

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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THE REGULATORY FRAMEWORK FOR PUBLIC ACCOUNTING

ADDRESS BY

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Recently I saw a cartoon which provides a setting for my remarks today. In the cartoon a person, who might have been an accountant, a company official or perhaps a member of the Financial Accounting Standards Board, is telling his psychiatrist that, "The SEC refused to accept our generally accepted accounting principles." No doubt the intent of the cartoonist was to illustrate the concern of some within the accounting profession or the business community that a federal government agency is wielding a heavy hand over the accounting profession and dictating acceptable accounting principles. In fact, however, the statement that the SEC refused to accept our generally accepted accounting principles, embodies the essence of a concept and a complex relationship between a profession and a government agency which has been effective over the last four decades, and yet is directly in the mainstream of today's national mood for limited government controls over private business institutions. I would like to discuss that relationship, the regulatory framework which presently exists for the accounting profession, and some of the problems facing the profession and the Commission.

The unique relationship between accountants and the Securities and Exchange Commission began forty-five years ago with the creation of the Commission to administer newly

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enacted securities laws, which were to provide for full and fair disclosure of the character of securities, and to prevent fraudulent, inequitable and unfair practices in securities transactions. The pattern of joint involvement and responsibility originated in the Securities Act of 1933 which required that prospectuses for the raising of capital from public investors include balance sheets and profit and loss statements "certified by an independent public or certified accountant" and presented "in such detail and such form as the Commission shall prescribe." The Securities Exchange Act of 1934 granted the Commission similar prescriptive authority with respect to financial statements required under that Act.

One of the first major policy decisions considered by the Commission was whether it would be in the public interest for the Commission to establish uniform accounting standards. In April of 1938, by a slim margin of three to two, the Commission announced its policy decision to encourage the observance of generally accepted accounting principles by presuming financial statements to be misleading, despite disclosure, if they were prepared in accordance with accounting principles for which there was no substantial authoritative support. If there was a difference between the registrant and the Commission regarding the proper accounting treatment, the Commission would accept disclosure

instead of requiring a change only when there was substantial authoritative support for the accounting principle and the Commission had not expressed a contrary view in an official release.

This Commission policy is the foundation on which a private standards-setting body, beginning in 1939 with the Commission on Accounting Procedures and progressing to the present Financial Accounting Standards Board ("FASB"), has generally been given the opportunity to establish accounting standards.

While the Commission looks to the FASB for the initiative in establishing and improving accounting standards with the expectation that standards promulgated by the Board will promote the interest of investors, we have not and cannot delegate our responsibility to assure that adequate financial information is provided to investors. The Commission participates in the process by which financial disclosure requirements are established in basically three ways. First, we establish disclosure requirements, including the form and content of financial statements to be filed with the Commission. Second, we monitor the agenda and work of the FASB and our staff comments as appropriate in response to discussion memoranda and exposure drafts of proposed statements of accounting standards. Third, although we prefer to defer to the established private sector standards-setting body whenever

possible, and do so in almost all instances, we can require the use of accounting principles other than those presumed to have substantial authoritative support in order to prevent misleading or inadequate financial statements.

For example, responding to the mandate of the Energy Policy and Conservation Act of 1975, the Commission found it appropriate to use its authority to supercede an accounting standard adopted by the FASB with respect to accounting for oil and gas reserves. Also, our replacement cost rule is an example of Commission action to deal with an accounting problem which we believed the private sector was not addressing sufficiently.

It is only natural that these actions would receive far greater attention than the overwhelming majority of instances in which the Commission and the FASB are in accord. And there has been some concern that such actions may indicate a change in Commission support for leadership by the private sector in the setting of accounting standards. I can assure you that this is not the case. But it is important to realize that a willingness by the Commission to disagree with the Board when our responsibilities require such a response is necessary to make this unique regulatory relationship between the government and the private sector viable.

Of course, the Commission must also be sensitive to the Board's responsibilities and take care not to interfere

unnecessarily with its efforts or the Board's effectiveness could be undermined. An illustration of the way in which the Commission is usually able to fulfill its functions without preempting the Board is provided by an action we took this summer amending Regulation S-X to require changes in the financial statement presentation of redeemable preferred stock.

Beginning in early 1975, the Commission's staff noted an increasing use of redeemable preferred stock in corporate finance. Many of these stock issues include terms which require the issuer to redeem the stock at a fixed or determinable price or on a fixed or determinable day. Some provisions require the issuer to redeem the stock at the option of the holder or at the time certain prescribed conditions are met which are not necessarily within the issuer's control. As a result of these special provisions, redeemable preferred issues differ from conventional equity capital and have some debt characteristics. The Commission determined that this category of securities should be distinguished from permanent capital and, accordingly, adopted amendments which are intended to highlight the future cash obligations attached to redeemable preferred stock through appropriate balance sheet presentation and footnote disclosures.

Recognizing that the FASB's conceptual framework project will address the issue of whether such securities

are appropriately classified as equity or debt, in our adopting release we said, "The Commission is cognizant of the conceptual problems in determining the appropriate accounting for and reporting of redeemable preferred stock and believes that these matters can best be addressed by the Financial Accounting Standards Board." We did, however, deem our action necessary as an interim solution to this financial reporting problem. Similarly, members of the Commission, including myself, have indicated a willingness to withdraw our replacement cost disclosure rule when the FASB's recently issued Statement No. 33, "Financial Reporting and Changing Prices," is fully effective.

Despite criticism by some that the SEC is interfering improperly in accounting standard setting and by others that we are relying too heavily on the private sector, in my opinion the relationship between the FASB and the SEC is regulation at its best because it makes maximum use of private sector expertise and financial support while retaining sufficient government participation to guard against conflicts of interest and protect the public.

Now, I would like to turn to the requirement in the securities laws that financial statements be "certified by an independent public or certified accountant." Opinions differ as to what Congress intended by this language. Having served on the staff of the Senate Banking Committee for 8 1/2

years and having been involved in hearings and mark-up sessions on many legislative proposals, I am well aware that seldom, if ever, is the intent of members of Congress or Congressional Committees as clearly stated either in colloquy or in reports as one would like. Nevertheless, having reviewed the Senate hearings and the reports of the Senate, House, and Conference Committees, it is clear to me that the provisions requiring audits by independent accountants were the result of an attempt to formulate the most effective and efficient way to protect the public from improper representations in financial statements.

The original draft of the bill that later became the Securities Act of 1933 did not require that financial statements filed with the Commission be certified by an independent accountant, but relied on the power granted to the Commission to investigate the affairs of the issuer. Colonel A. H. Carter, a representative of the accounting profession, stated in hearings before the Senate Banking Committee that the bill as drafted,

. . . imposes upon the Commission the responsibility of detecting the unscrupulous issuers who may attempt to veil the true picture of their enterprise. Thus the burden of proof would be placed upon the Commission rather than upon the issuer to develop full and reliable information.

He further stated that he did not see how the "Commission can properly discharge its duty by merely accepting a statement

that has not been independently examined and certified by an accountant."

He was asked by Senator Barkley if he didn't think that such a check or guarantee as to the correctness of financial statements would be more in the interest of the public if it were "done by some Government agency than by some private association of accountants." Mr. Carter suggested that public accountants would be more economic, faster, and more effective than Government auditors.

In response to questions as to whether the work of the independent accountant should be checked by a government auditor, Mr. Carter replied, "I do not think so. I do not think they would have to go to that . . . . I think if a corporation wished to issue some securities and had been employing independent accountants for 20 years those accountants should be able to make this examination more economically and quickly than the Government."

Fortunately, in my opinion, the final legislation incorporated the requirement that financial statements filed with the Commission be certified by independent accountants, thus embodying the concept that in auditing and certifying financial statements of public corporations, independent, private sector accountants participate in fulfilling the purposes of the securities laws and thus have a responsibility to investors and the public. In order to assure that audits

pursuant to Commission requirements are made by qualified independent accountants, the Commission was granted specific authority to "make, amend, and rescind such rules and regulations as may be necessary" including the definition of "accounting, technical and trade terms."

Pursuant to this authority the Commission approved Regulation S-X, which together with Accounting Series Releases, prescribes the form and content of financial statements required to be filed with the Commission and the bases upon which the Commission will recognize qualified independent accountants. The Commission also adopted Rules of Practice of which Rule 2(e) in relevant part provides that the Commission may deny, temporarily or permanently, the privilege of practicing before it to any accountant or other person who is found, after notice and hearings, not to possess the requisite qualifications to represent others or to be lacking in character or integrity or to have engaged in unethical or improper professional conduct. The Commission may seek to assure that public accountants meet their responsibilities under the securities laws either through filing injunctive actions in federal district courts or through administrative proceedings pursuant to Rule 2(e).

There has been some controversy with respect to the Commission's use of these enforcement tools. Last February in the Geotek Resources <sup>1/</sup> case, the Court of

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1/ Securities and Exchange Commission v. Geotek Resources, et al., 426 F. Supp 715 (N.D. Cal. 1976) aff'd sub nom, Securities and Exchange Commission v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979).

Appeals for the Ninth Circuit affirmed the district court's refusal to find violations of the antifraud provisions by, or to enjoin an accounting firm and four accountants affiliated with the firm. Aside from the question of whether in this particular case the accountants had knowledge of certain undisclosed material facts and thus should have been enjoined from participating in future violations of the law, the court suggested, in widely quoted dicta, that the Commission was attempting to "conscript" accountants, to make them both insurers of their clients' honesty and enforcement arms of the SEC.

I believe this language indicates a misperception of the Commission's position and of the important responsibilities accountants have in the corporate disclosure process. When accountants fail to discharge their professional obligations and aid and abet the non-disclosure of material facts, the Commission may bring enforcement actions to remedy these violations. In so doing, we are not conscripting accountants as enforcement arms of the Commission or causing them to do the Commission's work. The Congress gave accountants the duty to audit and give an independent opinion on the adequacy and accuracy of financial statements. The independent audit is not for the Commission's benefit but for the benefit of public investors. The Commission is only seeking to assure that investors receive the disclosure to

which they are entitled. While I would not characterize independent auditors as being indentured to the service of investors, they are service professionals upon whom the public relies and for whose services the public pays and they are required to comply with generally accepted auditing standards and to either assure that all material facts are included in financial statements or issue a qualified opinion.

The Court of Appeals for the Second Circuit in the recent Touche Ross<sup>2/</sup> case was very sensitive to the importance of accountants and other professionals in the regulatory scheme of the securities laws. In that case, the Commission's authority to discipline accountants practicing before it pursuant to Rule 2(e) of the Commission's Rules of Practice was affirmed. The Court sustained the validity of the rule "as a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general." The Court also found that the Rule provided the Commission with the means to ensure that professionals whom the Commission relies on in the performance of its statutory duties perform their responsibilities competently.

In reaching these important conclusions, the Court stated that:

The role of the accounting and legal professions in implementing the objectives of the disclosure policy has increased

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<sup>2/</sup> Touche Ross & Co. v. Securities and Exchange Commission,  
[Current] Fed. Sec. L. Rep. (CCH) ¶96,854 at p. 95,473  
(2d Cir. 1979).

in importance as the number and complexity of securities transactions has increased. By the very nature of its operations, the Commission, with its small staff and limited resources, cannot possibly examine, with the degree of close scrutiny required for full disclosure, each of many financial statements which are filed. Recognizing this, the Commission necessarily must rely heavily on both the accounting and legal professions to perform their tasks diligently and responsibly. Breaches of professional responsibility jeopardize the achievement of the objectives of the securities laws and can inflict great damage on public investors. As our Court observed in United States v. Benjamin,<sup>3/</sup> . . . "In our complex society the accountant's certificate or the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar."

It is clear to me that the accounting profession and the Commission have complementary roles to perform in providing the investor protections intended by the securities laws. The Commission is charged with assuring that our securities markets are fair and efficient and that sufficient information is provided for investors to make informed investment decisions. Members of the profession acting as internal and external accountants perform the functions of maintaining adequate and accurate books and records, auditing and reporting on financial statements and assisting with the preparation of required disclosure documents. Books and records that accurately account for the receipt and use of corporate assets, and documents that adequately disclose

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<sup>3/</sup> United States v. Benjamin, 328 F.2d 854 (2nd Cir.), cert. denied sub nom. Howard v. United States, 377 U.S. 953 (1964);

financial condition and corporate operations, are the heart of this system of accountability. Thus, certain minimum standards must be required of accountants and these standards must be enforced.

In an economic and political system like ours, which puts great value on freedom of action by private citizens, it is appropriate that standards of competence and performance should be developed and maintained, to the extent possible, by the accounting profession itself through professional organizations such as the American Institute of Certified Public Accountants and the various state societies. There are limitations, however, to what can be accomplished through voluntary private organizations. Therefore, governmental organizations such as the State Boards of Accountancy have been given the power to set and enforce standards and to license and discipline accountants practicing within their jurisdiction, and the Securities and Exchange Commission has authority to set and enforce standards and discipline those practicing before the Commission.

This framework of shared responsibility and authority is rational, and has been operating reasonably well for forty years. But in recent years critics have suggested that the framework is not achieving the desired results. For example, there have been rather widespread corporate payments for illegal or questionable purposes, which have not been

appropriately recorded in books and records or disclosed to shareholders and a number of major public corporations have failed, shortly after issuing disclosure documents from which shareholders did not suspect such impending difficulties. As a result, public confidence in corporate reporting and the accounting profession has been shaken and a more careful monitoring of how the profession and the Commission are fulfilling their responsibilities has been undertaken by members of the United States Congress. In addition, for the last several years both the Commission and the profession have been seeking to identify and remedy weaknesses in the practice of public accounting.

A primary concern of mine and of other members of the Commission is whether private accountants and their professional organizations will be able to regulate themselves in a manner that will meet public expectations, whether it will be necessary for the SEC to become involved to a significantly greater degree under the present structure, or whether Congress will determine that legislation altering the system is necessary. A specific area of concern is auditor independence.

The primary purpose of an audit is to verify the adequacy of the recordkeeping system and correctness of the representations made by those being audited, thus enhancing the credibility of financial statements. That the auditor

of a public company be independent of his client both in fact and in appearance is the most critical attribute he brings to the attest function. If this quality is absent, the accountant's opinion is misleading because it is not in fact an independent attestation. Regulation S-X, in part, states that "The Commission will not recognize any certified public accountant or public accountant who is not in fact independent." In addition to specifying certain relationships which result in a lack of independence, the rule states that "In determining whether an accountant may in fact not be independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances . . . ." One of the principal contexts in which the issue of independence has been raised recently relates to management advisory services. Both Congress and the Commission have been concerned for several years that provision of certain types of non-auditing services to audit clients may raise questions relating to the independence of the auditor.

In June of 1978, in Accounting Series Release No. 250, the Commission adopted a rule requiring disclosure in proxy statements of services provided by the registrant's principal independent accountants and whether the board of directors or an audit or other committee of the board had considered the possible effect on auditor independence and

approved each service. In that release the Commission stated that the AICPA's SEC Practice Section had asked its Public Oversight Board to consider whether providing management advisory services could impair auditor independence and that the Board should have an opportunity to present its conclusions before the Commission determined whether to propose prohibitory rules. In March of this year, the Public Oversight Board submitted its report which generally rejected limitations on management advisory services.

The Commission believed that the Public Oversight Board report did not adequately sensitize the profession and its clients to the possible effects performance of non-audit services could have on auditor independence and responded by issuing Accounting Series Release No. 264 entitled "Scope of Services by Independent Accountants." In the release we urged accounting firms, boards of directors, managements, and audit committees, all of which participate in the audit process, to consider carefully the effects that the performance of management advisory services may have on the relationship with audit clients.

Our release identified a number of factors to be considered, including the avoidance of supplementing management's role and of self-review, and in the case of management, the board of directors, and the audit committee whether the economic benefits derived from having the auditor

perform these services outweigh the potential adverse effects. The Commission's release should increase the profession's sensitivity to this very complex and controversial accounting issue and encourage self-discipline.

The Commission will be analyzing proxy disclosures and observing how the accounting profession and the business community determine whether particular non-audit services should be performed by the registrant's auditor. If private sector participants do not responsibly resolve questions of which services are appropriate to perform for audit clients and which are not, the Commission may find it necessary to take further action in order to foster greater investor confidence in financial reports of public companies. If the profession desires to avoid such a result, it should address management advisory services questions with the responsible professionalism of which it is capable.

Another major area of concern is the effectiveness of existing mechanisms for assuring that appropriate professional standards are satisfied. Again, the Commission has indicated its strong preference for a self-regulatory approach, and has supported the AICPA's effort to establish an effective program, but if that approach is not successful greater governmental regulation will be necessary.

I am unable at this time to discern the extent to which the AICPA's effort will be effective. It is evident

to me, however, that there are a number of rather formidable problems which must be resolved. Perhaps most important, many members of the profession appear to lack a commitment to the AICPA self-regulatory approach.

Although a majority of companies filing reports with the Commission are audited by members of the SEC Practice Section, a majority of accounting firms that perform audit services for firms that are subject to SEC filing requirements have not joined the Section and there appears to be little movement in that direction. Of the less than 600 firms that have joined the SEC Practice Section, only about 200 have clients which are publicly held companies. Of the member firms, only ten underwent peer review last year and about fifty volunteered to do so in 1979.

In addition, for the last two years in its July Report to Congress, the Commission has identified certain attributes which we believe the peer review process must possess, yet, the profession's response has not been satisfactory. One of these attributes relates to Commission access to the working papers of the peer review process. In my opinion, just as an auditor cannot certify to the accuracy and completeness of financial statements without access to underlying documents, the Commission cannot fulfill its oversight role responsibly without access to work papers. Access is not merely desirable, it is essential if the process

is to have the integrity necessary to be effective. Secondly, the Commission continues to maintain that the peer review process cannot arbitrarily exclude "problem" engagements. I believe the Commission may seriously consider withdrawing its support for the peer review process rather than risk the erosion of credibility that could result from reporting to the Congress again after three years that these significant issues still have not been resolved. It would be a mistake to assume that the Commission's patience to date with the slow progress being made is in any way due to a lack of resolve that our concerns must be satisfied.

The Commission is committed to fulfill the role of assuring that public corporations provide full and fair disclosure of the nature and character of their securities and operations. Books and records that accurately account for the receipt and use of corporate assets, and documents that adequately disclose financial condition and corporate operations, are vital to this system of accountability. I firmly believe that the private accounting profession and its institutions should have the opportunity to take the initiative in establishing and enforcing appropriate accounting standards, auditing standards, and standards of professional competence. I also believe that independent accountants are capable of certifying the adequacy and correctness of financial statements more economically and effectively than could government auditors.

To the extent that efforts by the profession to establish and maintain such standards in accord with public expectations are successful, Federal Government involvement will be minimized. If the members of the accounting profession and the business community do not actively support and participate in self-regulation, however, you can expect the SEC to assure that appropriate standards are set and maintained through greater use of our broad regulatory authority to promulgate direct rules and regulations and through enforcement actions. You can also expect greater pressure for additional federal legislation dealing with accounting issues. Whether accountants will retain the opportunity to be primary participants in their own regulation will be determined by members of the accounting profession, management of public corporations, and those who enter these professions. I wish you success.