

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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CURRENT DEVELOPMENTS AFFECTING SMALL BUSINESS AND  
SMALL AND MEDIUM-SIZED ACCOUNTING FIRMS

REMARKS OF

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## INTRODUCTION

Although the problems of small and medium-sized accounting firms, like the problems of small businesses, have been discussed for many years, such concerns were brought into focus during the recent Congressional scrutiny of the accounting profession. In November 1977, just two years ago, the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (Senate Subcommittee) issued a report entitled "Improving the Accountability of Publicly Owned Corporations and their Auditors". The stated purpose of that report was to set forth public policy goals which the accounting profession and the SEC were to achieve through specific programs they promised to develop and implement.

## SMALL AND MEDIUM-SIZED ACCOUNTING FIRMS

With respect to smaller accounting firms, the Senate Subcommittee Report stated:

The subcommittee is aware that many smaller accounting firms currently view establishment of special standards and procedures for auditing publicly-owned corporations as a move which will further concentrate the audits of such corporations among the large national accounting firms. If the goals set forth in this report are implemented as intended by the subcommittee, however, the opportunity for smaller accounting firms to serve as independent auditor for publicly owned corporations should improve substantially. Improvement should occur through increased public awareness of the capabilities of smaller firms, removal of

unnecessary restrictions on seeking audit clients, and sensible provisions to ease compliance with standards and procedures for accounting firms with only a few publicly owned corporate clients. 1/

Although the goals set forth in the Senate Subcommittee Report have not yet been fully achieved, substantial initiatives have been, and are being, undertaken designed to increase public confidence in the independence of accountants, the profession's resolve and ability to develop and maintain a viable system of self-regulation and self-discipline, and in the processes by which accounting and auditing standards are set. These developments are discussed in the Commission's first two reports to Congress on the Accounting Profession and the Commission's Oversight Role, and should serve to enhance the independence, professionalism and quality of work of all accountants who audit publicly-held companies.

I would like to discuss today some of the more significant developments occurring within the accounting profession and their impact on smaller practitioners.

#### Self-Regulation

The centerpiece of the accounting profession's response to the criticisms and comments set forth during Congressional

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1/ Report of the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs, United States Senate, "Improving the Accountability of Publicly Owned Corporations and their Auditors (November 1977) p.6.

scrutiny of the profession was the establishment, by the AICPA, of the Division for CPA Firms and within that Division, an SEC Practice Section. The two key objectives of the Section are (i) to improve the quality of practice before the Commission by CPA firms through the establishment of practice requirements for member firms, and (ii) to establish and maintain an effective system of self-regulation of member firms by means of mandatory triennial peer reviews of a firm's accounting and auditing practice, required maintenance of an appropriate system of quality controls, and the imposition of sanctions for failure to meet membership requirements. Although there are still uncertainties as to whether the profession's self-regulatory effort will be successful, the Commission has reported to the Congress that it regards the creation of the Section as a major accomplishment and that it is encouraged by the progress to date.

One of the uncertainties which remains relates to the voluntary aspect of the program. The Commission believes that if the profession's self-regulatory program is to be successful, it should ultimately embrace all accounting firms auditing publicly-owned companies. Yet, as of a recent date, present membership in the Section

represents substantially less than half of the accounting firms which have at least one SEC client.

For the most part, firms which have not yet joined the Section appear to be smaller firms with only a few SEC clients. Some apparent reasons for lack of participation include: (i) the short operating history makes it difficult to accurately gauge the impact of membership; (ii) fear that costs associated with Section membership will be prohibitive, and; (iii) apprehension about the inability of smaller firms to exercise influence over Section activities.

The Section has taken certain initiatives to examine the reasons for the lack of more widespread membership and to determine the special problems of smaller firms and what action may be appropriate to encourage their participation. As a result of this review, which is continuing, the Section recently has taken action to lower the dues and decrease insurance requirements for firms who have only a few SEC clients.

I believe that the Section should continue to do everything in its power to ensure that firms are encouraged to participate and support the self-regulatory effort. In this connection, the Section must be innovative in considering

possible solutions. However, I also believe that there is a need for firms who have not yet joined to recognize their special responsibilities in auditing publicly-held companies and the costs associated with those responsibilities. These firms should be actively working with the Division, the Section and the Public Oversight Board to remove any actual or perceived obstacles to their participation.

It seems likely that, in the long run, the importance of membership in a self-regulatory program will cause issuers, lenders, and others who employ auditors or rely on audited financial statements to view less favorably accounting firms that do not participate in such a program. The bottom line, therefore, is that firms who choose not to participate in the self-regulatory program face a serious risk of loss of business as participation in the program becomes recognized as evidence of quality performance.

#### Audit Committees

As you are likely aware, the Commission has long supported the establishment of effectively functioning audit committees as a means of promoting more reliable corporate financial reporting. The most recent Commission

action was the adoption of amendments to its proxy rules to require disclosures as to the composition of audit committees and the functions they perform. The Commission continues to endorse strongly private sector initiatives to establish independent audit committees, and in recent years has encouraged the self-regulatory organizations and the AICPA to explore the feasibility of mandating the establishment of such committees.

At the Commission's suggestion, the New York Stock Exchange adopted a requirement that listed companies have an audit committee, and the National Association of Securities Dealers and the American Stock Exchange are currently considering rule proposals in this area.

In addition, the AICPA established the Special Committee on Audit Committees to study the feasibility of promulgating an ethical or auditing standard which would require that an audit committee be established as a condition to an independent accountant's acceptance of an audit engagement. After studying this issue, the Special Committee concluded that the AICPA does not have the authority to require such committees in connection with expressions of opinions by independent auditors on financial statements. The AICPA pointed out, however, that it "continues to support the establishment of audit

committees and is prepared to support efforts by others having authority to require audit committees where such requirements give due recognition to a reasonable cost-benefit relationship."

The Special Committee also concluded that requiring a minimum number of independent directors would impose a significant cost burden on many smaller companies. The Commission believes that the efforts of the private sector should proceed, to the extent feasible, toward the goal of establishing effectively functioning independent audit committees for publicly-held companies. I recognize that there are serious cost-benefit questions with respect to the need for audit committees in small companies which must be considered.

In addition, a related concern exists, as noted by the AICPA, that audit committees once formed may dismiss smaller and medium-sized accounting firms in favor of national firms. While members of audit committees may have legitimate reasons for switching to a larger national firm, the Commission is concerned that too often their emphasis may be solely on the size or the name of the accounting firm. There are many smaller accounting firms which have excellent, well-deserved reputations and are

fully capable of providing quality audits. The Commission's view is consistent with the AICPA Board of Directors July 1978 Policy Statement on the Selection of Auditors by Audit Committees which concluded that the capability of auditing publicly-held companies is shared by a large number of CPA firms and size alone should not be a determinative factor in selecting and appointing independent auditors. Moreover, the existence of the SEC Practice Section, with its mandatory peer reviews and other requirements, presents an opportunity for the profession to achieve and evidence a uniformly high level of quality of audit services and should provide some assurance that all members of the Section conduct their practice at a satisfactory level of quality.

It must be emphasized, however, that, although the Commission is very sensitive to the problems of smaller accounting firms, its primary focus must continue to be on ensuring the integrity of financial reporting by public companies. Accordingly, resolution of many of the issues concerning the profession --including the audit committee issue -- which Congress, the Commission, and others have raised may further investor protection but at the same time create additional pressures on smaller accounting firms. For example, although many believe that the

tendency of audit committees to prefer the prominence and reputation of a national firm over a smaller auditing firm is unwarranted and harmful, we cannot ignore the fact that the growth of audit committees -- which is certainly desirable -- may be injurious to smaller firms. Dilemmas similar to this one exist with respect to other issues.

The Commission believes that the question of audit committees, their existence and their functioning is important. The Commission staff is reviewing the disclosures regarding audit committees under the recent amendments to the proxy rules, described above. Information concerning the prevalence of audit committees, the compensation of directors, and the composition of and functions performed by such committees will be compiled and analyzed. After completion of this study, we will be in a better position to determine what steps should be taken with respect to the establishment of audit committees and whether, and on what basis, separate consideration would be appropriate for smaller companies. Before reaching any conclusions, however, the Commission will consider the efficacy of private sector initiatives. The Commission

believes that the self-regulatory organizations have an opportunity to encourage the formation of independent audit committees in a manner which reflects an awareness of, and sensitivity to, the costs and benefits involved.

Other Developments

I would now like to discuss a number of issues which relate to the current competitive environment within the accounting profession and its impact on smaller practitioners.

Advertising, etc. - Smaller CPA firms have expressed concerns about the increasing competitive environment within the public accounting profession. Some believe that the recent elimination of AICPA rules prohibiting advertising, talking with another firm's clients, and talking with another firm's employees about possible employment without first informing the firm, has intensified competition to the potential detriment of smaller firms with less resources than their larger competitors. While it is too early to assess the effect of these rule changes, they are consistent with the public policy goals set forth by the Senate Subcommittee and should serve to increase the free flow of information needed to properly evaluate available accounting services.

In this connection, I have seen some encouraging reports which indicate that advertising can be beneficial to the smaller practitioner. 2/

Low-Balling - In response to concerns about the practice known as "low-balling" and its possible effect on the quality of an audit, the Commission believes that the risk of possible audit problems is sufficient to warrant consideration of a firm's policies and practices relating to setting audit engagement fees as part of a peer review. The Commission has requested that the SEC Practice Section consider the issue and we will continue to monitor this matter. It should be noted, however, that our principal concern and authority runs strictly to quality of audits rather than the competitive impact of practices such as "low-balling".

AICPA Special Committee - In response to concerns about the future role of smaller practitioners, the AICPA established a Special Committee on Small and Medium-Sized Firms to study the future viability and prospects of smaller and medium-sized firms and to develop programs to assure their ability to retain clients of significant size and

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2/ E.g., see "Should CPAs Advertise?" appearing in the Practitioners Forum in the September 1979 issue of the Journal of Accountancy.

standing in the financial community in competition with larger firms. The Special Committee's interim report has been issued and its final report is due prior to the AICPA's annual meeting in October 1980. I look forward to reviewing the conclusions and recommendations of the Special Committee. Every consideration should be given to efforts to ensure the viability and prospects of such a significant segment of the accounting profession.

#### SMALL BUSINESS

The Senate Subcommittee Report noted the need for recognition of the financial reporting problems of small businesses and small and medium-sized accounting firms and called for increased representation from that sector as well as organizational improvements to focus knowledgeable attention on their problems.

In our first two reports to Congress on the Accounting Profession and the Commission's Oversight Role, the Commission staff reviewed the various initiatives by the private sector designed to increase the involvement and representation of smaller businesses and small and medium-sized accounting firms in the standard-setting process. The Commission staff concluded that progress has been made toward recognizing and resolving some of the particular

problems faced by smaller businesses and small and medium-sized accounting firms. It was noted that while there has not been an increase in the representation from the small business sector at the Financial Accounting Foundation Trustee or the Financial Accounting Standards Board level, the initiatives by the private sector reflect an increased awareness of the special financial reporting problems of smaller businesses and the accounting firms that serve them, and of the information needs of users of financial statements of smaller businesses.

Let me now turn my remarks to some of the efforts on the part of the Commission to address the problems of smaller businesses and their concern with the increasing cost of government requirements. In this respect, the Commission has recently given special attention to the effects of its requirements on smaller businesses. The impetus for this attention was a recommendation in the November 1977 Report of the Advisory Committee on Corporate Disclosure that the Commission consider whether and how the reporting burden on smaller companies might be reduced.

In March 1978, the Commission announced a broad scale reexamination of the impact of its regulations on smaller businesses with an eye toward easing the burden wherever

possible consistent with the Commission's statutory responsibilities. A total of 21 days of hearings were held in cities across the country and 4500 pages of testimony were taken. Our re-examination of our regulations has resulted in a number of rule amendments and proposals which we believe are responsive to concerns expressed at these hearings.

The Commission has amended Rule 144 to more than double the amount of restricted securities which may be sold thereunder and to permit sellers to deal directly with a bona fide market-maker without engaging a broker. In addition, the Commission adopted a further amendment to the Rule which would remove the volume restrictions entirely -- after a certain holding period -- for persons not in a control relationship with the issuer.

The Commission has also endeavored to make offerings under Regulation A and Rule 146 more useful for smaller businesses. Thus, Regulation A was amended to increase the amount of securities which may be sold thereunder within a 12-month period from \$500,000 to \$1,500,000. Early indications are that both the number and size of Regulation A offerings have increased significantly. The Commission has also recently approved a rule amendment which permits the use of pre-effective selling documents in Regulation A underwritings. In addition to raising the Regulation A ceiling,

the Commission also amended Rule 146 to permit the use of Regulation A-type disclosure to satisfy the Rule's information requirement for offerings which do not exceed \$1,500,000.

The Commission has taken another significant step expressly designed to assist small business capital formation. We adopted a new registration form, called Form S-18. Because of the limitations of Regulation A, there was a need for a simplified and less costly form for the registered offering of securities by smaller businesses. In order to bridge the gap between Regulation A and the traditional Form S-1, with its rather elaborate and extensive disclosure, the Commission adopted Form S-18 and corresponding amendments to annual report Form 10-K. The simplified registration and reporting procedures which Form S-18 reflects were strongly endorsed by the witnesses at the hearings.

Using Form S-18 and the amendments to Form 10-K, a small unseasoned issuer may sell as much as \$5 million of its securities to the public without immediately incurring the full range of disclosure and reporting requirements -- and the resulting costs. To provide some liquidity to early investors and venture capitalists, the \$5 million dollar ceiling may include resales totaling as much as \$1.5 million of their security holdings in the company. We anticipate use of this form will significantly reduce legal and accounting costs.

The Commission is hopeful that Form S-18 and the other actions I have mentioned will be of substantial assistance to smaller businesses. We recognize, however, that the problems of smaller businesses under the securities laws deserve further and long range attention. Because of the recurring and pervasive nature of many of these problems, the Commission has established the Office of Small Business Policy within the Division of Corporation Finance. Mary Beach, the staff director of the Advisory Committee and currently an Associate Director in the Division of Corporation Finance, heads up the new Office.

As its first priority, the Office of Small Business Policy worked on the development of a special alternative rule to Rule 146 to exempt smaller businesses from the registration requirements of the 1933 Act. As a result, the Commission, in September 1979, proposed for comment a small issue exemptive rule under Section 3(b) of the 1933 Act which would allow certain corporate issuers to offer and sell up to \$2,000,000 per issue of their securities to an unlimited number of accredited persons, as defined to include certain institutional purchasers, and to 35 other persons, provided such issuers meet certain conditions, including furnishing to all purchasers, if any are not accredited, information generally of the kind specified in Part I of Form

S-18 if material. The proposed exemption from registration would be in the nature of an experiment, and the Commission would monitor closely the use of the new rule to determine if it has functioned as an effective means for issuers, particularly smaller issuers, to raise limited amounts of capital through unregistered offerings to the public consistent with the protection of investors.

Another problem which the Office of Small Business Policy intends to tackle is Exchange Act reporting. The Report of the Advisory Committee on Corporate Disclosure cited a number of factors which suggest that easier reporting requirements may be warranted for smaller businesses. In order to reduce disclosure obligations for smaller businesses consistent with the protection of investors and the public interest, the Commission would need to identify a class of smaller businesses entitled to such relief. But the Commission has never classified or differentiated issuers on the basis of their size. Accordingly, there is little empirical evidence available for us to support determinations as to impact and benefit or to provide a basis for appropriate classification.

In order to assist the Commission in selecting appropriate criteria for this purpose, the Office of Small Business Policy, in cooperation with the Commission's Office

of Economic and Policy Research, will seek to develop an empirical data base for issuers by asset size, revenues, earnings, trading activity, market capitalization, and other appropriate standards. Also, to aid in a determination of what relief, if any, should be granted to smaller businesses, consideration is being given to a survey of the information needs of investors in smaller enterprises. The staff has informed me that it will make every effort to develop proposals in this area by the end of this year. I hope they can, and I believe that the whole effort is well worthwhile.

#### CONCLUSION

Today I have touched on some of the developments affecting smaller businesses and small and medium-sized accounting firms. The Commission will continue its efforts to make rulemaking initiatives less burdensome to small businesses to the extent compatible with sound disclosure policy and the protection of the public interest. Likewise, the Commission will continue to encourage -- and work with -- the private sector in an effort to ensure the highest level of audit quality by all firms auditing publicly-held companies.

While larger firms with greater manpower may be better able to deploy resources to audit huge multinational

corporations, the quality of the audit still depends on the individual auditors involved, their training, commitment, and sense of professionalism, as well as on the support they receive from their firm's management to discharge their professional judgment without undue client or business pressure. In this connection, the Commission has not seen evidence that size alone of an accounting firm is determinative of whether a quality audit is accomplished.

The continuing implementation of the public policy goals set forth in the Senate Subcommittee Report should increase public confidence in the independence, professionalism and quality of work of all accountants -- regardless of size. The future role of smaller practitioners will be largely determined by the present role of the smaller practitioners in responding to the challenges facing them -- you must be actively working within the profession and with the Commission to ensure that the goals set by Congress are met and are met in such a way so as not to impede smaller practitioners from participation in SEC accounting.

In your May 1979 newsletter, Harry Reiss referred to the belief that large accounting firms dominated the profession as a "widely believed myth." He referred to an AICPA analysis of members in public practice which indicates that over 53% were with firms consisting of less than 10

members, a relationship which has increased since 1972. My advice to the smaller practitioners is to use your numbers effectively -- your voice will be much louder if you are actively participating in the profession's programs rather than standing on the fringes and deploring your unhappy lot.