11-20-1972

Ethics and Regulation. Address Before Ohio Society of CPAs, Cleveland, 11/20/72

Wallace E. Olson

Ohio Society of CPAs, Nov. 20, 1972.

ETHICS AND REGULATION

I am certain that you will all agree that the fundamental role of our profession is to protect the public interest. I am equally certain that few of you would dispute that the maintenance of our integrity and objectivity is of utmost importance. It seems clear that our usefulness would be minimal if we failed to retain the trust of those who rely upon our opinions.

One of the key factors in assuring the public that we are satisfactorily carrying out our fiduciary role is an effective system of regulation and discipline. Since this is so vital to our credibility I would like to review with you this evening the present scope and effectiveness of existing regulatory machinery and what future developments might be expected.

At the present time the regulation of our profession is carried out by a variety of jurisdictions. It starts with the official licensing bodies which are, of course, the state boards of accountancy. The state boards have the power to suspend or revoke a CPA's legal right to practice. To provide a basis for disciplinary action the boards have generally established codes of ethics under their statutory powers.

In general, the state boards are not very effective in surveilling the conduct of CPAs. Disciplinary actions are few in number. Complaints are seldom filed and the boards rarely instigate actions on their own initiative. There are exceptions, of course, but these tend to be limited to extreme cases where CPAs have been convicted of crimes.

The ethics committees of the state societies provide a second level of regulation. Each society has its own code of ethics which may or may not be wholly consistent with that of the state boards and the Institute. The disciplinary machinery of the state societies more often than not is also relatively ineffective. Generally, those complaints which are dealt with, involve infractions of the advertising and solicitation rules or criminal convictions. Cases involving failure to observe technical standards are rare. Moreover the strongest sanction at the disposal of the state societies is to suspend or expel a CPA from membership. As one member recently observed, this is closely akin to being slapped on the wrist with a wet noodle.

The professional ethics division and trial board of the Institute constitute a third jurisdiction. Although a considerably greater number of disciplinary actions are taken by the Institute than either the state societies or state boards, the bulk of such actions also involve either infractions of the behavioral rules or criminal convictions.

Many of the profession's critics have begun to ask why it is that the Institute is not disciplining those CPAs who are involved in the widely-publicized liability suits. Almost without exception the complaints filed in civil damage suits against CPAs contain accusations that if sustained, would warrant drastic punishment for failure to live up to the technical standards set by the profession.

The answer is that disciplinary action <u>is</u> being taken where the suits have been settled before trial or where litigation has run its course. But in the vast majority of cases, where litigation is in progress, the ethics division has little choice but to await its conclusion.

The ethics division does not enjoy privilege. Since its records and actions are all subject to discovery actions by plaintiffs' lawyers the attorneys representing CPA defendants insist that their cases not be discussed with the ethics division prior to trial.

At this point the division is faced with a choice between deferring action or suspending or expelling the CPA from membership in the Institute. The lack of subpoena powers leaves the division powerless to proceed. To expel a member for refusing to prejudice his case prior to being tried in a civil suit does not seem to be a reasonable alternative to pursue.

Several critics have observed that under these circumstances the profession is abdicating its self-regulatory responsibilities and leaving it to the civil courts to protect the public, at least insofar as adherence to technical standards is concerned. While this charge may be an overstatement, it is difficult to refute. This is a matter which I would like to come back to after I have mentioned the other regulatory jurisdictions which affect the CPA.

There are a number of governmental agencies which also can subject CPAs to disciplinary proceedings. Principal among these are the Securities and Exchange Commission and the Internal Revenue Service which can enforce adherence to prescribed filing requirements. CPAs can be barred from practice before these agencies if they fail to meet the government's standards. Such actions have serious implications for the CPA even though the jurisdictions of these agencies are somewhat limited.

The powers of the Securities and Exchange Commission also extend to the setting of financial accounting and reporting standards which must be observed by CPAs. The Commission has, at least in theory been content in the past to leave standard setting to the profession. However, there has been an ever present threat of action by the

Commission if the standards adopted do not meet with its approval. Therefore, it is less than realistic to assert that the profession has, in fact, been free to set its own standards.

Additional bodies which have the power to bring sanctions against a CPA are the stock exchanges which can refuse to accept financial statements audited by a CPA found to be deficient in his work. While such action seldom occurs, the possibility exists and CPAs are aware of its potential.

Perhaps the most powerful regulatory force of all is the threat of either civil or criminal litigation. This, of course, is not the same as organized regulatory machinery under an official body. But its impact is such as to be of very high concern to auditors and it cannot be overlooked as a potent factor in any discussion of the profession's ethics and regulation.

It should be clear from this array of potential discipline that under present circumstances our profession is not what could be characterized as self-regulating. If brought under intensive scrutiny, our internal efforts are likely to be regarded as being generally weak and ineffective in protecting the public interest.

On the other hand, external forces stemming principally from governmental agencies and the civil courts have a substantial effect on the conduct of the profession.

However, regulation by outside bodies is piecemeal and sporadic in its coverage and does not apply to the entire fabric of public practice.

External regulation, in its present forms has characteristics which are undesirable. For example, the sanctions which may be applied tend to be excessively harsh. An SEC 2(e) proceeding or injunctive action against a CPA is drastic medicine for anything short of outright fraud. A multi-million dollar class action damage suit is also a case of overkill where the CPA has been acting in good faith even though his work may have left something to be desired.

The application of discipline by outside parties also has the undesirable effect of eroding the reputation and credibility of the profession beyond that which may be warranted by the circumstances. It provides ready material for people who consider sniping at auditors the "in" thing, the height of fashion, and an easy bid for applause. Such people write articles suggesting that auditors are, at best, spineless and inept or, at worst, in collusion with their clients to mislead the public. None of these allegations is true. They are penny-dreadful stuff meant to titillate the credulous. Unfortunately all too many are anxious to embrace these false charges and to repeat them as gospel. The effect on the profession's image is devastating.

By now you are probably beginning to wonder where all this leaves us and where do we go from here? One thing is clear, the regulation of our profession is a jungle of jurisdictions fraught with multi-jeopardy for the same offense. Punishment is either so excessive as to be persecution or so minimal as to be meaningless. The effectiveness of disciplinary machinery is so uneven as to neither adequately protect the public nor provide justice to the profession or its members. In a word, regulation is a disorganized mess.

When matters of such importance to the public interest as regulation reach a state of disarray they are not likely to escape attention for very long. In my opinion, a day of reckoning for our profession is already on the horizon and approaching rapidly toward high noon. There are many reasons why I hold this view and I would like to cite them for your consideration.

In our present environment protection of the consumer and the public interest is the watch word. This is more than mere rhetoric. The SEC and the stock exchanges have been under severe pressure to institute reforms ever since the plunge in the securities markets in the late 1960s. The Moss and Williams committees of Congress have been intensively investigating how well the SEC has been doing

its job. The SEC, under the aggressive leadership of Chairman Casey, has, in turn, been reexamining the entire securities industry and exerting heavy pressure to bring about reform.

It may be that all this activity has so diverted attention to others that the accounting profession has temporarily escaped being the main target. But there is ample evidence that our turn is coming.

At our annual meeting in Denver, Mr. Casey gave us a strong warning that he expected us to make significant improvements in carrying out our responsibilities and that the Commission's patience was wearing thin.

Recently, the Institute was requested by the SEC to consider how the profession might carry out reviews of the effectiveness of quality control policies of CPA firms who agree to submit to such examinations as part of a settlement under 2(e) proceedings. Whether or not this request is part of a plan for more extensive regulation it certainly has such implications. A special Institute committee is currently studying this matter. It is too early to predict what may be the outcome of its deliberations.

The Commission has also been mounting a strong campaign for more and more disclosure of information in connection with financial reports. The current hearings

on the desirability of including forecasts in annual reports is an example of this trend. Much of the information being suggested for disclosure does not lend itself to objective verification. Nevertheless, auditors are being pressured to express subjective opinions about the quality of such information to provide a safeguard against improper manipulation by management. It is relatively easy to project that a hard look at the regulation of auditors is likely to evolve from these new developments.

Not all of the concern stems from the SEC. Congress, in setting up the Cost Accounting Standards Board under the General Accounting Office, no doubt had more in mind than just setting cost accounting standards for defense contractors. The GAO itself has recently promulgated auditing standards to be followed in performing audits of government social welfare programs.

Many of the governmental agencies responsible for administering grant programs have been critical of the quality of audits being performed for them by CPA firms.

The New York Stock Exchange is currently considering requirements for listed companies to include a great deal more information about their operations in their annual reports.

The barrage of adverse publicity continues every time there is a new lawsuit against a CPA firm or there is a dramatic collapse of a publicly-traded company.

The questions about the effects of consulting services on independence continue to be raised and may well lead to the more basic question of how the profession should be regulated.

All of these developments, as well as others, cause me to reach the conclusion that stronger medicine for the profession is just a swallow away. To suggest what actions we ought to take to deal with this possibility is a complex matter involving many considerations. However, I would like to make a few observations about how we might proceed.

First of all, it is likely that under any system of external regulation on the profession will still want to maintain its own internal disciplinary machinery. This being the case, the restated code of ethics represents a good first step toward improvement. This is the document which tells the public how we intend to conduct ourselves. It is likely to set a pattern that can also be adopted by any external regulatory body. I hope that you will not only vote for the new code yourself but that you will urge others to do so as well.

Based on my earlier comments it is also evident that a combining and integration of the disciplinary machinery of the state societies and the Institute should be considered. A proposal to accomplish this is about to be exposed by the Institute's ethics division for discussion within the profession. I hope that when this proposal reaches your attention you will give it your full consideration in the light of my remarks this evening.

Even if a new code and a streamlined organizational structure is adopted our internal regulation will fall short of being adequate if privilege, subpoena powers and limited liability for civil damages are not available to us. None of these can be obtained without some form of legislation. Accordingly, as dangerous as it may seem, it appears inevitable that some form of legislation must be sought if an orderly and satisfactory solution to regulation is to be attained.

If others are becoming concerned about better regulation of CPAs, as I have tried to demonstrate, they will almost certainly seek a solution through legislation. It behooves us, therefore, to consider whether we ought to take the initiative in seeking to bring order out of what is now a chaotic pattern of regulation of the profession. Certainly our posture would be far better if we take the lead rather than having something imposed upon us.

Other factors also dictate that this course of action be considered. We are being pressured by the movement toward disclosure of supplemental information in financial reporting to express subjective opinions about the quality of such information. Expressing opinions on matters which do not lend themselves to objective verification can only aggravate an already serious liability problem. If we are to meet the increasing public demand for subjective judgments by independent professionals we will have to find a solution to the liability problem.

A further consideration is the fact that examination and licensing is now carried out by all of the fifty states. In many states there are well organized attacks by non-CPAs seeking to reduce the requirements for public practice. Defeating these attempts is a time-consuming and expensive task when there are so many separate jurisdictions involved.

Regulation at the state level of what is largely an inter-state profession also poses problems of uniformity in examination grading and reciprocity.

Taken together, all of these considerations seem to point toward the need for a Federal public accountancy act. I am not prepared to suggest when or how this might be pursued but I do have some thoughts about what might be included in such legislation. It might, for example provide

the following:

1. Establishment of a Federal Accountancy Board to perform those things which state boards presently handle such as conducting examinations, issuing a federal CPA certificate and carrying out disciplinary proceedings.

2. Require audits of all business entities over a specified minimum size to bring under independent review the large number of companies that presently fall short of the SEC's filing requirements.

3. A statutory limitation of liability for civil damages coupled with privilege and subpoena powers for the disciplinary actions of the Federal Accountancy Board and the Institute's ethics division and trial board.

4. Authority for the Federal Accountancy Board to act as the sole regulatory body of the accounting profession in behalf of all federal agencies an in all matters involving inter-state commerce.

I am certain that at first blush these thoughts sound too radical to merit serious consideration. You may

quickly point out that to seek this type of legislation runs the grave risk of standards of practice being set by government. If you examine this carefully, however, you may come to the conclusion that government is already calling the shots through the power of veto. Thus any change stemming from legislation might be more in appearances and a shift in emphasis rather than in substance. In any event, standards embraced by a governmental agency might provide a far more certain defense in liability suits than those promulgated solely by the profession.

You may also scoff at the notion that in this day of consumer protectionism Congress could be pursuaded to pass legislation containing some measure of immunity for the profession. I believe, however, that a strong case can be made that the public interest would be much better served by providing the backing necessary for the profession to carry out its policing role.

Even if the odds of success are small it might be better to take affirmative action than to allow ourselves to drift into an involuntarily imposed program of regulation that would be far more stringent.

I don't anticipate that these bold thoughts will immediately receive widespread acceptance. Neither do I contend that they are well developed or necessarily the only

alternatives that might be considered. However, I am firmly convinced that the time is growing short before we come face to face with government scrutiny and some form of more extensive regulation than presently exists. For this reason I feel obligated to call my concern to your attention and to suggest that we embark on an intensive study before it is too late to take voluntary action.

If I have helped bring into focus the true dimensions of the importance of ethics and regulation then I have achieved my mission this evening. I hope that you will share my concerns and help support the new code of ethics as well as other actions that may be taken in the future to make ours a better and more effective profession.