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ACCOUNTING AND FINANCIAL REPORTING -- THE CHALLENGES OF THE 1980s

An Address by

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It is indeed a pleasure to participate in the Foundation for Accounting Education's 1980 SEC Conference. In many ways, accounting is unique among the professions. It does not advocate, heal, or counsel; rather, it certifies. That is, it assures the public that financial statements can be accepted as credible. As such, the most important characteristic of the accounting profession must be a high degree of public trust.

During the last decade, however, much occurred to challenge the trust which the profession has cultivated and enjoyed since the 1930s. For example, we witnessed the collapse of major corporations on the heels of financial reporting, reviewed by respected auditors, which did not communicate the threat of impending insolvency. Revelations of off-book payments to foreign officials further impeached credibility. Moreover, the relevance of traditional accounting principles came into question in an inflationary environment. And, the increasing emphasis which many auditors place on management advisory services as a revenue source led some to question both the independence of the profession and its commitment to its traditional role.

Whether these concerns were valid or not may be less important than the fact that they underscore the need for the profession to be vigilant in maintaining the public's trust. If such trust were to dissolve, calls for a greater governmental role in the profession's affairs would almost inevitably be heard. I, for one, do not believe, however, that government could play such a role without doing damage to the vigor and strength of the accounting profession.

Some of you may feel that this risk of expanded government authority over accountants is slight. Clearly, the American public is becoming increasingly skeptical of the benefits of greater regulation of the private sector. To some in the profession, that skepticism toward government may provide a degree of comfort. If you are of that view, your comfort may well be misplaced. The crucial question is the strength of the public's trust in the accounting profession -- and doubts about the efficacy of regulation will not protect the profession's independence if that trust were to be lost.

During recent years, the accounting profession has undertaken meaningful steps -- most notably the establishment of the AICPA's SEC Practice Section -- to strengthen the public's trust. While these initiatives lay the groundwork for an effective self-regulatory program, the success of that effort remains to be proven in its implementation. Similarly, while the Financial Accounting Standards Board has made important progress in better matching accounting principles to the demands of the modern economic environment, more must be done if financial reporting is to remain meaningful and useful to its users. I should like to share with you this afternoon some thoughts concerning the challenges which accountants face in each of these areas.

<u>The Work of the Auditor</u>

A. The Auditor's Role and Responsibilities

The independent auditor's job is to lend added credibility to corporate financial information in order that users of that information -- users who may well never have met the corporation's officers or seen its assets -- can rely on it. The importance of this process is difficult to overstate. In the private sector, audited financial statements provide the basis upon which the marketplace -- meaning the aggregate of investors and lenders -- allocates economic resources. Moreover, financial reporting shapes the attitudes which government -- and the general public -- hold toward business. Consider, for example, the public and political reactions which follow when major corporations report that their profits have reached "record" highs.

More subtly, both outside auditors and internal auditors are also major contributors to public confidence in the effectiveness of the corporate accountability process -- confidence which is the key to avoiding governmental intrusions into the private sector's decisionmaking process. To state it simply, many feel that the audit serves as a discipline inhibiting improper conduct which might prove very tempting were it not for the knowledge that the transaction in question would some day likely come to the attention of the auditor.

By virtue of this unique role, the outside auditor's role and his relationship with his client are not purely matters of private concern. The rationale for the auditor's work -- indeed, the only justification for the existence of the profession -- arises from the need for reliable financial information in order for our economy to operate smoothly. Thus, the auditor, in certifying financial statements under the federal securities laws, performs a quasi-public function. While many in the general public may fail to understand the limits of the audit process and tend to ignore the fact that the financial statements are management's, not the auditor's, the profession must keep clearly in mind the fact that, though it is engaged and paid by a client, its duties run to the public.

Significantly, however, there is today no clear articulation of the parameters of the auditor's role. One of the factors which serves to obscure the auditor's proper role is confusion between the level of conduct which the law demands, and the level of conduct called for by changing economic conditions and by user and public expectations. Quite naturally, faced with a conflict between the two, auditors tend to conform their conduct to the law and ignore the more amorphous expectations of the public.

The United States Supreme Court's decision in Ernst & Ernst v. Hochfelder */ is a good illustration of the confusion which exists between the scope of legal liability on the one hand, and public expectations concerning professional responsibility on the other. In that case, the Court held that an auditor was not liable to a customer who had been injured by the collapse of the auditor's client. The client was seeking monetary damages under the Commission's general antifraud rule -- Rule 10b-5 -- for the auditor's allegedly negligent performance of the audit. The Court held that such liability requires a showing of scienter -- that is, intent to defraud. The Court's underlying message, I believe, is that it would not impose liability which seemed to be wholly disproportionate to the task which the auditor had undertaken. In essence, it rejected what it considered to be an unreasonable and unfair imbalance between the auditor's responsibilities and the monetary liability incurred when those responsibilities are not met. The point of the decision was not, however, that the auditor's responsibility to use care in performing the audit, or the public's expectations of the auditor, are any the less.

Thus, the profession must be cautious in interpreting superficially conflicting signals concerning its role and

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*/ 425 U.S. 185 (1976).

responsibilities. The objective of each accountant should be to ensure that his conduct comports -- not merely with the letter of the law -- but also with the changing expectations and needs of users of financial information and the public. Those expectations tend to change more quickly than does the law. The signals which the legal system give off lag behind the emerging expectations in response to which the profession's performance is measured. Sensing such changes and responding before the law imposes new requirements is the key to retaining the initiative and reducing the risk of losing the ability to shape the profession's future.

B. Self-Regulation in the Accounting Profession

As a step toward meeting this challenge, the American Institute of Certified Public Accountants' has created the SEC Practice Section. The Section is the linchpin of successful, voluntary self-regulation, and its birth was a major accomplishment. The question now is whether the Section will be effective in practice. In my judgment, there are three areas -- the peer review process, the Section's disciplinary mechanisms, and the extent of its membership -- which demand special attention to help assure the success of the self-regulatory program. I want briefly to focus on each of these issues.

The first element which calls for special attention is the peer review concept. Commitment to meaningful, in-depth peer reviews by independent and objective reviewers is a prerequisite to the success of the profession's efforts.

Experience alone will tell whether the peer review program is adequate to meet its objectives. The Commission is, however, encouraged by the effective leadership which the Public Oversight Board displayed in facilitating the Commission's and the Section's successful efforts to reach an accommodation on the issue of Commission access to peer review workpapers. Moreover, I sense that the Section's leadership and the POB are committed to making the peer review process an effective mechanism for addressing and correcting quality control or other deficiencies. While questions concerning the effectiveness of the program certainly remain, I am optimistic.

The second area for special attention relates to the disciplinary measures which the Section will invoke against members which deviate from the profession's standards. Again, as in the case of the Section itself, a framework has been put in place. The sanctioning process and procedures have not yet been tested, however, and their timeliness, fairness, evenhandedness, and efficacy remain to be demonstrated. In the final analysis, however, the profession's resolve and commitment in sanctioning its own members is likely to be the acid test of meaningful self-regulation.

The third area for attention relates to membership in the Section. On the positive side, the Section includes among its members 245 firms which have Commission registrants as clients. Together, these firms audit almost 9,000 public companies -- including virtually every company listed on the national stock exchanges and a significant portion of NASDAQ-traded companies. Unfortunately, however, approximately 600 accounting firms with at least one SEC audit client have not yet joined.

If the Section functions as intended, there will be increasing pressure on all firms with public clients, regardless of firm size, to become members of a recognized and effective self-regulatory program. Membership in the Section -- with its attendant peer review requirements -- provides a basic level of assurance of quality audits. Accordingly, the onus has shifted to the firms which have elected not to participate in a self-regulatory program to justify their failure to do so. Moreover, it may be important for investors to be informed as to whether a registrant's auditors are members of a self-regulatory program and whether the auditor has been subject to a peer review. Companies should consider making this sort of disclosure voluntarily; clearly, it may be useful to shareholders and other users of financial information in evaluating the overall quality of a registrant's financial reporting.

C. Independence

I want to turn now to the issue of safeguarding auditor independence. Like self-regulation, this subject occupied the profession's attention during the 1970s and will continue to be a focal point. Two issues -- independent audit committees and the scope of services which the auditor provides his client -- are particularly important.

The audit committee issue is, of course, one which I have addressed repeatedly. Today, about 85 percent of public companies have established audit committees, and, as a result of that consensus, the burden has shifted to the minority of corporations which still lack them to justify their decision.

The ultimate value of audit committees depends, however, on how well these bodies actually function, rather than on whether they simply exist in theory. And, in turn, whether or not such committees function effectively will depend on the combined efforts of the accounting profession, other professional advisers, the corporate community, and individual audit committee members. This is the ultimate goal toward which we must all be working. Auditors are obviously the focus of audit committee operations, and I urge the accounting profession, in its own self-interest, to continue its efforts to enhance the effectiveness of audit committees.

A second issue bearing directly on auditor independence is the scope of services performed by independent accountants.

The Commission has addressed this area principally in two releases. First, in 1978, the Commission promulgated Accounting Series Release No. 250, which requires disclosure of nonaudit services performed by independent auditors in terms of percentage relationship to audit fees. ASR 250 provides data upon which users of financial information can evaluate the relationship between companies and their auditors. Similarly, these disclosure requirements will enable the Commission to monitor the nature and extent of services performed by independent accountants and will assist us in developing an empirical base from which to determine whether any need for further action in this area exists.

The second facet of the Commission's consideration of the scope of services issue is reflected in ASR 264 issued last year. The impetus for this release was the Commission's judgment that the sensitivity of registrants and their auditors to the concerns surrounding the performance of management advisory services needed to be heightened. The profession, through the Public Oversight Board, had studied the question of scope of services by CPA firms and issued a report in March 1979. Dissatisfied with the lack of more specific guidance in that report, the Commission presented its own views in ASR 264, detailing the factors which the Commission believes that management, the audit committee, and the accountant should consider in determining whether a proposed engagement should be offered or accepted.

ASRs 250 and 264, read together, provide an appropriate framework within which the parties who are primarily concerned with the independence which characterizes the audit relationship may determine the scope of services appropriate in the circumstances. In developing ASR 264, the Commission consciously determined not to prohibit particular types of management advisory services engagements. Accountants, and not the Commission, must serve as the front-line guardians of their professional independence, as their own ethics literature recognizes. Similarly, corporate boards, and not the Commission, should have primary responsibility for the credibility of issuer financial reporting. ASR 264 seeks to guide the auditor and the issuer's board in discharging these responsibilities.

The Commission has not ended its examination of the scope of services issue. Rather, we view the issuance of ASRs 250 and 264 as part of a continuing examination of the relationship between registrants and their independent accountants. The Commission's staff will continue to review and evaluate ASR 250 disclosures. Over time, these disclosures will generate the data necessary to identify trends in the scope of auditor services. After reviewing future proxy disclosures, the Commission may revisit this area, and we encourage comments, particularly from the accounting and corporate communities.

Standard-Setting

I want now to turn to the second broad area in which accountants are being challenged to maintain the credibility of their profession -- the setting of accounting standards. The need for timely and meaningful standards, established within an effective and adaptive framework, has never been clearer. The credibility of financial reporting is critical to the profession's future.

The Financial Accounting Standards Board appears willing to meet this challenge. Most importantly, the Board has made considerable progress toward the development of a conceptual framework for financial reporting. The FASB must continue to pursue this project aggressively. While its completion will not provide answers to all difficult accounting and financial reporting problems, it will provide a coherent structure within which to resolve these problems in a timely, effective, and consistent manner.

Despite the Board's positive leadership -- as evidenced by the conceptual framework project -- the Board's future success in discharging its responsibilities should not be taken for granted. If the FASB is to be a permanent and viable feature of the accounting landscape, it must be able to rely on the support and encouragement of the accounting profession and the corporate community -- regardless of the effect of particular Board decisions on individual reporting companies and regardless of whether those companies and their auditors fully agree with the Board. Those, especially in the corporate community, who are tempted to withhold or reduce their support for the Board because they dislike its approach to particular issues ought to reflect on whether they would truly prefer the alternative to private sector standard-setting. And, they also ought to reflect on whether the implicit assumption underlying this approach -- that the FASB should be influenced in its decisionmaking by the size of its contributors' support -- is one which they truly wish to see implemented.

A complete catalogue of all of the difficult accounting issues which currently face the profession is beyond the scope of my remarks today. I would, however, like to highlight three areas -- inflation accounting, cash flow, and pension disclosure. Each of these topics illustrates the need for accounting principles to evolve in response to changing economic conditions. Each also sheds light on the interplay between FASB and Commission oversight of the standard-setting process.

A. Accounting for Changing Prices

Perhaps the single most important accounting issue today is the reconcilation of traditional, cost-basis accounting with an economic environment in which inflation is chronic. Inflation renders superficially illuminating financial figures virtually meaningless, since historic-based earnings bear little necessary correlation to economic reality. Traditional financial standards and rules of thumb no longer seem to apply. Thus, users are increasingly demanding inflation-adjusted financial reports, and management should be doing the same if it is to avoid operating with a distorted view of corporate performance.

Let me illustrate the importance of this issue. One analysis by a national accounting firm shows that inflation-adjusted 1979 corporate income among selected industrial companies is only 60 percent of the figure reported under traditional accounting methods. And, as a result, taxes and dividends are a much higher percentage of real income than traditional measures reflect. Indeed, the aggregate of taxes and dividends approaches -- and in some industries exceeds -- inflation-adjusted corporate income. Therefore, much of the corporate community is distributing more than its real income to shareholders and the tax collector. Thus, for all practical purposes, a substantial part of American industry -- the keystone of our prosperity and our liberty -- has begun to liquidate.

The FASB's Statement No. 33 is a significant step toward coming to grips with the distortions which inflation works on financial reports. Statement No. 33 represents a milestone --

and not merely because it departs from the profession's exclusive reliance on historical cost-based accounting. Rather, its greatest importance is in its innovative approach to the formulation of accounting standards. Statement No. 33 recog'..zes that certain issues cannot await formulation of a perfect solution and that, at times, one must allow for the experimentation that is the only practical source of necessary experience and empirical data.

Ultimate success in this area will depend to a large extent on the efforts of the accounting profession and the business community in applying Statement No. 33 and in experimenting with additional disclosures which may help users assess the impact of changing prices on particular entities and industries. The corporate community has an obligation to contribute both to the private sector standard-setting process and to better user understanding of financial data by adequately disclosing all additional information which will make reporting more meaningful and more complete.

In this connection, the Commission has restructured the management discussion and analysis requirement to elicit information concerning the effects of inflation and changing prices. Thus, all registrants, including those which are not required to present Statement No. 33 information, should make some textual presentation with respect to these matters. A meaningful response by smaller companies to the Commission's requirement would add to the utility of their financial reports, while at the same time contributing valuable empirical evidence to the FASB's on-going evaluation of its standards.

B. Cash Flow and Liquidity

A second important pending accounting issue is disclosure concerning cash flow and liquidity. For a variety of reasons, the traditional net income figure is becoming less and less useful in providing information relevant to the entity's cash position. In part, liquidity issues have become more significant as a result of inflation and its impact on the utility of net income as an analytic tool. In addition, novel and often complex financing arrangements -- such as various types of off-balance sheet financing -- seem to be straining the capacity of the historic-cost framework to provide meaningful disclosure. As a result of these factors, it is clear that the financial reporting system must be supplemented by information which conveys the adequacy of a company's cash resources.

The FASB's vehicle for addressing these basic issues is the "Funds Flow and Liquidity" phase of the conceptual framework project. This aspect of the project is now under increasingly active development. Major improvements in financial reporting will take time, however, and will involve some basic challenges to traditional patterns of accounting thought.

While the FASB addresses these questions, the Commission will need to play a role in ensuring that investors receive the basic information they need. At present, the Commission's revised management discussion and analysis requirements present both the opportunity and obligation to the corporate community to provide meaningful information about liquidity position and capital resources. The Commission's rules now require a specific discussion concerning a company's liquidity position and capital resources in management's presentation, although the registrant has substantial flexibility in determining the actual content of the discussion. This increased flexibility carries with it increased responsibility to provide an effective presentation. Financial reporting must not be dominated by a bottom-line obsession; it needs to be more balanced. And that, in my view, requires greater emphasis on cash flows and enterprise liquidity.

The problems of meaningful liquidity disclosure are complex, and neither the Commission nor the Board has the answers today. Nonetheless, I am intrigued with the parallels between efforts in this area and the path which led to FAS No. 33. As you know, with respect to inflation disclosure, the Commission took the initiative in 1976, with the issuance of ASR 190, which required certain large issuers to make supplemental disclosure concerning the replacement cost of fixed assets. While this measure was not greeted with great enthusiasm in either the profession or the business community, it did serve to provide a base of experimentation and experience. With the adoption of Statement No. 33, which built on that experience, the Commission withdrew ASR 190. In the cash flow area, we are obviously now at the earliest stages of consideration with our rule on the disclosure of capital resources and liquidity. I am hopeful that the response of the corporate and accounting communities will provide the necessary experimentation to make this disclosure meaningful, and that the FASB will move ahead in this area promptly. It is, however, possible that the Commission will need to consider repeating the ASR 190 pattern in order to move the subject of cash flow from the discussion to the experiment stage.

C. Disclosure of Pension Information

A third important area in which the accounting profession and the corporate community can contribute significantly to the evolution of more useful financial reporting standards relates to disclosure of pension information. Because of the growth and magnitude of pension plans, their importance to the economy and to the social fabric, and questions concerning the size of unfunded liabilities, pension disclosures have taken on special importance in recent years. As in other areas, the challenge is to formulate disclosure standards which meaningfully address user needs.

In May 1980, the FASB made significant progress with the issuance of Statement Nos. 35 and 36. In particular, Statement No. 36 revises required disclosures about defined benefit pension plans in the financial statements of employers which sponsor such plans. The revised disclosures have been established on a temporary basis until the FASB can fully address the issues relating to employer accounting for pension and other post-employment benefits. The Board presently anticipates that this comprehensive project will be completed in late 1982. In the meantime, the disclosures required by Statement No. 36 should make pension disclosure information more comparable among companies.

While I recognize that the Statement No. 36 disclosures are only a temporary solution and were adopted primarily to achieve comparability, I am concerned because disclosures required by Statement No. 36 are not indicative of future pension expenditures by the employer. The actuarial present value of accumulated plan benefits which must be calculated in accordance with the FASB's Statement No. 35 does not anticipate increased benefits related to future salary increases. In determining the amount of pension cost to be accounted for and funded each year, most companies, however, now use actuarial cost methods which do anticipate such increases. Thus, as a result of the issuance of Statement No. 36, many companies will perform two actuarial calculations -- one for accounting and funding purposes and the other for disclosure purposes. Users of financial statements could draw incorrect conclusions if they try to relate the current year's pension cost -- which is set forth in the earnings statement and generally approximates the amount funded -- to the accumulated plan benefits disclosed in the notes.

Because of the complexities of pension accounting and the length of time the temporary rules will be in effect, I believe it is necessary that companies highlight these differences for users of financial statements. I would also expect registrants to expand their disclosures where necessary to assist users in understanding the information presented, and I urge registrants to provide such additional information which, in their judgment, will make this disclosure appropriately meaningful.

The Commission's staff will be carefully reviewing the pension disclosures in this year's financial statements. If the disclosures are not adequate, the staff may well recommend that the Commission consider implementing additional requirements until such time as the FASB is able to complete its project on employer accounting for pension and other retirement benefits. I am hopeful, however, that the private sector response in this area will make such regulatory action unnecessary.

Reporting on Internal Accounting Control

I want to turn now to another kind of challenge facing the accounting profession -- reporting on the adequacy of internal accounting controls. Like Statement No. 33, cash flow disclosure, and pension disclosure, this is an area in which private sector creativity and leadership are necessary. Unlike those other disclosure issues, however, internal control reporting is largely uncharted and much remains to be learned concerning user needs and disclosure format.

As most of you know, disclosure concerning the adequacy of issuer internal controls originates in part from the statutory requirement that public companies maintain adequate control systems. As one consequence of the enactment of the Foreign Corrupt Practices Act of 1977, the Commission proposed a disclosure rule which would have required an issuer statement concerning the adequacy of its internal controls and a limited auditor's opinion on that statement. This proposal was, to say the least, controversial. After extended consideration, the Commission, in June 1980, withdrew the proposal in order to allow existing voluntary and private sector initiatives for public reporting on internal accounting control -- both by registrants and accountants -- to continue to develop.

The Commission continues to believe that management disclosure concerning its system of internal accounting control has considerable value. That value is, however, partially dependent on meaningful auditor involvement. The Commission will monitor carefully voluntary private sector developments in this area. The Commission expects that significant progress will be made over the next two years and intends to revisit these questions before the Spring of 1982.

In that regard, the Commission is interested in hearing from issuers, accountants, and their counsel -- not only about questions relating to management statements on internal accounting control and auditor involvement with such statements, but also about the guidance which the Commission set forth in the withdrawing release concerning the design, implementation, and monitoring of internal accounting control systems, the need for documentation, and the importance of a proper control environment. Data on actual costs incurred by issuers is also of particular importance. Quite clearly, our decisionmaking can be no better than the information we receive, and I urge each of you to participate in our comment process.

I want to stress the need for the private sector to maintain the initiative in this area. It would be a serious mistake to interpret the Commission's decision to withdraw its disclosure proposal as a reluctance to move ahead in a controversial area or for issuers to assume that the Commission's call for voluntary disclosures can be ignored. I firmly believe that information bearing on the effectiveness of an issuer's system of internal accounting control is useful and material to investors and other users. Accordingly, I anticipate a substantial increase in both the quantity and quality of such information in 1980 reports. While I believe that voluntary development of reports on internal accounting control -- with the attendant flexibility in approaches -- is preferable to a Commission requirement, a determination as to whether further regulatory action is necessary will depend on the private sector's response. Accordingly, I hope that each of you will encourage your clients to make disclosures of this nature, and that, consistent with Statement on Auditing Standards No. 30, you will contribute to that process.

Conclusion

Today, I have touched on only some of the vital issues impacting auditing, accounting, and financial reporting. The coming decade will surely witness innovative and important changes in these fields. Most importantly, there is an unmistakable trend -- recognized in the Report of the Commission on Auditors' Responsibilities, the Congress' scrutiny of the profession, and the FASB's first statement of financial accounting concepts -- toward an increasing emphasis on the needs and expectations of users of financial information. Accountants must be sensitive to this trend and how it affects their work.

In the area of auditing, as the social, business, political, and business environments continue to change, and new and different approaches evolve, there will be increasing pressure on the profession to alter and expand its role. It seems clear that, in the future, auditors will be associated with disclosures which are more subjective and less precise than has been traditional. Auditor involvement with certain supplementary financial information, such as the effects of changing prices and oil and gas reserve data, has already come to pass. Similarly, auditors may be called upon to play an increased role in the corporate accountability process. Auditor involvement with management reports on internal accounting controls is part of that trend.

Similarly, in the area of financial reporting, the trend toward a user orientation should lead to the reporting of financial information that is more relevant, but perhaps less reliable; more reflective of the impact of inflation; more forward-looking; and more disaggregated. Consequently, there should be less emphasis on the "bottom line" and its surrogate, earnings-per-share, and more emphasis on the key components of operating performance and cash flows.

The lesson which I draw from these developments -- and the theme I want to leave with you today -- is that accountants must be sensitive to the need to adjust the traditions and goals of the profession to the expectations of society. When the public -- most often speaking through government -- makes demands which are unrealistic, accountants must work to inform, educate, and change the attitudes and views which give rise to those demands. But, if the profession ignores the new responsibilities with which its critics seek to charge it and clings to a limited view of its role, accounting as an independent profession will suffer. During the 1970s, the groundwork was laid for a restructured and vigorous profession. Your obligation -- each of you -- is to ensure that the 1980s witness the completion of that effort.