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THE ACCOUNTING PROFESSION: RESPONSES TO AN ENVIRONMENT OF CHANGE

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on Current SEC Developments
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It is a pleasure to again address the AICPA National Conference on Current SEC Developments. When I appeared before this Conference a year ago, it was clear that the accounting profession stood on the threshhold of important changes.

-- The Metcalf Committee Report, the sequel to a widely-discussed and rather critical Congressional staff report, had just recently been issued.

-- Congressman John Moss had indicated his intent to hold further hearings on the accounting profession's role and had hinted that legislation to regulate accountants might be forthcoming.

-- In response to these challenges, the Institute had conceived and begun to implement its Division of CPA Firms as a framework for professional self-regulation.

-- Several weeks before your 1978 Conference, Congress had enacted the Foreign Corrupt Practices Act, the accounting provisions of which seemed to foreshadow a new role for both government and accountants in corporate recordkeeping.

-- Finally, in order to evaluate developments in this area, the Commission had undertaken to submit an annual report to Congress, the first by July 1, 1978, analyzing the progress of accountants' responses to the many challenges which they face.

Quite clearly, 1978 more than fulfilled its promise as a year of important change in the accounting profession. During the past 12 months, the SEC Practice Section has become operational, and 11 peer reviews -- perhaps the

heart of the self-regulatory program -- have been or are in the process of being completed. The full initial membership of the Public Oversight Board, which I have repeatedly characterized as the key to the Section's success, has been appointed, and the five distinguished and able Board members have begun to tackle some of the crucial issues on which the profession requires their guidance -- most notably the appropriate scope of nonaudit services provided public clients. During 1978, Congress' interest in the work of accountants continued, and legislation was introduced to subject the profession to much greater federal regulation. The Commission itself also took several significant actions impacting on accountants, including new disclosure requirements bearing on management advisory services and rules concerning oil and gas accounting principles. Further, as we had committed to do, the Commission submitted its first Annual Report on the accounting profession to Congress in July. As most of you know, that Report concluded, among other things, that the profession's progress in conceiving and implementing a viable plan had been sufficient to support an interim opinion that self-regulation was attainable, although much remained to be accomplished.

While 1978 was perhaps particularly a year of flux, I do not believe we have any reason to expect that it was unique or that the years to come will be significantly less eventful or change-laden. Stan Scott, as you know, put it this way in his remarks upon stepping down as Chairman of the Institute:

> We're very much at the point that the Allies were in November of 1942 when Winston Churchill looked at the War situation and said, "Now this is not the end. It is not even the beginning of the end. But, it is, perhaps the end of the beginning."

You must expect that 1979 -- and the years that follow -- will be years of challenge and change. A major part of the stress that the profession is under stems from its failure in the past to recognize this reality timely and fully. The challenges and changes will -- as they already do -- embrace the full spectrum of the profession's activities. Stan was talking specifically about the Institute's efforts at self-regulation, and, in that context, his "end of the beginning" characterization is an apt one. In the larger context, however, of the challenges, expectations, and changes which the profession must face, there is no "end" to look forward to.

I say this not to raise anxieties or dispair, but to urge upon the profession a different perspective, attitude, and responsiveness. Indeed, the advantage -- the essence

-- of a private, independent accounting profession should be its dynamism and ability to respond to change. If accountants as a group lack that attribute, then they lack the ability to muster the most telling argument which can be made against those who would place their profession under the control of government -- an institution itself which is characteristically less able to be as responsive or as innovative as the private sector.

For that reason, I want to share with you today some thoughts concerning the opportunities for accountants to demonstrate the positive and creative problem-solving abilities which, I believe, should be the profession's strength. It is, of course, easy to urge flexibility and receptiveness to change in the abstract. I would, however, like to make that notion concrete by relating it to some of the specific challenges confronting accountants and the profession today.

The Dislosure Process and the Needs of Its Users

In large measure, the accounting profession exists to bring reliability and uniformity to the communication of economic information from business entities to shareholders, lenders, customers, suppliers, government, and most other users of financial information. As is more clearly understood

today than at any time in the past, the utility of financial disclosure is no better than the accounting methods and principles on which it is based. Unfortunately, however, the job of insuring that accounting principles are in harmony with the economic environment and with the needs of information users is one which, by its nature, demands constant effort. Accountants, it seems to me, should be the leaders in the process of thinking, experimenting, analyzing, and evaluating which that effort entails.

The FASB has, of course, made important strides in addressing some of the fundamental issues inherent in the standard-setting process. Indeed, the FASB's conceptual framework project has the capacity to provide a flexible structure within which accounting issues can be related to the broad objectives of financial reporting. The Board's recent statement, "Objectives of Financial Reporting by Business Enterprises," for example, does not limit the scope of financial reporting objectives to financial statements, but rather -- and wisely, in my view -- sets forth those objectives in terms of financial reporting in general. In addition, its focus on <u>users</u> of financial reporting and their interest in evaluating <u>future</u> performance, including earnings, is a significant and worthwhile step. I am optimistic that a consequence

of that focus will be more thought, experimentation, and timely action in recognizing and addressing the inadequacies in financial information.

In the past, however, the profession has sometimes accepted only part of its responsibility to input in the standard-setting process. Take, for example, the events which preceded the Commission's decision last August to undertake the development of a new accounting method -- reserve recognition accounting -- for oil and gas producers. The accounting profession had recognized for years the inadequacies of the two historical cost based accounting methods -- full cost and successful efforts -- prevalent in the oil and gas industry. Leaders of the profession -- in auditing firms, reporting companies and the academy -- had peppered the literature with criticisms of existing methods and proposals for experimentation and change. Users had long ago made the inadequacies of existing approaches abundantly clear.

Nonetheless, it was left to the Commission, implementing a Congressional directive, to come to grips with oil and gas accounting. Ironically, the Commission has been criticized for proposing reserve recognition accounting,

the implication being that the Commission is interested in expanding its role at the expense of the private sector. In fact, however, I think it is fair to state that the Commission would very much have preferred that the accounting profession take the lead. At a minimum, a well developed body of thinking and experimentation with alternative oil and gas accounting methods would have made the FASB's and the Commission's jobs much easier.

Disclosure of the impact of changing price levels is another example of an opportunity which the profession ignored for too long. The need to deal with the problems inherent in the interplay between chronic inflation and historical cost-based accounting have been treated in the professional literature for some time. And yet, here too, the Commission provided the impetus reflected in ASR 190, which introduced a limited requirement for disclosure of the replacement cost of certain assets. I am no more prepared to defend ASR 190 as the ultimate answer today than I was when I came to the Commission. While some, including the Financial Executives Institute in a recent study, have questioned

the significance and effects of replacement cost data, others increasingly indicate the value of information derived from replacement cost disclosure and its usefulness in addressing areas which historical cost data cannot illuminate. The FEI's study did find that, while corporate and financial executives were critical of the need to disclose replacement cost information, they viewed the impact of changing prices on financial statements as an important issue which required experimentation. Nevertheless, the study also found that the Commission's characterization of replacement cost disclosure as "experimental" caused management to be particularly critical of the cost burden of compliance. Short of the Commission requirement, however, the experimentation was virtually non existent.

Personally, I am fully committed to insuring that users receive adequate financial information about the impact of changing prices on corporate earnings and assets. I continue to urge that the profession's best efforts be addressed to that end. The Commission is prepared to consider the continued usefulness of ASR 190 in the context of future developments. Whether those future developments will arise from the the Commission's efforts or from innovative private sector initiatives, such as the FASB's exposure draft on the subject, depends on the response of the profession.

These observations about oil and gas accounting and disclosure of the impact of inflation may sound harsh and are, of course, only one side of the coin. The need for greater sensitivity to the need for innovation and change in financial reporting is not a criticism of the FASB, but rather a disappointment at the lack of involvement of others. The lack of constructive efforts on the part of the profession to address the financial information needs in oil and gas and inflation is a criticism of the entire profession -- independent auditors, management accountants, academics, and others. Further, I am extremely disappointed at the paucity of user input and involvement with the profession. It is not only that users have not involved themselves, but also that their systematic involvement has not been adequately called for or insisted upon. The responsibility is one which all elements of the profession must share.

I would urge therefore that all segments of the community invest more of their time and effort in what might be characterized as accounting research and development. Accounting firms, reporting companies, academics, and users must engage in the development of better means of communicating financial information. The fundamental problems we face demand imaginative

and progressive solutions. That, I believe, is the message in the Commission's decision on oil and gas.

The issues of oil and gas accounting methods and the appropriate response to inflation are areas where, to a degree, accountants have, by default, invited the Commission to assume a leadership role more properly the profession's. Nevertheless, there remains plenty of opportunity in both oil and gas and accounting for inflation for the private sector to shape and determine the end result.

Foreign Corrupt Practices Act

Another area where accountants can make an important contribution is the complex and thorny problem of compliance with the accounting provisions of the Foreign Corrupt Practices Act.

As most of you are undoubtedly aware, Section 102 of that Act requires every public issuer of securities to make and keep accurate books and records and to establish and maintain a system of internal accounting control which provides reasonable assurance that four specified objectives are met -- objectives which were taken from Section 320.28 of *Statement on Auditing Standard No. 1*. While the Foreign Corrupt Practices

Act adds an additional dimension to the consideration of internal controls, the establishment and maintenance of sound control systems have always been important responsibilities of management. At a minimum, the Act reaffirms that an adequate system of internal accounting control is a necessary component of both management's ability to provide shareholders and investors with reliable financial information on a timely basis and of management's broader duty of accountability for the manner in which assets are utilized.

The work of the AICPA's Special Advisory Committee on Internal Accounting Control -- the Minahan Committee -- helps put internal accounting controls into perspective. In that Report, the Committee noted that

> [T]he internal accounting control environment established by management has a significant impact on the selection and effectiveness of a company's accounting control procedures and techniques . . . [I]t is important to recognize that a poor internal accounting control environment would make some control procedures inoperative for all intents and purposes because, for example, individuals would hesitate to challenge a management override of a specific control procedure.

This statement is particularly important because it highlights a point that I believe has been overlooked in the furor over the Foreign Corrupt Practices Act -- that is, the importance of the "control environment." In my view,

it is only possible realistically to assess the effectiveness of internal accounting controls when they are examined in the context of the environment in which they operate. I have no doubt, for example, that many, and perhaps most, of the companies involved in sensitive payments problems had well designed systems of internal accounting control. However, the people who administered the system either ignored or intentionally circumvented the controls, with results which became front-page news and spawned the Congressional concern which in turn produced the Act. And, similarly, Congress, in my judgment, did not intend the new legislation to impose simply a requirement that a theoretically sound internal control system be in place. On the contrary, the Act, I believe, will be read to require that management also foster an _environment_ which is conducive to the effective functioning of controls. In particular circumstances, that may require codes of conduct for corporate employees, enhanced internal audit mechanisms, changes in the way the company responds to the recommendations of independent auditors, and possibly other approaches outside the vocabulary of those who are used to thinking of controls narrowly and in isolation from the environment in which they operate.

The Commission's staff is, as I have stated publicly before, working on rule proposals to require managements to report on their systems of internal accounting controls. A possible corollary to that type of reporting may well be a requirement that independent public accountants evaluate and report on management's representations or possibly on the controls themselves. The Commission will, of course, give careful thought to these recommendations when they reach us, and if we decide to propose rules, the accounting profession's input in this area is obviously extremely important.

The concept of a management opinion on internal controls raises, however, a host of difficult questions. Auditors, of course, are skilled in assessing controls from the standpoint of determining whether and to what extent they may be relied upon in conducting the audit. The result of that assessment is a judgment concerning the scope of the audit and the selection of audit techniques. While management's evaluation of controls for purposes of the Foreign Corrupt Practices Act may require it to draw heavily on the skills and knowledge auditors have thus developed, it goes well beyond traditional concerns -- roughly stated, the objective of the evaluation is to determine whether the control and recordkeeping system affords a reasonable

measure of management accountability for the disposition of corporate assets. And, as I mentioned a moment ago, that issue cannot be divorced from the environment in which the system operates.

Independent auditors cannot, of course, be expected to make legal judgments concerning compliance with the Act. They must, however, be sensitive to the need for changes in the control environment and specific controls. If the Commission proposes rules which would require auditors' involvement in reporting on internal controls, we will need the best thinking the profession can muster concerning the potential scope of its review. Similarly, just as the Commission has traditionally relied on the accounting profession to develop comprehensive auditing standards, we will expect accountants to take the lead in formulating techniques and procedures for forming a conclusion on management's representations concerning its system of internal accounting control.

Before leaving the Foreign Corrupt Practices Act, I want to raise one final implication which I find in the Minahan Committee Report's suggestion that the effective functioning of a system of internal controls depends heavily on the corporate environment in which controls operate. In a previous talk, I indicated that one factor to be considered by companies seeking assurance

that they are in compliance with the Act, and high standards of corporate accountability in general, is the effective use of their internal auditors. I indicated in that talk that careful consideration should be given to the appropriate executive to oversee the work of the internal audit staff and that the internal audit staff generally should not report to either the chief financial officer or the chief accounting officer.

These comments have provoked considerable controversy. My point, however, was not to suggest that I view the Foreign Corrupt Practices Act as prescriptive about the internal lines of authority issuers must establish. This determination in any given situation depends on the specific organization structure, specific duties of the individuals, and alternative reporting possibilities. The weight to be given to the internal audit activity must be judged factually, based on the competence and adequacy of the staff and the reporting relationships. Statement on Auditing Standards No. 9 states the principle very well:

> When considering the objectivity of internal auditors, the independent auditor should consider the organizational level to which internal auditors report the results of their work and the organizational level to which they report administratively. This frequently is an indication of the extent

> of their ability to act independently of the individual responsible for the functions being audited.

I would urge that accountants explore with their clients the ramifications of this statement in terms of the client's particular program to insure compliance with the Foreign Corrupt Practices Act and the importance of the independence of the internal audit staff to an effective system of internal controls.

Audit Committees

Another important control environment factor for companies to consider in seeking assurance that they are in compliance with the Act is the existence of an audit committee. Last year at this time, in the context of the evolving program of self-regulation, I requested that the Institute either establish an auditing standard requiring accountants to insure that their public clients maintained independent audit committees or analyze for the Commission the reasons why this was not feasible. As I am sure you are aware, the Commission has long been on record in support of audit committees comprised of directors who are unaffiliated with corporate management. Indeed, the Commission has been endorsing the audit committee concept since at least 1940, and the desirability of audit committees has been formally recognized by many groups, including the

New York Stock Exhange and the American Bar Association in their Guide for Corporate Directors.

The Institute, on the recommendation of the special committee which it chartered to analyze this question, has recently declined to establish an audit committee requirement and has set forth its reasons. In so doing, the Institute reiterated its support for the audit committee concept, and the committee's report indicates how widespread audit committees have become. The report cites several surveys which indicate that, not only had a majority of NYSE corporations formed audit committees prior to the NYSE requirement, but also that 68 percent of NASDAQ companies have audit committees of some type.

The Commission staff presently is studying the AICPA committee report, and as I have said many times before, the matter is one of serious concern to the Commission.

I am cognizant of the difficult issues which audit committees may raise with respect to smaller companies. I am also aware of the related concern expressed by some about the impact of audit committees on the retention of registrant clients by smaller and medium-sized accounting firms. Many smaller accounting firms are complaining that

newly-appointed audit committees feel under some pressure to appoint a Big 8 firm as independent auditors. While audit committees may have legitimate reasons for switching to Big 8 accounting firms, I am concerned that too often their emphasis is solely on size or the desire for a "name" accounting firm. There are many smaller auditing firms which have excellent, well-deserved reputations and are fully capable of providing quality audits to most American corporations. Moreover, the existence of the SEC Practice Section of the AICPA Division of CPA Firms, with its mandatory peer reviews and other requirements, should provide a basic level of assurance that the members of the Section -- be they large or small -- conduct their practice at a satisfactory level of quality. The Board of directors of the AICPA has adopted a policy statement on this issue which was recently reaffirmed in the Institute's committee's report.

> In carrying out this function [to evaluate select, and appoint the independent auditor] . . . audit committees should . . . recognize that all CPA firms whose partners are members of the AICPA are subject to the same stringent rules of conduct with respect to maintaining their independence and must comply with quality control requirements described in Statement on Auditing Standards No. 4. . . . Thus, the capability of auditing publicly-held companies is shared by a large number of CPA firms and size alone should not be the determinative factor

in selecting and appointing independent auditors.

I would urge that audit committees include this statement in their deliberations concerning auditor selection. The decision to engage a particular firm must, of course, depend on a wide range of factors both tangible -- such as the cost of its services and any special expertise of its members -- and intangible -- such as the trust and confidence which the firm inspires in management and the directors. In my view, however, the audit committee which limits its consideration to the largest firms should weigh very seriously the role it may be playing in creating a public accounting profession comprised solely of fewer than twenty firms. If we are to maintain a profession which includes firms of all sizes -- and there are many who believe as I do, that this is extremely important -- it is vital that audit committees carefully consider all factors -- that bigger is not synonymous with better.

The mere existence of an audit committee, however, does not end the inquiry. From the profession's standpoint,

whether or not it mandates audit committees, it is clear that it benefits significantly from effectively functioning, responsible audit committees, and, conversely, will pay the price, along with the corporate community, for audit committees that exist primarily in name only. The independent auditor can play a key role in helping audit committees be effective, while, at the same time, serving his or her personal interest. Indeed, it is in the auditor's vital interest that the audit committee be functioning effectively, with full understanding of its responsibilities, if and when the auditor needs it. Otherwise, independent auditors cannot expect to derive much comfort or protection from the committee.

Management Advisory Services

Just as the implementation of the Foreign Corrupt Practices Act presents an opportunity for auditors to demonstrate their commitment to pre-empting government control, another important question facing the profession which currently is undergoing careful reexamination and study is the practice of many accounting firms of providing certain types of nonaudit services to their publicly held audit clients. This issue has been before the profession since at least the 1960s and is presently

being studied by the Public Oversight Board. The Commission has postponed consideration of the appropriate scope of services until after the POB completes its deliberations.

While the prohibition of some nonaudit services raises complex factual issues, the question of whether management services should be <u>disclosed</u> is far less difficult. As the Cohen Commission stated:

> [T]he concern of users that provision of other services impairs the auditor's independence decreases as their knowledge about the service increases. The best way to dispel concerns of any potential conflicts of interest is to disclose the facts.

Accordingly, the Cohen Commission recommended "that all companies disclose in their management report information on the nature of other services provided to them by their their independent auditor * * *" and went on to suggest that if management fails to make this disclosure, the Cohen Commission would call upon the auditor to make appropriate disclosure in his own report.

The Commission concluded that the scope of services provided by a public company's independent accountant is important information for investors to evaluate in order to better understand a registrant's relationship with its independent accountants. We therefore adopted, in Accounting Series Release No. 250, a requirement calling

for disclosure of such services and of whether the board of directors or its audit committee has approved each such service.

Some have criticized the Commission's disclosure requirement because, they assert, it has resulted in some companies determining not to utilize management advisory services. In addition, the rule has been criticized for failing to offer any guidance to the audit committee or board concerning the factors they are to consider -- other than independence -- in determining whether to engage their auditors to perform nonaudit services. The Commission's disclosure requirement was not intended to prejudice or preclude such services where a company's board or audit committee concludes that the services are appropriate in the context of independence; similarly, our rule does not indicate that the Commission has in any way prejudged the more complex question of what, if any, services might warrant prohibition. Whether or not we are compelled to give guidance on that point depends -- like many of the other points I have treated today -- on whether the profession itself is able to take meaningful action.

The fundamental issue with respect to management advisory services, as I see it, is whether the provision of nonaudit services impairs, in fact or in appearance, the independence of auditors. I believe that the disclosure

requirement that we have adopted in this area will help to promote the objective of strengthening public confidence by providing investors with factual information about other relationships between independent accountants and their clients and give reassurance that the audit committee has considered the implications of such relationships. I trust that the new disclosure requirements alone will not lead issuers to terminate indiscriminately management services arrangements, and we want to know if it does. It is important to acknowledge that there often are benefits to registrants in having their accounting firms provide certain nonaudit services. If the new requirement does result in managerial decisions not to utilize its auditing firm for certain services, we all should consider seriously the implications of these decisions -- not only economically, but in relation to the underlying issues and concerns raised about "scope of service." Any relationship which cannot stand the light of investor scrutiny or which reporting companies choose to avoid rather than disclose may well reflect circumstances or implications which we all ought to examine.

SEC Practice Section

Turning to an area where the profession has made dramatic strides toward effective self-regulation,

I would like to spend a few minutes discussing the SEC Practice Section. The establishment of this Section demonstrates that the profession is clearly capable of fashioning a meaningful alternative to government regulation in order to maintain private sector control. In establishing the Section, the profession had no model to build on or to copy; it has, nevertheless, created a nucleus which has the potential to become a comprehensive self-regulatory structure. There are, however, several important issues affecting the efficacy and credibility of the self-regulatory efforts of the Section which remain. I am, for example, concerned that a significant number of smaller firms which audit public clients have apparently not yet joined the SEC Practice Section. While they collectively audit a small percentage of public companies, no matter how well the program is organized it cannot succeed if a significant segment of the profession is unwilling to submit to and abide by its requirements. I am most anxious to hear from such firms and understand their reluctance. It may be vital to the success of the program.

The credibility and value of the peer review process is another open issue, although important progress has been made. The Commission had expressed some concern about

firm-on-firm reviews and the need for assurance as to the objectivity of these reviews. The decision to use a Quality Control Review Panel in cases where firm-on-firm reviews are elected should improve the credibility of firm-on-firm review, since the Quality Control Review Panel will be ultimately responsible for the review and will issue its own report without merely expressing reliance on a report of the firm engaged to perform the review. Similarly, the decision to make public not only the reviewers' overall evaluation of the reviewed firm's system of quality control, but also the reviewers' recommendations for improvements in the reviewed firm's system, and the reviewed firm's responses to those recommendations, should provide significantly more credibility to the process.

There are other questions concerning peer review with which the profession must deal. These include the role of the Commission in the peer review process, particularly the ability of the Commission's staff to appropriately evaluate the adequacy of the program; the ability of reviewed firms to unilaterally exclude certain engagements, such as those which are the subject of litigation, from the scope of the review; and the exclusion of

work performed outside the United States. The manner in which the profession addresses these issues is particularly important for the future of its self-regulatory efforts. The Commission will be issuing its next report to Congress in July, and substantial progress must be made before that time.

As I have said many times before, I have no desire to see the transfer of regulation of the accounting profession or the setting of accounting standards from the private sector to the public sector. It is, however, a familiar law in both physics and government that vacuums are abhorent -- to the extent that the profession fails to come to grips with the difficult issues confronting it, the Commission or some other government body will almost surely fill the void.

I have outlined today the reasons why, in my view, 1979 -- like its predecessor -- will be a year of change. In particular, the profession's self-regulatory efforts will succeed only to the extent that the profession is able to identify and address adequately and timely the changing needs of those who rely upon accountants' independent assurances of corporate accountability. If the profession is, however, content to patch holes for

the purpose of addressing the concerns of Congress, the Commission and others, rather than assuming the initiative, it is, in the long run, destined to suffer increased governmental regulation and legislation. he responsibility for choosing which course to follow is yours, and I look forward to your success.

Thank you.