I would much prefer that this role be formalized by conferring line authority on the Public Oversight Board. Such authority would greatly enhance the probability of success and the appearance of responsiveness to the public interest. I believe, however, that the self-regulatory program, even as presently proposed, can still fulfill the expectations of Congress and the Commission if the Board is, in fact, independent, has certain essential characteristics, and is committed to its responsibility to oversee the self-regulatory program. Stated differently, the crucial question is not the lines of authority traced out in the Section's organization chart, but rather the resolve, commitment, and ability of the POB's members. And yet, structure and authority are still important; success, over time, cannot depend alone on the traits of individual Board members.

The process of filling the Board has been very slow and, accordingly, so has the process of providing the Board with a staff. Indeed, more than six months after the Section's birth, the Board still lacks one member. I do not say

that critically; I understand the problems of getting something of this sort established, especially in light of the need for people who will bring the qualities of integrity, ability, and independence to the Board that are vital. And yet, time is of the essence. The absence of a fifth member must not deter the current Board members from moving forward aggressively in considering the key aspects of the profession's self-regulatory program. I will be discussing this program with the Board at a meeting scheduled for May 17, and will reiterate to its members the importance of the Board's oversight role to the success of the program.

Aside from the commitment and dedication of Board members, there are several other characteristics which, in my view, will determine whether the Board is effective. The first of these is, of course, that the Board members must be independent of the profession -- in fact and appearance. Second, the Board members must recognize that their task will be time-consuming and that Board members will need to devote substantial personal time and energy to the oversight of the Section's self-regulatory program; similarly, this will require that they have the necessary funds and staff at their disposal to enable them to perform their duties. Third, Board members must be aware of, and responsive to, the public's expectations

concerning their functions and responsibilities. Fourth, the Board must recognize a special commitment to oversee the peer review process and its results. Fifth, the Board must recognize a similar special commitment to oversee the Section's disciplinary mechanism and its results. Finally, as I have indicated on previous occasions, the effectiveness and credibility of the Board depends on its willingness to be critical when called for and on its ability to make public its conclusions, recommendations, and criticisms. The willingness of the Board to comment publicly on all aspects of the self-regulatory program -- to criticize where necessary and to praise where appropriate -- is the feature which, in the last analysis, confers on the Board the potential power necessary meaningfully to oversee the activities of the Section and to enhance its own and therefore the profession's credibility. Closely associated with this ability to go public is the Board's willingness and ability to provide the Commission with access to the information we consider essential to our oversight responsibilities.

At its meeting on April 11, the Board addressed several pressing matters, including its oversight role in the self-regulatory program and its involvement in the peer review process. It proposed changes in the Section's organizational

document relating to the term, selection, removal, and compensation of Board members and to the Board's by-laws and staff. Further, the Board indicated its intention to address important substantive self-regulatory issues, including the nature and scope of the peer review process, the appropriate scope of auditor services, the scope of special peer reviews, and the possible sanctions resulting from particular audit failures. The Board, however, has not indicated its timetable for dealing with these issues, and neither the Division of CPA Firms in general, nor the Public Oversight Board specifically, have progressed far enough for me to be confident that the self-regulatory effort will succeed. The time is rapidly running out for discussing organization and formulating agendas. Concrete results must begin to emerge.

Another important component of the success of the AICPA's program of self-regulation is the effectiveness of the quality control process -- including the related disciplinary framework. Clearly, the program needs to encompass adequate sanctioning capability. The situations in which self-regulatory efforts typically fail are those in which serious problems surface involving one or more major firms in the self-regulated industry or professional organization. Thus, if the disciplinary framework is to be

effective, the sanctioning power of the Section must be used, when appropriate, against member firms of all sizes. Conversely, if the potential sanctioning power does not have adequate substance, the entire self-regulatory program will not be credible. The Board's willingness to address the scope of special peer reviews and of sanctions indicates a recognition of the importance of the disciplinary framework, and I urge the Board to follow through with meaningful involvement in this area. The disciplinary structure must be in place before it is needed. It is enormously difficult to design such a system in a crisis and then expect it to be effective, fair, and credible.

Mandatory peer review of each firm's accounting and auditing practices is a significant part of the quality control effort. The issues of the appropriateness of firm-on-firm reviews, the proper scope of peer reviews, the appropriate body to issue peer review reports, and the inclusion of the international operations of firms in peer reviews all demand the Public Oversight Board's attention. Resolving the issue of firm-on-firm reviews versus reviews performed by a more broadly-based team will entail striking a balance between the benefits derived from the enhancement of objectivity -- or at least the appearance of objectivity -- which would result

from having such reviews against the increased costs and inefficiencies of using a team approach. The fact that one cannot point to concrete evidence that firm-on-firm reviews will lack objectivity does not detract from the real public concern about the appearance of "back-scratching."

It seems to me that firm-on-firm reviews could be acceptable if, in some fashion, the peer review report is issued by a committee rather than by the firm itself. This approach would permit such a peer review committee to utilize a single firm as its staff, and thus achieve the attendant efficiencies, while attaining the benefits of enhanced objectivity which will flow from having individuals from outside that firm responsible for the issuance of the peer review report. I recognize the problems and the burdens that this approach entails. We are open to other suggestions, but the Commission cannot ignore the problem of the diminished credibility incident to firm-on-firm review. In this regard, I believe that the involvement of the Board and its staff in determining the scope and structure of peer reviews and in observing the actual operation of the peer review process is critical.

Another thorny problem surrounding the peer review process is the extent to which its results will be open to the

public and to the Commission. I understand that current plans for peer review procedures call for the letters of recommendation and supporting documentation prepared by the reviewing firm or team, and the reviewed firm's response thereto, all to be part of a nonpublic file. I doubt that this type of confidentiality can be acceptable to the Commission. The Board must establish a mechanism which will provide the Commission with the type of access to this information necessary for us effectively to fulfill our oversight responsibilities. I recognize the concerns some have expressed -- that the Commission might utilize access to the peer review process to engage in investigatory "fishing expeditions." I do not take those concerns lightly. We need to address them and to find a way to resolve them while still recognizing that the Commission does, indeed, have an oversight responsibility that it must be able to discharge. Bear in mind that the Commission would inevitably be part of the process if a formal, governmentally-instituted peer review program were created.

C. Establishing accounting principles and auditing standards

I will close with some brief comments on the subject of setting standards -- both for the performance of audits and for financial reporting. I am committed to the concept that the responsibility for standard-setting belongs where it is

now lodged -- in the private sector -- with an oversight role on the part of the Commission.

With that thought in mind, I want to offer a few observations with respect to auditing standards. First, I believe that an important initiative in this area rests in the hands of the Institute's special committee studying the structure of AudSEC. As you are, of course, aware, the Cohen Commission recommended the creation of a small, full-time board responsible for the establishment of auditing standards. The currently proposed part-time board and chairman, with a full-time executive director, may have enough positive attributes to give the process the enhanced objectivity and effectiveness it needs. These attributes include adequate staffing, non-AICPA member involvement, open meetings, adequate research capacities, smaller membership, and an active advisory council. While I agree with the Cohen Commission's conclusion that the process for setting auditing standards has been generally satisfactory, I have supported the establishment of a small, full-time board because of the increasing importance that I anticipate will be placed on the formulation of auditing standards over the next several years. In the final analysis, whether full-time or part-time, the new auditing standards board, once implemented, will bear the burden of demonstrating

that it can do the job, and do it effectively. That is the ultimate test.

Second, I believe that the profession should consider carefully other recommendations of the Cohen Commission. My judgment is that these recommendations are, by and large, appropriate for the profession today. When deciding whether to adopt them, consideration ought to be afforded to how those recommendations reflect public expectations. In my judgment, those expectations demand that the auditor's report evolve into a document that covers all aspects of financial reporting. The aggressiveness of any auditing standards board in addressing this issue will be an important test of its overall effectiveness.

Beyond these initiatives, one of the important, and possibly the most important, of the issues confronting the profession with respect to its theoretical underpinnings is the FASB conceptual framework project. Not only is the project important in its own right, but it entails the kind of fundamental undertaking through which accountants can demonstrate to Congress -- and to the profession's critics -- their effectiveness and resolve in confronting the important issues.

The fruits of the conceptual framework project should provide a rational structure within which to establish accounting principles and a reporting model for a disclosure system that will serve the profession and the business community well regardless of the changes in the economic climate which our society may experience in the future. The project is also the logical focus for consideration of whether the FASB should restrict its scope to financial statements or whether it should expand it to cover financial reporting in general. Thus, the conceptual framework should not be limited to formulating principles germane to the kind of data incorporated in traditional financial statements. I would urge that, within the conceptual framework, there be both mandatory disclosure of the impact of inflation on the firm and its financial statements and the flexibility to encompass any other type of disclosure which, in the future, is determined to be meaningful to users. Samples of these types of disclosures include management's discussion and analysis of the summary of operations, forecasting, and interim reporting. The inclusion of such disclosures in reports furnished to shareholders is a trend which the Commission has favored in recent years.

Closely associated with this concept is the issue of whether the auditor should be associated with such information and perform an independent review. Auditors must recognize that, as the Cohen Commission's conclusions reflect, they are increasingly expected to review any information of a financial nature which management issues. The degree of association that an auditor should be expected to have with that information depends upon the "hardness" or "softness" of the data presented. The statement on auditing standards concerning replacement cost data is one example of how auditing standards can be developed for review of information that is relatively less precise -- "softer" -- than the traditional information contained in audited financial statements. I envision that the auditor's report itself could similarly evolve into one that covers all aspects of financial reporting.

#### Conclusion

In conclusion, I hope that my remarks have made clear that the Commission fully supports the goal of fostering a strong, private accounting profession capable of providing the public with independent assurance and verification of the reliability and meaningfulness of the financial information

which public companies disseminate. We intend to discharge this responsibility with vigor and commitment and to work actively with the profession, with the Public Oversight Board, and with Congress.

The profession has made a start -- an important start -- towards achieving its goals, but much remains to be done. As members of the profession, you should have no illusions that the task will be an easy one. The differences between the economic interests, the scope of services offered, and the philosophies of the various firms which make up the SEC Practice Section are great -- greater, I think, than many outside the profession realize. Accordingly, in reaching decisions on issues confronting the Section, hard choices will have to be made -- choices which will hurt some members more than others. Each firm and each member of the Institute must, however, bear in mind that some trade-offs and compromises are necessary if the long-term objective -- self-regulation of the accounting profession by its members, rather than by government regulation -- is to be attained. Particular decisions will be painful for particular Section members. In my view, the goal is, however, more than worth the price.