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"CHALLENGES FOR THE PROFESSION"

An address to the Partners of Alexander Grant & Company by W. E. Olson, President of the AICPA and former Executive Partner of the firm, at their 1976 Annual Partners Meeting - November 16, 1976

It seems a long time ago since I last participated in one of your annual meetings. I hope that the message that I bring you today will not cause you to wish that my return visit had been delayed forever!

It would be my preference to bring you nothing but good news about our profession, about our future; but I'm afraid that matters are often beyond our control and my task today is to alert you to some of the serious developments that are taking place in Washington.

Let me start by saying that the Public Accounting profession is perhaps at its most critical period in its history. There are two of our principal objectives that are being challenged by the imminent threat of federal governmental intervention.

Most members of the profession would agree with these two objectives. One is retaining the setting of accounting and auditing standards in the private sector. The second objective is retaining regulation and discipline in the private sector to the maximum extent possible.

The only piece of good news that I have for you this morning is that the existence of the private profession is not at stake. You can expect to continue to be a private profession

as far as we at the Institute can see, and I think you are going to prosper as you have never prospered before.

But the bad news is that the environment and manner in which the profession practices is going to be changing very rapidly and it's that environment that is at issue.

I would like to direct my remarks to basically three things: one is examining our current problems in Washington; second is reviewing the outlook with respect to accounting and auditing standard setting and finally, to analyzing some of our problems in connection with self-regulation.

Let me start then by talking about governmental intervention and the developments in Washington.

In order to understand and fully comprehend what is happening you have to look at some of the attitudes that prevail in Congress today. It is fair to say that one of the fundamental attitudes in Congress is basically anti-business and because our profession is regarded as being part of the business world we are swept up in the concerns that exist about big business.

The major concern in the minds of some members in Congress is to impose controls to prevent corporate irresponsibility. The desire is to impose and enforce a greater degree of management accountability. One of the organizations charged with that responsibility is, of course, the SEC. It is one of the major guardians of the public interest insofar as business is concerned. As a result independent auditors have become of increasing interest to Congress. We have come to be regarded

as a key part of any mechanism that might be adopted to help improve accountability on the part of large corporations.

There is a two fold perception in the minds of some members of Congress. One is that there is an increasing need to expand the responsibility of auditors. That is very natural, because we are seen as an important tool in achieving greater accountability. But at the same time there is a second attitude of growing concern that CPA firms are not sufficiently independent of their clients and are not fully meeting their responsibilities. There is an increasing belief that CPA firms should be regulated to insure that they carry out their role in a satisfactory manner. The fact that this concern is not directed at individual CPAs but at CPA firms has some important implications for the structure of our profession which has traditionally been organized to deal solely with individuals.

One other point should be made. Not all members of Congress are involved in the attitudes I have been describing. There are only a small number of individuals who are threatening action with respect to our profession. But the few who are involved are powerful individuals who have significant influence in Congress.

There are a number of events that have been taking place that point toward governmental intervention. Taken individually they may not be altogether earth-shaking, but taken together, they form a mosaic that leads you to some tentative

conclusions. I would like to discuss some of these events that are the elements of this mosaic.

One serious problem started with the energy legislation passed in December of 1975. One of the fundamental concerns in Congress at that time was that they were not getting accurate or comparable financial data out of the oil and gas industry. They blamed the industry for this but they also blamed the auditors. They felt the auditors were conspiring with their clients to avoid providing such information. Because of this concern, Congressman Moss inserted an amendment into the energy legislation. I won't go into all the details, or all the machinations we went through to get the amendment changed, but the final legislation wound up mandating that the SEC should see that uniform accounting standards were established within twenty-four months for the oil and gas industry. The bill also provided that the SEC could look to the FASB to establish such standards but if the FASB wasn't successful the SEC should take its own action within the twenty-four month period. This means that there is an important deadline coming up in December of 1977. This is one of the several things that presently puts the FASB under severe pressure.

A second item in the mosaic results from the fact that Congressman Moss chairs a subcommittee of the Interstate Commerce Committee. That subcommittee has oversight responsibility over the regulatory agencies. It recently completed a part of a study

of the regulatory agencies which included the SEC. In its report the subcommittee concluded that the SEC was the best of a bad lot of regulatory agencies. However Chapter II of the report is devoted to criticisms of the SEC. The same chapter includes a critique of our profession and some of the things said in the report were not at all complimentary. It quoted extensively from one of our members, Professor Abe Briloff, who was the only individual invited to testify before the subcommittee.

The report recommends many significant things, but principal among them is that the SEC should establish a uniform framework for accounting standards; the SEC should take over the setting of auditing standards; the SEC should set standards of conduct for CPAs and enforce them stringently; and the SEC should require auditors to report on the adequacy of the systems of internal control of their clients. Another recommendation was legislation to overturn the findings of the Hochfelder decision. The effect of that, of course, would be to expand the exposure to legal liability of auditors since they could then be found subject to civil damages on the basis of negligence rather than requiring proof of scienter.

A third item in the mosaic relates to a subcommittee of the Government Operations Committee chaired by Senator Metcalf which has been conducting an extensive study of the profession. Questionnaires were sent to the big eight firms, the

AICPA, the FASB, the SEC, the CASB, as well as others to gather data about our profession.

The subcommittee is investigating the profession's relationships with clients, with the SEC, and with the FASB. It is looking into the standard setting process and particularly the self-regulatory structure of the profession. The study will result in a preliminary report which is nearly completed. We expect that the report might be published late in December. It is expected to serve as a source book of information about our profession. We also expect that public hearings will be held next spring.

Our expectation is that after all the effort which has been expended it is most unlikely that the subcommittee is going to reach a conclusion that everything about our profession is just fine and that no legislation or administrative action is required. To the contrary, we expect that it will probably try to out-do the recommendations of the Moss subcommittee.

Item number four in the mosaic is the proposed illegal payments legislation. I can't think of anything that has had a greater impact on the concern about corporate accountability than the revelations about illegal payments by large corporations. This has become a very important political issue and as a result there are several groups in Washington who have proposed various forms of legislative cures. But the one that most affects us is the legislative proposal put forth by the SEC. It has far ranging implications for the profession with respect to our

relationship with systems of internal control and our ability to get audit information either from the client's personnel or from third parties.

The AICPA has objected to various aspects of this legislation and in our lobbying in the Senate we were so successful that the bill passed by a vote of 86 to 0. The legislation did not pass in the House, however, since it was not "marked up" in the dying moments of Congress.

We haven't heard the last of this issue. The legislation is going to be re-introduced as soon as Congress reconvenes. The SEC is currently putting together a composite bill incorporating not only its previous proposals but some others as well.

A fifth item in the picture is an on-going consideration by the Senate Commerce Committee of the broad question of whether something shouldn't be done about establishing more control over corporate entities in our society. There is a belief on the part of some that there has been substantial abuse of power by large corporations and something must be done to deal with this problem.

The hearings that have been conducted by this Committee are partially centered on proposals by the Nader group which suggest that there should be federal chartering of corporations over a certain size and that the independent auditors should be rotated every five years.

This is a long-range study that is a little further away from reaching any conclusions than some of the other matters which I have been describing. But there is little question that our potential role as enforcers will be an important part of the considerations of that committee.

Item number six in the picture is the concerns of Congressman Vanik who serves on the House Ways and Means Committee. Congressman Vanik is worried about the impact of accounting standards on Federal Income Taxes. He doesn't like current value or replacement cost concepts being applied as part of our accounting for U. S. businesses. He is afraid they might lead to being used for tax purposes as well which would result in lower revenues for the federal government. So he has a very high interest in the accounting standard setting process and he, too, thinks that maybe it would be a good idea to transfer this to a federal government agency such as the SEC.

What can we conclude from the picture which I have been painting. Well, if you put it in the perspective of social trends which occur in our society, you can gain some clue as to what we can expect to happen. Some clear social trends of our times have been consumer protection, ecology, equal opportunity, the energy crisis and several more. Each of those trends or events has led to legislation and there is strong reason to believe that what we are currently experiencing will lead to a similar result.

The social trend that's leading legislation to our doorstep is the demand for greater control over corporate behavior and accountability. Legislation or some other form of governmental action intervening in the affairs of our profession, seems inevitable. It isn't any longer so much a question of "will it happen" as "when will it happen and what form will it take." My guess is that the next twelve to twenty-four months will be a critical period. As I have already indicated, there are two areas that are most likely to be affected; one is standard setting and the other regulation of the profession.

With regard to accounting standards I believe that the FASB is in one of its most critical periods. There are several reasons why this is so. The Moss subcommittee report recommendations that I mentioned earlier and a number of highly controversial issues that must be resolved in the next few months have an important bearing on the survival of the FASB. The restructured debt issue is one that has spawned a major battle with the banking world and the mandate that the FASB deal with the highly controversial issue of oil and gas accounting by December 1977 will surely be difficult to fulfill.

Another reason why it is a critical period for the FASB is the attempt to establish a conceptual framework of accounting. I am concerned that the expectations regarding a conceptual framework are likely to far exceed what can be achieved. Many people seem to think that somewhere there is a Holy Grail

that will make everything in accounting standards internally consistent. Because accounting standards are essentially the result of a political process of balancing conflicting interests I doubt that there is such a Holy Grail. This is likely to cause many to be disappointed by any attempts to arrive at a conceptual framework.

Finally the Metcalf study may well come to the conclusion that accounting standards are too important to be left to the private sector thereby threatening the continued existence of the FASB.

There are, of course, a number of strong countervailing forces that might prevail. The SEC has always followed the policy of deferring to the private sector and they continue to do so. I think the Commission will be very much on our side. However, we currently have litigation against the SEC seeking to set aside its policy. I don't think the lawsuit will be successful but it nevertheless has the damaging effect of conveying the impression in the minds of members of Congress that the profession is hopelessly divided and, therefore, government must intervene.

Another factor is the prevailing preference of chief executive officers in industry that accounting standards be set in the private sector. Also some members of the profession believe that the CPAs are capable of effectively lobbying with members of Congress.

It is difficult to predict what may be the ultimate result of these forces but I think we should recognize certain possibilities. No doubt there will be strong Congressional pressures on the SEC which may cause the Commission to abandon their traditional position of deferring to the private sector. Also, we should recognize that when specific interests of industry groups are gored by a standard of the FASB, those groups are likely to turn to Congress for relief. I think they are likely to do this on individual issues but I doubt that they will ask Congress to transfer the entire standard setting process to government. If they seek relief on individual issues, however, it will undermine the FASB.

In dealing with this problem there are some alternative courses of action available to the profession. We can and ought to continue our active support of the FASB. We can undertake a concentrated educational program with Congress through our key person program, although that is a long term and up-hill struggle! We can propose legislation under which FASB standards might be legally enforceable with appropriate veto power by the SEC. However, proposing such legislation might result in accelerating a take-over by government and we have tentatively decided against this course of action.

In summary, it is difficult to conclude whether or not we will be successful in retaining the setting of accounting standards in the hands of the FASB.

The proposal of the Moss subcommittee for the SEC to take over auditing standards is brand new. There have been some prior trends in this direction but they have been minor. The SEC at one time proposed in connection with the ALI recodification of the Securities Acts that the Commission be given explicit power to set auditing standards. We opposed that proposal and it was removed from the draft that is currently under consideration. At least some lawyers believe that the SEC has implicit, if not explicit, powers to intervene in auditing standards. In fact the Commission has recently exercised this power by requiring auditors to review interim financial statements. Also there is a pending proposal for requiring auditors to report on their reviews of their clients' systems of internal control. These certainly constitute invasion of the field of auditing standards.

It is difficult to predict whether the profession will be successful in retaining the auditing standard setting function. However we are likely to be less vulnerable than we are in the area of accounting standards. Even so the SEC sometimes becomes impatient with us and may well decide to intervene from time to time on specific issues. Also congressional desires to expand auditors' responsibilities may lead to more intervention. A good example of such action is the illegal payments legislation.

The Commission on Auditors' Responsibilities is also addressing the issue of who should set auditing standards. It

expects to issue a final report during 1977. The report will be helpful if it concludes that the profession should continue to establish its own standards for auditing.

Having discussed at some length the problems relating to accounting and auditing standards I would like to devote the remainder of my remarks to our problems with self-regulation. The concerns of Congress are that the enforcement of our technical standards is not adequate and that the reliability of financial statements ought to be virtually guaranteed by independent audits.

The fact that this unreasonable expectation has not been fully met results in the notion that CPAs are not sufficiently independent and thus require more regulation. This view results mainly from the sensational audit failures that have occurred.

We have some difficult problems with our self-regulation where alleged violations of technical standards are involved. We don't have privilege or subpoena powers which makes it difficult to carry out investigations and disciplinary actions. Almost all the highly publicized cases have involved litigation and when we try to carry our disciplinary action, we can't get access to the information because the firms refuse to open their records on the advice of their legal counsel. They don't want to prejudice their case in court which is understandable. This problem raises the fundamental question of whether it is appropriate for the profession to attempt to proceed with disciplinary

action before litigation ends and thereby preempt the judicial process. So far the profession has chosen not to do this. The result is that we just can't deal with the highly publicized cases on a timely basis which reduces the credibility of our self-regulatory machinery.

There are a number of possible governmental actions that may take place with respect to the regulation of our profession. I have already mentioned the Moss subcommittee report which recommends that the SEC set standards of conduct for the profession and proposes legislation to repeal the Hochfelder decision. The report also urges the SEC to suspend firms from practice and to send more cases involving auditors to the Justice Department, which is to say that the cases should be dealt with as criminal cases.

There are other possible types of governmental regulation that have not been suggested as yet. However, they are distinct possibilities. One might be Federal licensing of the profession. Another might be a government examining force to review CPA firms in a manner similar to bank examinations. Others might be restrictions on the scope for services of auditors particularly with respect to management advisory services or rotation of auditors.

There are two basic questions that ought to be addressed by the profession in the area of self-regulation. The first question we might ask is whether the discipline of SEC enforce-

ment and criminal and civil liability is sufficient to assure a high level of performance by auditors without an additional layer of self-regulation? I believe that the threat of lawsuits is a strong deterrent to any wrongdoing on the part of the profession and additional self-regulation is probably unnecessary. If so we should decide whether to abandon any attempts to discipline members under our technical standards' cases or continue our present efforts simply for the sake of appearances. We might also consider whether we should substitute a different kind of effort consisting of an investigation and evaluation service for use by the SEC in its enforcement actions and for use by the Courts.

There are several alternatives available to the profession in dealing with the problem of regulation. We can, for example, fight all the proposals that are made for changes in the present arrangement. The lawsuit of Touche Ross & Co. challenging the authority of the SEC's Rule 2(e) is an illustration of a fighting strategy.

Another approach that has been suggested would be to form a voluntary organization of firms under which the member firms would agree to submit to early investigation of any charges of wrongdoing. To be workable, this plan would require us to obtain privilege and subpoena powers through legislation. However, I seriously doubt that any of the major firms would be willing to participate in such a program because it would entail assignment of a part of their sovereignty to a voluntary trade

association.

Another action that might be considered would be the establishment of a peer investigation and evaluation service, somewhat similar to an arbitration panel, to provide input to the SEC and the courts. This approach might also require legislation to obtain privilege and subpoena powers during the period of investigation.

The profession's quality control review program which is just getting underway will also be an important part of our scheme of self-regulation. Its principal thrust, however, is educational rather than regulatory.

To summarize, we are highly vulnerable to criticism of our system of self-regulation. As a result, additional forms of regulation are almost inevitable. No voluntary self-regulatory scheme can truly be effective without some kind of punishment such as fines rather than suspension of membership in an association. Because suspension inflicts too many damages on innocent parties even the SEC has generally refrained from imposing this form of sanction on the larger CPA firms.

In conclusion, I have been describing the threat of federal governmental intervention in the activities of our profession and the likely effects on setting accounting standards, setting auditing standards, and on regulation. The AICPA has been studying the desirability of proposing a legislative program designed to deal with some of the more important problems that

have been identified. Such legislation might provide a statutory base for the FASB and our Auditing Standards Executive Committee. Also it might seek to establish a means for the profession to participate in its own regulation on a meaningful basis along the lines that I have mentioned. To permit the profession to assume new and broader responsibilities we might also include provisions for limitations on liability or alternatively a plan for government insurance to cover financial reporting risks.

We are currently deliberating in the Board of Directors of the Institute, in the Council and in the advisory groups of firms about what course of action we should adopt to deal with the present initiatives in Washington. I can't tell you what we will conclude but I am certain that the profession can expect to experience significant changes in its environment in the period ahead. It's only a matter of time and we have little time left to act. The challenges are very real and promise to have a far-reaching and permanent impact on our profession.

Thank you for the opportunity of appearing before you this morning.