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The public accounting profession in the United States has come under heavy attack in recent times because of the perceptions of its critics and the emerging recognition, particularly in Congress, of the importance of financial reporting and the role of auditors. The criticisms of the profession are leading to profound changes, especially in the role and responsibilities of auditors. Because the ultimate objective of these changes is to provide improved corporate accountability, they will have a significant impact on corporate management as well.

Auditors have traditionally been looked to as a principal means of providing a reasonable degree of assurance as to the reliability of financial statements to help protect investors and credit grantors from being misled by misrepresentations or frauds. More recently, however, the function has taken on added dimensions because government officials have come to realize two things:

> First, financial statements underlie the financial data and statistics which are used in the formation of national policies,

particularly those relating to the economy and capital formation.

And second, independent audits are a vital ingredient in the scheme of control over the conduct and accountability of the corporate entity within our country.

To a large extent, the criticisms leveled at the profession stem from a series of spectacular business failures starting in the late 1960's. But they are also a result of a general loss of confidence in the integrity of business. The energy crisis spawned widespread doubts about the reliability of the financial and statistical reports of the oil and gas industry. Also, the hundreds of revelations about illegal political contributions, bribes, and off-book slush funds caused untold damage to the credibility of corporate management.

It does not follow, of course, that these events were necessarily accompanied by failures of auditors to meet their responsibilities. Nevertheless, it is clear that the result has been a serious erosion in the credibility of the independent auditors. This loss of confidence is focused principally on perceptions that audit failures occur for three reasons:

First, the accounting and auditing standards being set in the private sector are deficient in quality, quantity, and timeliness. Therefore, it is suggested by some that the setting of these standards should be transferred to a governmental agency.

Second, it is alleged that the auditors were negligent and exercised poor judgment or were not sufficiently independent of their clients and either knowingly or unconsciously protected the interests of management at the expense of shareholders and other users of financial statements.

Third, it is asserted that the profession's technical, independence, and due care standards are not being enforced and CPAs and CPA firms are not being adequately punished. Therefore, the SEC is urged by the critics to exercise its enforcement authority more vigorously and additional forms of governmental regulation of the profession are alleged to be necessary.

These perceptions are so serious that the profession can ill afford to ignore them even if they are greatly exaggerated. I believe it is safe to say that a great

majority of the profession would vigorously assert that such conclusions are not supported by the facts.

Because of the perceived deficiencies in the performance of auditors and the accountability of corporate management, there has been an avalanche of recommendations for reform. These have been put forward by congressional committees and their staffs, an independent Commission on Auditors' Responsibilities, the SEC, and by CPAs themselves in their testimony and written submissions to Congress.

Many of the changes which we have adopted, particularly those in response to the Commission on Auditors' Responsibilities, are aimed at improved corporate accountability. Others are intended to bolster the independence of auditors and to establish an effective system of regulation of CPA firms.

Having described only very briefly some of the reasons why the profession finds itself faced with heavy pressures for reform, I would like to devote the balance of my remarks to where matters currently stand.

Following the hearings of Senator Metcalf's subcommittee on Reports, Accounting and Management in June 1977, the

AICPA developed a program of changes to respond to the criticisms that had been raised. As a result, a new division was established by the AICPA to provide an oganizational structure through which regulatory requirements and sanctions can be imposed on CPA firms. Prior to this action, the AICPA and the profession had no vehicle for dealing with firms as entities since the Institute membership is composed solely of individuals.

The new division for firms is made up of two sections, one for SEC practice and another for private companies practice. CPA firms can join either or both sections simply by meeting the requirements, which are designed so as not be exclusive. Firms need not have SEC clients to join the SEC practice section.

Requirements imposed on firms joining the SEC practice section include these:

- Mandatory continuing professional education of forty hours a year for all partners and each CPA and non-CPA member of the professional staff.

- A mandatory peer review of the firm's quality controls at least every three years and at

such other times as may be imposed as part of a disciplinary action. Such reviews will take into account all matters which may adversely affect the quality of audits.

- Imposition of sanctions on firms found to be deficient in meeting the AICPA quality control standards or other requirements. The sanctions which the section may impose can range in severity from required remedial actions to expulsion and may include monetary fines.

- Annual filing of relevant information about the firm for inclusion in the files open to public inspection.

- Maintenance of legal liability insurance coverage as prescribed by the executive committee of the section.

- Report to the either the audit committee or the board of directors any disagreements with management about accounting or auditing matters which, if not resolved, would have resulted in a qualified opinion.

- A proscription on performing certain types of management consulting services for SEC clients, even though no instances have been identified in which an auditor's independence was in fact impaired by rendering such services. This matter is currently under study to determine what additional proscriptions should be imposed, particularly with respect to recruiting directors or others who would be involved in engaging auditors.

- Report annually to the audit committee or board of directors of SEC clients a description of consulting services rendered and the amount of fees charged for such services. Also, the percent of a member's total domestic revenues represented by management consulting, tax, and accounting and auditing fees must be reported annually to the section for inclusion in its public files.

- Rotation of the partner in charge of an SEC audit at least every five years and have a "fresh look" review performed each year by

a partner other than the partner in charge of an audit before issuing an audit report.

- Filing with the section annual reports identifying clients from whom fees exceed 5 percent of the firm's domestic fees.

Crucial to the success of the self-regulatory plan of the SEC practice section is the appointment of a Public Oversight Board to monitor the operations of the section and, at its own discretion, report any information, findings, views, or recommendations to the executive committee of the section, the SEC, congressional committees, or the public at large. The board consists of five individuals of stature from outside the profession with established reputations for integrity and concern for the public interest.

The board has access to all files, meetings, and activities of the section and authority to employ its own staff and set its own compensation to be paid from dues charged to the firms.

Although joining the SEC practice section is voluntary, it is believed that as a practical matter most if not all

firms auditing SEC companies or wishing to do so will join the section. At the date of this report, all of the seventeen largest firms (which audit over 7,150 SEC registrants) as well as nearly five hundred other firms have become members.

The section for private companies practice is largely parallel with the SEC practice section except that the requirements reflect the different needs of the type of clients being served. The principal objectives of this section are to improve the performance of practitioners, facilitate participation by smaller firms in the affairs of the profession, and develop ways to tailor technical standards to fit the circumstances of smaller and/or privately-owned businesses.

In November 1977, Senator Metcalf's subcommittee on Reports, Accounting and Management issued a report based upon the hearings that concluded in June 1977. That report contained a long list of recommendations that incorporated those of the Commission on Auditors' Responsibilities as well as many others. These recommendations are very important because they will be used as a benchmark against which the profession's actions will be measured.

Subsequent to the death of Senator Metcalf in December, there was considerable uncertainty about what would happen next. However, early this year the subcommittee was discontinued and its former responsibilities relating to the profession were reassigned to the subcommittee on Governmental Efficiency and the District of Columbia chaired by Senator Eagleton. At the same time, John Chesson, author of the Metcalf staff study, "The Accounting Establishment," transferred to join the staff of Senator Eagleton's subcommittee.

In April, Senator Eagleton sent a letter and questionnaires to the AICPA, the FASB, the CASB, the SEC, and the eight largest firms. The questionnaires were designed to determine the extent to which the Metcalf subcommittee report recommendations were being adopted and implemented. All those contacted have responded to the questionnaire.

It is expected that the subcommittee will hold hearings early next year focusing principally on the response to the Metcalf subcommittee report and on a progress report which it received from the SEC on July 5th. In an earlier meeting with Senator Eagleton, we were

assured that he is not inclined to propose legislation to deal with the profession so long as he is satisfied that the AICPA and the SEC are making progress toward implementing changes that he believes to be necessary. So far, he has not commented on the report of the SEC.

In addition to these developments, Congressman John Moss' subcommittee on Oversight and Investigations held hearings in late January and early February followed by a partial day of hearings on March 3rd.

Some of the principal positions taken during the course of the hearings were:

1. Senator Percy affirmed the Metcalf subcommittee's decision not to support new regulatory legislation at this time and the subcommittee's preference for having the profession carry out its own reforms in cooperation with the SEC.

2. Although strongly supportive of the AICPA's program, Harvey Kapnick, Chairman of Arthur Andersen & Co., stated that his firm was prepared to join with others to establish a self-regulatory body for SEC practice

outside the AICPA if for some reason the AICPA's SEC practice section of firms was suspended or terminated.

3. Eli Mason, a practitioner from New York and one of the petitioners in a lawsuit against the AICPA, recommended legislation that would require all CPAs practicing before the SEC to be registered with the SEC.

4. Dr. John C. Burton, Professor at Columbia University and former Chief Accountant of the SEC, urged legislation to establish a statutory self-regulatory body for individuals and firms practicing before the SEC similar in nature to the National Association of Securities Dealers. Key recommendations included mandatory quality reviews, sanctions, authority to set auditing standards, requirements to qualify for membership, setting negligence as a standard of legal liability under the securities laws, and establishing limitations on the amount of auditors' liability.

5. SEC Chairman Harold Williams, although critical of several aspects of the AICPA's program for self-regulation, opposed legislation and supported giving the profession time to prove that its program would be effective.

At the close of the hearings, Chairman Moss promised that a report would be issued and that he would be proposing legislation in the near future. Although a report has not yet been issued, a proposed bill was introduced on June 16th by Congressman Moss. The bill, as drafted, is based in part on suggestions made by Messrs. Burton and Mason in their testimony before the subcommittee. It proposes the establishment of a National Organization of SEC Accountancy (NOSA), a regulatory body for the profession under the direct authority and control of the SEC, and provides for --

1. Mandatory registration of all independent public accounting firms (and their licensed partners or shareholders) which furnish audit reports to the SEC and voluntary registration by all other firms.

2. Establishing registration requirements in the body's bylaws, including the assessment of dues to fund the organization.

3. Filings of financial statements and other pertinent information by each registered firm or practitioner.

4. Mandatory quality reviews of compliance with generally accepted accounting and auditing standards to be conducted by the new regulatory body at least every three years.

5. Investigations of any identified problems or complaints regarding inadequate audit performance or alleged violations of the federal antitrust laws.

6. Sanctions including censure, fines, limitations of operations or services, suspension, expulsion, or any other appropriate sanction based on the results of investigations.

7. Suspension or expulsion for failure to produce any document or cooperate with the new regulatory body in conducting an investigation.

In addition, the bill provides for the following:

1. Negation of the Hochfelder decision by establishing negligence as the standard for legal liability.

2. Authority for members to conduct SEC

audits across state lines without regard to state licensure.

3. A requirement for foreign firms and practitioners furnishing audit reports to the SEC to register and be subject to the same regulation as registered domestic firms.

4. The SEC --

   a. Shall identify accounting, auditing, and quality control standards to be established or modified by designated bodies within specified time periods and to set such standards itself if the designated bodies act too slowly or unsatisfactorily or if existing standards have not achieved optimum uniformity.

   b. Shall require a standard for divestitute of all services which would prejudice the audit independence of registered firms or practitioners.

   c. May take disciplinary action on its own initiative in the same manner as provided in the bill for the new regulatory body.

d. Shall require all publicly-owned corporations to establish independent audit committees with authority to engage independent auditors.

On July 28, 1978 the Moss subcommittee again held hearings to interrogate the AICPA's SEC Practice Section of Firms and its Public Oversight Board on the progress made to date to implement a self-regulatory system. At the same hearing, Chairman Williams of the SEC was questioned regarding the Commission's report on the profession's program. In view of the opposition of the SEC at this time to the legislation proposed by Congressman Moss, the hearing ended without an indication of what further action might be forthcoming.

Because Congress recessed in August for election compaigning, there is not much chance that legislation will be passed this year. Nevertheless, a bill will set the stage for subsequent action by Moss' successor or by Senator Eagleton, should he become persuaded that legislation is desirable. Also, the SEC will almost certainly find it advisable to comment on the merits of the bill even though its position to date has been to oppose legislation until the AICPA's program has had a chance to prove itself.

Under these circumstances, it is imperative that the initiatives taken by the AICPA be successful if federal regulatory legislation is to be avoided. Standing in the way at the end of July were a number of hurdles, including a lawsuit filed by 18 members against the Institute and a number of extremely difficult issues raised by the SEC.

The principal issue in the lawsuit was whether a new class of membership in the AICPA was created by the establishment of a Division for CPA Firms. If so, the action would require a vote of the membership under the bylaws. The petitioners were seeking to force such a vote and to suspend further activities of the division pending the outcome. The AICPA's response was that the Division for CPA Firms did not create a new class of AICPA members and that Council acted within its powers in creating the division.

Briefs were submitted and oral arguments were heard on April 27 before a judge of the NY Supreme Court. On August 2nd the judge issued his finding that the AICPA had acted within the authority of its bylaws. This determination is appealable, so a resolution of the matter might be further delayed if the petitioners decide to take the case to a higher court.

In the meantime, the SEC submitted a progress report to the Congress on July 5th. It continued to oppose legislation at this time and is supportive of the Institute's program. However, in the report, the SEC continues to press very hard for action on a number of fronts. I would like to list these briefly because they present issues that are extremely difficult to resolve.

1. Establishing the extent to which auditors should be prohibited from rendering management advisory services to SEC clients.

2. Modifying peer review requirements of the SEC practice section to provide, among other things, for --

    a. Committees to monitor and participate in firm-on-firm reviews and accept full responsibility for the adequacy and results of such reviews.

    b. Access to peer review working papers by the SEC.

    c. Coverage of work done outside the United States on international engagements.

3. Whether alleged audit failures which are the subject of litigation must be investigated and appropriate sanctions imposed without waiting for the results of the litigation.

4. Whether the AICPA should and can legally impose a requirement that SEC clients have audit committees as a condition to auditors' expressing unqualified opinions on their financial statements. Such a requirement might take the form of an auditing standard or a modification of the independence rule under the rules of conduct.

5. Whether the Public Oversight Board should have more line authority or should act as an appeal body with respect to sanctions.

6. Whether auditors should be required to report publicly on the systems of internal control of SEC clients.

We believe the SEC will continue to oppose new regulatory legislation unless we encounter material failures in our program.

In the meantime we are also implementing a number of other key changes.

1. Meetings of senior committees and Council have been opened to the public starting last January.

2. Three public members are being added to the AICPA Board of Directors.

3. The AICPA's rules of conduct have been modified to permit advertising and solicitation.

4. Representation of the eight largest firms on senior technical committees has been reduced.

5. A whole series of proposed changes relating to auditor's reports and financial reporting are under study.

6. The structure of the Auditing Standards Committee is being revised to improve the efficiency of the standard-setting process.

While we continue to be optimistic about remaining self-regulated, it is clear that the outcome is far from certain. If we fail to take sufficient action to retain the support of the SEC, the likelihood of new federal regulatory legislation that would ultimately affect the entire profession would be greatly increased. If a

regulatory body similar to that proposed by Congressman Moss was established in which membership of all firms practicing before the SEC would be required by law, the likely results would be --

1. The profession would be split on a virtually irrevocable basis by the existence of two separate bodies.

2. The present strengths of the AICPA would be greatly diminished because the new federal statutory body would more than likely be assigned the functions provided in the legislation currently being proposed by Congressman Moss. These functions are a substantial part of the basis for the Institute's ability to effectively represent the public and the profession. Thus, the center of attention and influence would shift to the new body.

These are very trying times for the profession in the United States. But I am hopeful that through bold actions and a willingness to make adjustments to meet the social changes that are affecting us, we will emerge from this period a stronger and better profession.