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THE SEC AND THE ACCOUNTING PROFESSION: "CREATIVE TENSION"

An Address By

A. A. Sommer, Jr., Commissioner

Securities and Exchange Commission

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THE SEC AND THE ACCOUNTING PROFESSION: "CREATIVE TENSION"

A. A. Sommer, Jr. *
Commissioner
Securities and Exchange Commission

I would like to share with you today a few reflections with regard to the historic relationship of the Securities and Exchange Commission and the accounting profession, the manner in which that relationship expresses itself today in connection with the Financial Accounting Standards Board, and the future course of Commission action in the accounting area, and then conclude with some thoughts concerning what I think should be the future course of the accounting profession.

First, it is well to reflect upon the nature of the Commission's responsibility with respect to accounting. Under the Securities Act of 1933 and the Securities Exchange Act of 1934, the Commission was given very broad powers with respect to the content and the manner of preparation of financial statements contained in filings with it. These provisions were sufficiently broad that few have been tempted through the years to quarrel with the proposition that for all practical purposes the Commission has the power to become, if it so wishes, the final arbiter with respect to accounting principles, at least for publicly-held companies subject to its jurisdiction. In addition, the Commission is given a broad responsibility of implementing and enforcing the disclosure requirements of those Acts and, of course, a large and significant part of the disclosure requirements relate to financial information. And, finally, the Commission is given the responsibility to deter and punish fraud

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and other kinds of undesirable conduct in connection with securities transactions, wherever it might appear.

To carry out these responsibilities, Congress gave the Commission considerable power and through the years there have developed, in addition to formal remedies made available, various unlegislated techniques through which these powers have been exercised and the responsibility satisfied. The Commission is given the power, after following appropriate procedures, to make rules and it has exercised this power, as you are all aware, in the accounting area by adopting Regulation S-X, Accounting Series Releases and in taking numerous other actions that have impacted accounting matters. Furthermore, the Commission has the power to bring administrative proceedings against professionals, including accountants, whose conduct may have appeared questionable, and upon determining it was, to suspend or bar such professionals from practice before the Commission. In addition, the Commission has the power to bring injunctive proceedings against anyone in the federal courts and it has the authority, when violations of the law appear to involve criminal conduct, to refer cases to the Department of Justice with a recommendation for criminal enforcement. The Commission has the power to issue a stop order with regard to any 1933 Act registration statement filed with it which is found wanting. The fact that this power is relatively infrequently used is a reflection of the ingenuity of the earlier administrators of the 1933 Act who quickly determined that informal conferences, proddings and other less rigid procedures were sufficient in most cases to secure compliance with the Commission's requirements. Through this process, by indicating wherein financial statements included in filings with the Commission were deficient, the staff and the Commission have through the years

exercised subtle, but nonetheless effective, influence upon accounting developments. Finally, the Commission has with varying degrees of vigor "jawboned" about accounting matters and, thus, indicated to business and the profession its attitudes and wishes with regard to accounting matters.

The history of the relationship between the Commission and the accounting profession is an interesting and varied one, but I think it has been consistently characterized by a high degree of cooperation. The suggestion was made in a recent thesis that Congress had intended that the Commission take the initiative and leadership in establishing accounting principles, but that in 1936, as a consequence of the pressures of the accounting profession and the fatigue of then Chairman James M. Landis, the Commission abdicated its responsibility and gave it over into the hands of the accounting profession. In 1967, Carman G. Blough, the first Chief Accountant of the Commission, described this period and indicated that through 1936, 1937 and the early part of 1938 there was a heated controversy among the Commissioners concerning this matter. He states that two of them (identified recently by Justice William O. Douglas as himself and Judge Healy), both of whom were lawyers, which may be some explanation of their position, were of the opinion that the Commission itself should promulgate a set of accounting principles that would have to be followed by all companies required to file financial statements with the Commission. Mr. Blough stated that the other Commissioners and the Chief Accountant were opposed to this proposal and eventually prevailed. Interestingly, in his recital of these events he tells that the Chief Accountant (who was himself) "took the opportunity, during the 15th Anniversary Meeting of the American Institute of Accountants in the fall of 1937, to make it clear to the members that unless the profession

took steps to reduce the areas of difference in accounting practices, the Commission would." Recalling recent discussions, it certainly recalls the French saying that the more things change, the more they are the same!

The issue was resolved, at least for the moment, by the publication in April of 1938 of Accounting Series Release No. 4 which established the ground rules, which are still recognized, for the Commission's recognition of financial statements prepared in accordance with "generally accepted accounting principles."

The fact that the Commission has left the initiative and leadership with regard to the establishment of accounting principles to the private sector does not mean, of course, that the Commission has been indifferent, quiescent, unconcerned or ineffective. Through the years, there has been a great deal of formal and informal give and take between the accounting profession and the Chief Accountant of the Commission and through these processes the Commission has had significant impact upon the development of accounting principles. Furthermore, the Commission has increasingly strengthened the standards of independence required of those who practice before it and has had significant influence upon the development of the independence standards of the profession as a whole. The Commission's Accounting Series Releases and Regulation S-X have unquestionably affected the development of rules and procedures in the private area.

The Commission has recently reaffirmed in an unprecedented fashion its commitment to the private sector establishing accounting procedures through Accounting Series Release No. 150. In this, the Commission explicitly, unequivocally and forcefully expressed its support for the Financial Accounting

Standards Board and stated that principles, procedures and standards promulgated by the FASB would be deemed to have substantial authoritative support and those contrary to such promulgations will be considered as having no such support.

This strong statement has not been without its critics. There are those who still feel that the Commission has the prime responsibility for the establishment of accounting principles and there are those who are concerned that by stating its position in this matter as it has, the Commission may be laying itself open to the renewal of the charges made in the Arthur Andersen case attacking Accounting Series Release No. 146. In that case, the plaintiff questioned the authority of the Commission to interpret the pronouncements of private bodies otherwise than by a rule-making procedure. Quite obviously, if all such interpretations were to be the subject of formal rule-making procedure, the entire process would be terribly slowed and encumbered. More seriously, if the courts should be disposed to determine that the Commission could not accept as authoritative pronouncements of private bodies, like the APB and the FASB, unless it had first adopted them as its own through a rule-making procedure, then of course the Commission would be in the business of establishing generally accepted accounting principles and the FASB would lack significant authority and would, for all practical purposes, be a superfluity.

The relationship between the accounting profession and the Securities and Exchange Commission has, of course, fluctuated and changed through the years. The state of that relationship at a particular time has depended upon the mood of the times, the intellectual and financial environment, the approaches,

attitudes and personalities of those who are joined together in the relationship. While the Commission has had 40 years of continuous existence, nonetheless it would be naive to deny that each time a new Commissioner joins the Commission its coloration undergoes some slight variation, and when there are a number of changes within a short period of time, the change is often quite evident. The relationship between the Commission and the accounting profession is a dynamic, ongoing, ever-changing relationship.

And that brings us to the present situation. The environment in which we find ourselves today is one in which there has developed perhaps more distrust of American industry and its financial practices than there has been at any time since the late 20's and early 30's. Our sensibilities have been assaulted by too many instances of gross misconduct by management: the names of Equity Funding, U. S. Financial, Westgate, Penn Central, Realty Equities and innumerable others come quickly to mind. Unfortunately, many of these debacles have been attended by charges that in some measure the public was misled by the failure of auditors to perform their duties properly, carefully and professionally. Making these events of even greater public note is the fact there has been a steady growth, at least until the last couple of years, of public involvement in the securities markets. At the present time, over 30 million people hold securities directly. Beyond that, as a consequence of interests in pension funds, investment companies and other forms of pooled investment, innumerable others have indirect interests in American industry and its integrity. It is probably no exaggeration to suggest that the number of those with direct and indirect interests in American corporations probably approaches the total of the adult population.

During this period there had been the erosion of confidence in the Accounting Principles Board as a principle setting body, an erosion that led to deep and hard soul searching by the profession and by industry, after which the Financial Accounting Standards Board was formed. The transitional period has been accompanied by problems, misgivings, questions, but happily it appears the transition has been made successfully. Accompanying this re-examination of means by which accounting principle standards are established has been a truly massive and masterful effort to identify better the objectives of financial reporting, expressed most notably in the so-called Trueblood Committee Report.

Added to this mix has been the vigilance of the financial press which has frequently found in financial debacles of substantial companies plenty of meat for sensational stories that command a great reader interest. And, of course, there should be mentioned the vigor of the plaintiffs' bar which has utilized, particularly in recent years, the class action suit as a means of enforcing financial redress on behalf of innumerable shareholders who individually would not have been able to pursue their claims.

Underlying all this have been some more basic movements which have affected not only the financial and accounting world but the nation and, indeed, the world. Every institution, every traditional practice has been called before the court of public opinion and compelled to justify itself in terms of today's needs. It is no longer enough to say that we should do it this way because it was done that way yesterday. In the course of this culture-wide re-examination it would be naive to suggest that the role of the accountant and the role of industry would remain unexamined. Already there have been significant questions

raised concerning the social responsibility of corporations. There is the compelling need of rejustification by every role player in society of his role and the manner in which it is played.

And, of course, there have been changes in the personnel. Candor demands that we recognize that the style of Sandy Burton, the relatively new Chief Accountant of the Commission, is different from that of Andy Barr, his predecessor. Andy Barr performed the job of Chief Accountant with unparalleled skill and success. But we all recognize Andy accomplished his objectives differently from the way in which Sandy wishes to achieve his. This has been a time when everyone has been adjusting to this difference in style, to the transition from the APB to the FASB, and to new people emerging as the leaders of the effort to establish accounting principles, notably Marshall Armstrong and his colleagues.

It seems to me that we are moving in the direction of resolving many of these problems that are posed by the changing environment, the scandals of the past, the emergence of new people on the scene. Speaking only about the Commission, it seems to me that we can probably now discern the directions in which the Commission is likely to go in the months and years ahead.

The Commission will, in general, by word and deed press for higher standards of financial disclosure and a greater adherence to the standards established. The Commission will press for greater participation by auditors in the entire financial disclosure process, for higher standards of performance in the performance of their function and for greater independence in relation to their clients.

How will these objectives and these "programs," if you will, translate themselves?

First, I think the results will be apparent in enforcement. The Commission, I believe, will continue to bring cases where it deems it appropriate. This does not mean that the Commission will try to substitute its judgment for that of the auditors or bring injunctive actions when the auditor has been guilty of nothing more than bad judgment. However, when it appears that the auditor's conduct has gone beyond that and he has either bent unduly to the pressures of his client, or disregarded his responsibilities of care and independence, or when his actions bear the signs of pervading unconcern with the investing public, then in my estimation the Commission has no choice, given its statutory responsibility, other than to name auditors. The suggestion has been made that perhaps the Commission should confine itself to actions against individual auditors rather than against firms. While there is an argument to be made for this approach, nonetheless, in many cases the faults identified by the Commission are the results of firm insufficiencies -- inadequate control, insufficient training, failure to enforce standards. Beyond that, of course, in effect the firm assumes collective responsibility by the manner in which audit reports are signed.

One thing of which I would like to reassure you and the accounting profession as a whole is that the Commission does not authorize actions, either administrative or injunctive, against auditors without the most painstaking analysis of the case and strong conviction that the facts under the law justify legal action. This does not mean that honest men may not differ with the judgment of the Commission, but actions against professionals are brought only when the failures seem clear.

With regard to criminal actions, all of us grieve when previously respected professionals become defendants in criminal actions. I for one would hope, simply as a matter of selfish avoidance of anguish, that we have no such problems involving professionals during the time I am on the Commission. However, when it appears that misconduct has risen to a criminal level, that the auditors have knowingly and wittingly, or so recklessly that it amounts to that, aided and abetted a fraud by their client, then the Commission has no choice but to refer the matter to the Justice Department for appropriate action.

Finally, the Commission will continue in its enforcement actions to seek, either through consent orders, or judicially shaped remedies, means whereby litigation will terminate in constructive improvement of auditors' performance. Examples of this approach are evident in the peer review procedures that were incorporated in the Laventhol and Touche settlements. Through these means there is an opportunity for accounting firms involved in litigation to have the benefits of outside assistance in identifying within their own organizations weak spots so that similar difficulties may be avoided in the future.

The Commission would expect to be actively involved in the formulation of accounting principles, although I would reiterate that it wants and expects the profession to take the leadership in this effort. We would expect to cooperate formally and informally with the FASB. Commission personnel are assigned to keep abreast of the work of the several task forces that have been organized and, in addition to that, our Chief Accountant, John C. Burton, is liaison with the Advisory Council. We frequently have occasion to discuss with members of the FASB pending matters and would expect to avail ourselves in

appropriate cases of the submission procedures that have been developed by the Board. We would hope most strongly that when pronouncements of the Board are finalized, we will be able consistently with our responsibilities to accept them and endorse them fully. This will be the consequence of a meaningful on-going relationship between the FASB and the Commission at every level of its activities.

It would be fatuous to deny that a few months ago tensions were rising between the Commission and the FASB. The Chief Accountant of the Commission had sought to define the respective responsibilities of the Commission and the Board in terms of measurement, the Board's responsibility, and disclosure, the Commission's responsibility. Such a delineation was rejected by the Board and unfortunately an issue, leasing, emerged with respect to which it was more difficult than in most cases to discern where the line lay. While I subscribe to the formulation of Dr. Burton, nonetheless I think it is fruitless for the Commission and the Board to engage in lengthy discussions with regard to the conceptual differentiations of responsibility. Rather, I have advocated, privately and publicly, that the best course for both the Board and the Commission to follow is to simply identify and solve problems. In specific cases if it appears that there is overlap between their activity and ours, I am sure that reasonable men can reconcile differences and find specific accommodations. I am encouraged to believe that this is happening and that in the future any tension between the Board and the Commission may indeed be what Marshall Armstrong described as "creative tension."

In an effort to make financial disclosure more meaningful, the Commission began several months ago to elaborate the notion of "differential

disclosure." This entails enhanced detailed disclosure in financial statements filed as a part of the Form 10-K which is available for public examination and copying, but which does not receive as wide circulation as the annual report to shareholders. The notion is that this increased detail would be appropriately summarized in the annual report and in other financial information circulated publicly. This notion has met with some opposition on the grounds that essentially financial statements are unitary and that differential disclosure results in the development of two basic sets of financials. Without going into a detailed discussion of this, I would suggest that these concerns are perhaps excessive and it does not seem to me that it is necessarily inconsistent with basic accounting concepts to further the notion of financial disclosure tailored to different audiences. In a sense, this is the reverse of another trend which has been apparent, the incorporation in the annual report of more information which heretofore appeared only in the Form 10-K. I would not regard these trends as inconsistent. Rather, I would regard them both as a sorting out of information to provide to the various audiences for financial information the readiest means of securing and comprehending that which they are capable of using in making investment decisions. Complexity and the inability of the average investor to deal with amplified information should not be an excuse for denying it to those who can appropriately deal with it; on the other hand, the need for professional and sophisticated investors for more detail should not be used as an excuse for confusing the average investor with an abundance he cannot cope with. The Commission will continue this effort to tailor information to the user.

The Commission is deeply concerned with the problems posed by inflation, with the enhanced realization that such inflation renders even more questionable traditional financial statements prepared on an historical cost basis as means of conveying economic reality. In Accounting Series Release No. 151, the Commission exhorted issuers to disclose in their financial statements, or in footnotes, or otherwise, the impact of inflation on inventories and profits. At the present time the Commission is considering a proposal by one issuer to incorporate in its annual report financial statements prepared, in part at least, on the basis of current value. I think I can say with confidence that the Commission received this approach enthusiastically and has directed the staff to work with the issuer to resolve some of the problems which were apparent. I am confident that in the near future the fruits of this effort will be available for public examination. Interestingly enough in this instance the company's auditor, one of the "Big Eight," was willing to associate itself with the financial statements prepared on the basis of current value to a limited extent, notwithstanding all the discussion there has been with regard to the dangers of expanded liability for auditors.

The Commission is continuing to pursue the goal of rules with respect to optional forecasting. Despite the fact that recent experience with oil shortages and increased energy prices has upended many forecasts previously, and confidently, made, nonetheless we still think that there is the need for permitting selected companies -- those with earnings histories and budgetary experience -- to include such information in filings with the Commission.

Finally, the Commission will continue to be concerned with the independence of auditors. A significant step for ensuring this independence was accomplished when Form 8-K was revised to provide for the disclosure of

information concerning changes of auditors and whether during the 18 months preceding the new auditor's engagement there were any disagreements with the former accountants on any matter of accounting principles or practices, financial statement disclosure, or auditing procedure, which disagreements, if not resolved to the satisfaction of the former accountant, would have caused him to make reference in connection with his opinion to the subject matter of the disagreement. The Commission has received information which leads it to believe that in many instances the requirements of this rule are being circumvented, among other ways by postponing dismissal of auditors until 18 months have elapsed since the disagreement concerning accounting principles. I would hope that in time the Commission may strengthen this disclosure requirement and eliminate the opportunities for evasion. In addition, I think there is much to be said for the incorporation of such disclosure in the annual proxy statement. I think shareholders are entitled to know the circumstances under which auditors are dismissed, and I think it may be that they should also have the opportunity to know the auditor's side of any controversy. I doubt whether the Commission has the power to require a shareholder vote on any such change, but I think appropriately disseminated information concerning such changes may do much to augment the independence of auditors.

Looking beyond these matters, there are strong pressures upon auditors to expand their involvement in the total financial reporting process. It has been suggested that they assume responsibility for the integrity of all financial information in annual reports and that, in addition, they have responsibility for press releases including financial information. Similarly, it is suggested that they be more intimately involved with interim statements.

This proposal has particular importance, it seems to me. Increasingly the market appears to be a short term market; a single bad quarter can often have excessive impact upon the price of an issue of securities; hence, there is great temptation on the part of management to use various devices to smooth out earnings. Only if the independent auditor is involved in the interim reporting process can this temptation be thwarted. Furthermore, there is increased discussion of the proposal that the choice of accounting principles, when more than one is available, should be the province of the auditor and not of management. Closely related to this, of course, is the idea that there is a responsibility on the part of auditors to determine the overall fairness of the financial presentation, not merely whether it has been made in accordance with generally accepted accounting principles. And there is some discussion of the idea that auditors should be elected for terms, with any dismissals subject to arbitration by perhaps the American Institute of Certified Public Accountants.

The inevitable concomitant of these discussions, of course, is concern with liability. Certainly no one can be sanguine in the face of the multiplication of litigation against auditors. In many cases the claims are so huge that if they were ultimately recognized in any significant part, they would ruin firms of national standing. I don't think anyone would wish to see a national firm wiped out because of a single bad audit or even because of willful misconduct by one or two professionals.

However, we must recognize that civil liability serves a purpose. It is one of the means by which society enforces the wishes expressed in its laws concerning the conduct of people, including professionals. It is

unquestionably a most effective means of social control. I doubt if anyone would assert that the standards of the accounting profession and the profession's adherence to them are unchanged in the face of the prevalence of civil liability. But even effective means of social control can be abused and have results beyond those that are socially desirable.

One facet of this problem, of course, has been the huge increase in the number of class actions, largely as a consequence of the liberalization in 1967 of the Federal Rules of Civil Procedure which made it far easier than it had been to maintain such actions. There have appeared recently signs that these actions may have reached a high point and that the trend is receding. At the present time the United States Supreme Court is considering the Eisen case. If it affirms the restrictive decision of the Second Circuit, the incidence of class actions will be significantly reduced.

Beyond that, it seems to me that if the accounting profession evidences a willingness to consider seriously the expansion of its responsibility for the financial reporting of its clients; then it may be well for all of us, including the Commission, to seriously entertain the possibility of legislation limiting the liability of auditors. Perhaps a model for this is contained in the present draft of the American Law Institute sponsored Federal Securities Code. In that, it is provided that as to any particular filing (or with respect to the same representation in more than one filing), unless the misrepresentation was made with knowledge, the liability of an auditor is limited to the greater of \$100,000 per defendant or 1%, with a maximum of \$1 million, of the defendant's gross income in the last fiscal year. Judging by the income statement of the only major auditing firm which has made public financial information concerning itself, the million dollars would constitute

a very small portion of a year's income for some firms, but the amount should be sufficient to be an effective deterrent. Furthermore, unquestionably such a limitation would probably have a strong effect upon insurance premiums which in the past have only gone in one direction.

I am hopeful that the future may have in store a period of very fruitful collaboration between the accounting profession and the Commission. I think the Financial Accounting Standards Board and the Commission are gradually developing a highly beneficial and constructive relationship. Furthermore, it seems to me that the American Institute is moving in the direction of greater responsibility. We have recently reached with them a tentative and, I must confess, subject to re-examination, agreement with regard to the powers of the Commission concerning accounting matters to be included in the Federal Securities Code. Further evidence of the constructive attitude of the Institute has been the cooperation with the Commission in developing a peer review procedure for utilization in the future. This initiative by the Institute, in my estimation, is most commendable and noteworthy.

The task that confronts all of us is to restore integrity in, and the confidence of the public in the integrity of, American corporate life. At the present time, I fear that as a consequence of the debacles of the near past this confidence has been seriously undermined. There are those who would say that Commission enforcement actions simply accentuate this tendency and that, therefore, the Commission would be well advised to lay back. I disagree most profoundly with this viewpoint. Rather, it seems to me that in even more determined effort to confound wrongdoers, to raise standards, and to enforce compliance with those standards lies one of the quickest and surest ways of restoring confidence in American business.

The role of the auditor in this restoration of confidence is absolutely essential. Earnings are the measure of management's performance, and management would be less than human in many circumstances if it did not utilize all of the legal tools available to it to maximize its performance as measured on that scale. It is the job of the auditor to restrain this very human tendency, to put holds on the optimism of management and see to it that the portrayal that American industry makes to the investing public of its performance is an accurate one, fully reflective of economic reality and not financial trickery.

Notwithstanding the rather dramatic departures from proper standards that have been identified in the recent past, I think it is fair to say that the accounting profession has increasingly performed its role with integrity, independence and, in many cases, heroism. With the disclosures in the Form 8-K now available, we realize that in many instances accountants have stood steady on their ground even at the cost of losing a client.

It seems to me that the members of the American Accounting Association peculiarly are in a position to contribute to the restoration of integrity to the accounting and financial reporting process. You have the opportunity to shape not only the technical competence, but the sense of responsibility of incoming generations of accountants. In my discussions with members of this Association, not only at this meeting but on other occasions as well, I know that that responsibility and that opportunity are well recognized. Good luck to you!