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NAVIGATING IN CHANGING CURRENTS

by

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NAVIGATING IN CHANGING CURRENTS

When Waldo Sowell asked me to appear on your program I suggested that I might talk about "navigating in changing currents." It seemed like a good idea at the time but I must confess that right now I am completely at sea about what I had in mind. Perhaps it was the memory of my service in the U.S. Navy that led me to believe that I knew something about navigation.

But navigation in terms of steering a ship as compared with charting a course for the future of a profession are two completely different things. Channels, shoals and coral reefs are relatively static and can be charted with considerable accuracy. But deciding whether the profession should veer to the port or starboard or continue steady as she goes -- or whether it should go full or half speed ahead -- or full reverse is quite another matter. The confusing array of events that have been cascading over the world, our country and our profession, in particular, causes one to wonder whether anyone can plot a course with any acceptable degree of assurance that it will be a safe one.

However, being a reckless type, I shall attempt to lay out the course that I think the profession is apt to navigate over the next few years journey and some of the hazards we

are likely to encounter. In the event we run aground or get hung up on a coral reef I trust you will lay the blame on the elements or a drunken helmsman and not on the navigator.

For the benefit of you CPA types who are land-lubbers and wouldn't understand nautical terms I am going to discuss a possible route in terms of a forecast for the profession. Of course, some of you aren't too anxious to be associated with forecasts either. But those of you who have prepared forecasts know that the first thing you have to do is to make some assumptions. My first assumption is that I am among friends. I hope I can speak freely without fear of being regarded as having taken leave of my senses.

Let me begin by observing something that is reasonably safe. Our profession is in the waning stages of adolescence and is suffering all the pains and mixed emotions about becoming an adult. We yearn for the status quo but natural forces are propelling us into assuming all the responsibilities of a grown up. Like Gigi, we have bloomed into full flower and all of a sudden everyone is noticing us. I should add however that the analogy is a poor one because it is clear that not everyone has fallen in love with us. Perhaps it might be more accurate

to say that some regard us as an enticing candidate for rape.

Clearly, recognition of the importance of our role as attestors has become widespread. Those involved in the functioning of our capital markets have become acutely aware that fair financial disclosure is fundamental to maintaining investor confidence and assuring an adequate flow of capital.

There is abundant evidence of this increased visibility and recognition. I hardly need remind you of the constant publicity about the profession which appears in the Wall Street Journal, Business Week, Forbes, Fortune, the New York Times, Barrons and major newspapers all over the country. Neither do I have to call to your attention the substantial volume of litigation where CPA firms are the defendants in both criminal and civil actions.

Perhaps not as well known is the often scathing criticism of the profession that is prevalent in governmental circles where we have become a visible and attractive target for criticism.

Other evidence of our visibility is the fact that the first stirrings of disclosures about CPA firms have

emerged. I refer, of course, to the issuance of annual reports by one or two of the big eight. I think such disclosures will become common place, if not required.

I believe that these developments are merely reflections of basic changes in our economy and in our society in general. The public's demand for greater accountability, the growing intricacy of business transactions, the highly developed techniques of capital raising, the more elaborate entity structures and the seemingly irreversible trend toward greater governmental intervention -- all lead to a single conclusion. Our profession is and will be in great demand to provide the watchdog services that are so badly needed. And that demand is and will be accompanied by an increasing visibility and concern about how well we perform.

Like the adolescent that we are, much of the profession would prefer to go back to not being noticed quite so much. But there is no way to hold back the maturing process and the sooner we recognize this, the better.

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My second prediction stems from the same forces that have so abruptly shoved us into the spotlight. We are and will be under escalating pressure to find ways to provide greater assurance of the reliability of financial information.

Growing sophistication in business circles has been accompanied by a mounting list of spectacular business failures that have resulted in massive losses which were largely unheralded. It should come as no surprise that there is widespread concern about how to avoid these catastrophes in the future and about the effectiveness if not the independence of auditors.

It is difficult to generalize about the root causes of the absence of advance warning of these failures. During the 1960s the hue and cry was for more and better accounting standards and the APB struggled mightily to deliver. But the poolers, the franchisers and the real estate developers were always a few jumps ahead. In more recent times the SEC staked out disclosure standards as their bailiwick while the FASB was gearing up to replace the APB.

It remains to be seen whether the problems of investor and creditor losses can be satisfactorily overcome by more and better standard-setting in accounting. Unfortunately rules generally beget more rules because they invite loop-hole seeking. Furthermore, they have had the tendency to cause auditors to feel secure when the rules have been complied with, thereby blunting the

obvious need to look to substance rather than mere compliance with rules.

I don't advocate that we abandon all standards or the attempts to improve them. But I predict that a vast array of complex and minute accounting rules will repress the exercise of judgment and by themselves will fail to provide the early warnings of impending disasters that are being sought.

I am not, however, optimistic about the prospects for a slackening in the drive for more and more definitive standards. The SEC is proceeding on the basic assumption that more and more disclosure will protect the mass of investors. This may not be a totally valid assumption since there is reason to believe that too much information is self-defeating. Also there is basis for doubt as to how much reliance the average investor places on his own analysis and understanding of financial statements.

The Commission has lately been extolling the virtues of what is called "differential disclosure" which is another way of saying that the sophisticated analyst needs more information than the average investor. If this concept prevails we will witness the inevitable result of multiple financial report formats to meet the needs of diverse users.

I predict that at some point in time it will be recognized that a far more effective solution lies in the direction of an expansion in the role of auditors. This is already foreshadowed by the prevalent view outside the profession that auditors ought to go beyond expressions of opinions of mere compliance with standards. Responsibility to evaluate and report on economic substance is what third party users are seeking. And the next step is to go beyond expressing opinions on the reliability of data to drawing conclusions about the meaning of the data presented.

When this point is reached the auditor's role will have been transformed to that of an independent analyst and reporter on a company's affairs. I hasten to add that present day financial analysts would not be supplanted by this transformation since their expertise in the securities markets would continue to be required.

In this day of unlimited liability it is unlikely that our profession will embrace such a role with enthusiasm unless some relief from liability exposure is granted. However, I submit that an expanded role could have the effect of dispelling the present damaging misconceptions about the preciseness of financial statements. Furthermore, expressing conclusions about the meaning of reported

financial data would force auditors to make the kind of judgments that would be based on substance rather than form and therefore withstand legal challenge.

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Another concern that has been slower to emerge than that related to accounting standards has been the question about the effectiveness of auditors and auditing procedures. The Equity Funding debacle has brought loud demands that auditors accept responsibility for the detection of all material frauds. Although the profession has denied responsibility for such an absolute guarantee in the past I doubt that the demands will be dispelled by repeating the dogma contained in our pronouncements. The profession will ultimately be forced to draw a distinction between responsibility for detection of fraud and the impossibility of providing iron-clad guarantees. Auditors cannot logically deny responsibility for remaining alert and detecting frauds under circumstances where they should reasonably be expected to uncover them. They can, however, disclaim responsibility where the facts support the conclusion that the alert application of auditing procedures would not have revealed a fraud.

The growing volume of business transactions between related parties promises to be another major hazard for auditors.

Those who are bent on perpetrating fraud have discovered this device as an effective means of carrying out and concealing their schemes. This compounds the problems that must be solved in the attest area.

All of this leads to my next prediction that our profession will find it imperative to bring an increasing array of skills to bear on the performance of audits. Appraisers, actuaries, engineers, economists, lawyers and behavioral scientists, to name a few, may all have to be employed for various phases of an audit. Computer specialists and statistical sampling experts have already had their impact on auditing.

Not all of these skills will necessarily be represented on the payrolls of CPA firms. But it seems more than likely that at least some of the more frequently needed skills will be maintained in house. Thus it seems inevitable that a multi-discipline approach to practice will be the way of the future even if the services of CPA firms were to be restricted solely to the attest function.

It is this conclusion that has led the Institute's Scope and Structure Committee to the opinion that the profession must begin the task of establishing accreditation machinery

for specialists in the various disciplines. If such accreditation is equal in stringency to that of the CPA exam it will provide a basis for bringing persons from the various needed disciplines into the mainstream of the profession through some form of status in the Institute. It will also bring uniformity to what is now diverse de facto specialization and provide the opportunity for the smaller practitioner to attain specialist status.

I predict that the profession will move forward with the development of specialization examinations. Furthermore, I foresee the eventual creation of status in specialist divisions in the Institute for persons who pass most parts of the CPA exam plus a stringent specialization examination. These examinations would be conducted in behalf of the Institute for specialists who cannot meet the experience or educational requirements of the various State Boards of Accountancy because their education was concentrated in a discipline other than accounting.

CPAs would, of course, be eligible to take the specialization examinations. Success in passing the examination would entitle a CPA to be designated as a member of a specialist division of the Institute.

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I would like to return for a few moments to the subject of more effective audits to make another projection for the future. There is reason to expect that the expectations and demands of the public for more effective audits will both precede and exceed the ability of the profession to deliver. If this gap is substantial, which I believe it currently is, there is likely to be a strong groundswell for more stringent regulation of the profession. Evidence of this is already visible in the form of the SEC's stepped up sanctions and imposition of quality control reviews and its recent attempts to insert explicit regulatory powers in the American Law Institute's recodification of the securities statutes. It is not unreasonable that Congress, in its concern about the capital markets, might also get in the act if it becomes clear that the profession's self-disciplinary machinery is not sufficiently effective.

Couple this with a scenario of a growing erosion of the state accountancy statutes and the likelihood of political action backlash from FASB pronouncements and you can begin to see the makings of a shift from state to Federal regulation. While I do not predict that we are apt to take the initiative to seek Federal legislation for our profession, I urge that we give strong consideration to doing so.

Federal accreditation and licensing is long overdue and is needed to overcome the problems of dealing with over 50 political jurisdictions. We also need a form of Companies Act to strengthen the hand of auditors and to clarify audit requirements. A Federal Board of Accountancy could provide these things as well as needed strength to an NASD type of self-regulation. Such a board could utilize the present state boards for administering examinations and providing a basis for issuing a Federal certificate that would be required for interstate commerce engagements.

If we are unwilling to take this initiative we are apt to get a form of involuntary Federal regulation that all of us would find unacceptable.

* * *

It is a paradox that in the face of all these pressures for the profession to do better, there are also strong pressures for it to perform additional services. Most of these services fall in the category of a need for some form of middle level of assurance. Association with interim financial reports of publicly held companies, forecasts, comfort letters for stub periods, reporting on social responsibility and GAO standards regarding reporting on economy, efficiency and effectiveness of government

grant programs are all examples of where we are headed. Similarly, there seems to be a demand for a greater variety of management consulting.

It takes very little courage to project that the profession's scope of services will continue to expand in the future. Despite representations to the contrary, CPAs are in fact already involved in a broad range of activities whose only apparent common characteristic is that of expressing opinions and providing advice on accounting for and management of resources for the production of goods and services. There is nothing inherently wrong about this and I believe that over a period of time CPAs will come to regard themselves less as exclusively accountants and auditors and more as broad-gauged consultants on business management encompassing all of the present services.

Whether or not some of my projections come true, it is increasingly evident that the profession must find ways to either reconcile or else meet the diverse needs and interests of its membership. The needs of national firms have become in some respects sufficiently different from those of the local and regional practice units so that we are finding it more difficult to serve all members in the same manner.

Splitting up into separate groups is not a satisfactory answer in my view. But I am not certain that reconciliation of interests is a totally achievable alternative. We certainly need to give more attention to the special needs of various groups including the CPAs in industry and government. My prediction in this area is that we will move toward establishing separate committees and task forces to deal with those areas where divergent needs exist. We are already experimenting with this on a limited basis and I believe it may prove beneficial.

* * *

I have left my predictions about continuing professional education to last because whatever happens in the scope and structure of the profession will have a profound effect on the educational effort.

If the profession does in fact embrace the notion of being multi-disciplined and if it proceeds with recognition of specialization, the type of education necessary will be greatly effected.

Preparation for entrance to the profession may have to take on a broader coverage of the management sciences with less intensive concentration on accounting and auditing. Thus if schools of professional accounting are established the curriculum may involve a broad range of subject matter.

Under these circumstances continuing education would become an even more important factor in providing intensive how to do it training in accounting and auditing. In addition the inventory of courses would have to provide wider coverage of the various kinds of management techniques to provide the basis for CPAs to become accredited in more than one type of recognized specialization.

The content of the CPA examination might also evolve into coverage of a wider range of subject matter to reflect a profession based on multi-disciplines. This would, in turn, have some effect on the educational preparation for entrance to the profession.

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To summarize my forecast for the profession, I have predicted the following:

1. Our visibility and the importance of our role will continue to grow at an accelerating rate.
2. The drive toward more extensive and detailed accounting standards and reporting disclosures will continue unabated but will not be wholly successful in achieving their objectives because rules alone are not enough.
3. The role of the auditor will evolve into expressing opinions about the meaning of the data contained in financial reports. In short he will

become an analyst and reporter in addition to being an attestor.

4. A greater array of skills will have to be brought to bear on the audit function to develop more effective techniques of fraud detection and to support an expanded role as an analyst reporter.
5. We will gradually come to accept the concept that our profession is based on several disciplines and will adjust our approach to how we should be structured and will provide alternate routes for gaining status in the profession.
6. We will move toward accreditation and formal recognition of specialization in the not too distant future.
7. We are likely to have more stringent regulations imposed upon us if we fail to take the initiative ourselves. We may find it desirable to seek a form of Federal legislation that will help strengthen the effectiveness of our audits and solve many of our present licensing, disciplinary and liability problems.
8. Our scope of services will continue to expand in the future and we will tackle a whole new family of engagements that involve providing some middle level of assurance.

9. We will move further toward establishing separate committees and task forces to deal with the divergent interests that exist within the profession.
10. Education at the universities and our continuing education programs will be forced to provide a broader coverage of management techniques in their courses. As a result, continuing education will have to pick up the slack in providing more intensive training in accounting and auditing.
11. The CPA exam will evolve toward coverage of a broader range of subject matter.

The profession is on the threshold of becoming an adult and must accept all the responsibilities that this transition implies. It needs to learn to strike a better balance between client interests and public needs.

We will go on to far greater achievements in the future but to do so, we need to adopt a more receptive attitude toward adjusting to the changing currents in our society.

The increased tempo of problems to be solved is but a manifestation of the growing importance of our role. Our future has never been brighter, providing that we navigate with great foresight and quick reflexes.