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Accounting Heresy: The Sec As Standard Setting Body

Irrational Fears Of Government Take-over Are Concealing Some Of The Advantages

By Ronald L. Madison and William J. Radig

Accountants, financial analysts, businessmen, those from academia, and representatives from various governmental bodies have been debating whether the setting of accounting standards should be moved from the private to the public sector. This is an important question to all concerned, because in talking about standards, we are including not only rules and regulations but, to some extent, postulates, concepts and the entire area of accounting theory. This broad view is taken because all of the foregoing terms are only vaguely defined and have different meanings to different groups. In the final analysis, the group or individual that has authority over standard setting has the power to define terms such as "general acceptance" and "substantial authoritative support" and exercises great, if not overpowering, influence over all of accounting theory.

The purpose of this article is to dispel some of the fear readers may have over governmental control of the standard setting function and to present the Securities and Exchange Com-

mission (SEC) as a body that could logically perform this function most efficiently in the best interest of the general public. Despite conclusions reached in the report entitled, "The Accounting Establishment", by the Metcalf staff, it appears the SEC is the logical arm of the government to have authority over accounting standards. In this staff report, it was suggested that some other governmental agency assume the standard setting role because the SEC had been too close to accountants and business leaders.¹ We feel this objection would be overcome by the awareness of newly exercised power, prestige and responsibility if the SEC were given the task. Obviously, the SEC is aware of Congressional feeling in this area. The SEC already has a well established reporting, control and informational network. It would seem logical that this avenue would be most efficient. As pointed out in the Metcalf Subcommittee Report, the SEC stated that it already has Congressional authority under the Securities Act of 1933 and the Securities Exchange Act of 1934 to

do the following:

- a) Set accounting and auditing standards
- b) Require public accounting firms to register with the SEC and to publish financial statements
- c) Discipline Certified Public Accountants (CPAs)
- d) Use subpoena power to obtain records of CPAs and their clients
- e) Order divestiture of the Management Advisory Services (MAS) portion of the CPA's business
- f) Promulgate standards of independence for CVAs
- g) Require audit committees for public companies
- h) Assure that the auditor's report clearly informs the public of deficiencies and uncertainties and require disclosure of the effects of alternative accounting standards in corporate financial statements.²

With the above organizational system presently available, it would appear reasonable that the SEC would be the proper arm of the government to set standards, should we decide to move in the direction of public sector control. In the private sector, the Financial Accounting Standards Board (FASB) seems the logical organization with which to make comparisons due to their current position of authority and esteem in the accounting profession and business world.

Consider the most prominent arguments against the SEC. If we can refute or minimize the significance of these arguments, we may dispel some of the irrational fear that various groups exhibit when responding to the suggestion of governmental intervention in the private sector.

The SEC Would be Inflexible to Changing Needs of Business, Investors and the Accountant

This criticism is not unique to the SEC as it has been used by some CPAs in showing their displeasure with the FASB and the American Institute of Certified Public Accountants (AICPA). The argument of inflexibility is advanced by CPAs practicing individually or with small-to-medium-size firms. Such complaints were heard at the 1977 AICPA annual convention, various American Accounting (AAA) meetings and at meetings of the West Virginia Society of Certified

Public Accountants. While this does not refute the argument against the SEC, it does suggest that we would not be at any greater disadvantage under SEC authority, relative to our present position under private (AICPA, FASB) sector control.

Let us consider the history of the SEC's relationship with the private sector. As previously stated, the SEC has had broad substantial statutory power for over forty years. However, it has generally exercised restraint and has been flexible over this long period in working with business and the accounting profession in allowing the private sector to work out numerous problems and establish accounting standards. It is true the SEC has exerted pressure on these groups upon occasion, but this is to be expected considering their broad charge by Congress. Most CPAs and businessmen will admit the SEC has used its veto power sparingly. Most informed individuals give the SEC good marks for having a sophisticated, dedicated leadership and they concede that rules and regulations reflect, for the most part, input from the private sector. In fact, a recent study by Joshua Ronen and Michael Schiff disclosed that the SEC received its highest marks in the areas of expertise and competence and this was from all survey groups.³

The SEC Would Cost More

The FASB has an annual budget of approximately \$5 million dollars, more than half of which is consumed in salaries and employment costs.⁴ We can find no specific dollar studies that attempt to prove that an SEC operation would be more costly. In fact, it would seem that the SEC could perform FASB functions within the same employee and dollar cost framework now in existence. Effectively, the total cost incurred would remain in the private sector. Taxpayers would have to support an increased SEC budget. However, under present FASB funding methods, the funds provided by the large CPA firms, by corporations and other interest groups, are ultimately recovered through higher fees and increased product prices that are ultimately the burden of the general taxpaying public.

Certain FASB costs might be reduced under the SEC. One example is that the \$100,000 annual salaries of Board members are above government maximums. Others costs, such as leased space or equipment, may be

reduced through elimination of the present dual FASB/SEC areas of responsibility.

Past Dissatisfaction With Government Regulation

Critics point to the operations of such governmental agencies as the Interstate Commerce Commission (ICC) and the Federal Power Commission (FPC), noting their bureaucratic mess, characterized by occasional scandal and endless red tape. As previously discussed, the SEC has historically not been this kind of agency. Therefore, it should not be classed with the other governmental types such as the ICC and FPC. There is some precedent for the type of reasoning which permits the exclusion of certain agencies from the overall stigma of inefficiency attached to governmental units. Similar to the SEC, the Internal Revenue Service (IRS) is another agency which commands respect. The IRS has received criticism from CPAs, business and others over the years, but not to the extent of that aimed at the ICC, FPC and some others. While the tax laws and the regulations are complex and subject to interpretation, many people feel that the IRS does a good job in administration and enforcement, considering the vast array of taxpayers and IRS importance in meeting the revenue needs of the entire country. CPAs have learned to adapt and work well with the IRS, with a minimum of friction. So far as the entire regulation aspect is concerned, some accountants, notably those in the academic world, are dissatisfied with the present regulation by the FASB. It may be appropriate to concede that the complex needs of our society today call for more government regulation than in the past.

Self-Regulation of the Profession Will be Sufficient

This argument simply defies reality. Not that the accounting profession has not endorsed and applied self-regulation in the past; it has simply not done it well or on a timely basis. Earlier gains in credibility based on the absence of friction, trouble and lawsuits, from both within and from outside the profession as well as the level of public esteem, have been wiped out by the well publicized excesses, lapses and other events of the recent past. As a result there were a number of recommendations in the Metcalf Subcommittee Report, such as:

It may be appropriate to concede that the complex needs of our society call for more government regulation than in the past.

- a) A quality review program for CPAs
- b) More openness by the FASB
- c) Segregation of the profession into those groups having SEC clients and others.⁵

The accounting profession has reacted to the above and to other such recommendations, but only after prodding and the ever present fear of SEC takeover. The Chairman of the Structure Committee of the Financial Accounting Foundation reported that his Committee had made certain recommendations to the FASB, which that body has agreed to adopt. They are as follows:

- a) Future discussion memoranda will have a "businessman's summary" in plain language
- b) The FASB will hold more open meetings
- c) The veto pressure of CPAs will be removed; no member of the FASB need be a CPA
- d) There will be FASB study in the area of friction among academic, industrial accountants and public accountants.⁶

There have been other well publicized reforms such as the quality control program of the AICPA and greater emphasis on required continuing education for CPAs. Sadly, these much needed reforms are a reaction of the profession to what is considered a threat of government takeover. If accountants had really been concerned, these reforms could have been voluntarily introduced over the past 40 years as the actions of a deeply concerned profession.

We Have Too Much Government—Nobody Wants any More

In the Ronen/Schiff survey mentioned earlier attention was drawn to

Specific Advantages

The SEC Would be More Independent

Willingham and Carmichael refer to independence as, "... the hallmark of the auditing profession."⁹ Mautz and Sharaf devote a full chapter of their book to independence, noting that the appearance of independence is as important as independence in fact.¹⁰ Independence is a prime concern of not only the accounting practitioner, but of the FASB as well. It is considered vital that the standard setting body be considered independent if the financial community, government, or general public are to have a high level of confidence in it. The FASB has been criticized from the beginning in this respect since it is dependent for funding primarily on the large CPA firms and on large corporations. The FASB may well be independent in fact but fails the test when it comes to the appearance of independence. The dilemma of the profession and the FASB is obvious; no alternate source of funding has been found. Many spokesmen for large CPA firms have said they would like to reduce their contributions but have been unable to do so since no alternate source seems to be available. With the SEC, this problem would be resolved since funding would be from general tax revenues.

SEC Would Offer Greater Acceptability

Under the SEC, new meaning would be given to generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). Particularly as regards GAAP, these principles are only vaguely defined and are of such a variety that "substantial authoritative support" can be claimed by so many that the term loses its meaning. Under current reporting practices, only GAAP as stated by the FASB (and its private sector predecessor, i.e., APB, CAP) are acceptable without disclosure by the independent accountant; a procedure vehemently opposed by academicians and some others.

The SEC could be expected to act in a definitive manner, but it should not be expected to act in haste. In a relatively short time there should be an orderly listing of GAAP, GAAS and accounting rules, procedures and methods. Some flexibility in choice of procedures may be anticipated but not to the extent of current practice. All of these changes would add com-

parability and would give greater meaning to the principle of full disclosure. With the force of law behind it, the SEC would bring order to a profession that has seemed to be confused and subject to so many outside pressures in its choice of principles and procedures. The new order need not stifle creative thought or prohibit the development of new or more sophisticated theories; research and writing would still go on and the SEC could change the law in response to professional need.

A committee of the American Accounting Association (AAA) chaired by Yuji Ijiri recently reported that several pronouncements of the FASB which were most controversial were issued with minimal referral to reliance upon available research.¹¹

The SEC would also be able to do more for the establishment of international accounting standards. As a governmental agency with the necessary legal enforcement powers, it would carry more weight on the international scene than either the AICPA or FASB. It should be noted that the accounting standards and procedures in many countries are under the control of the central government. Another point to consider in this discussion of expanded SEC influence is the present limit of SEC power to those companies required to register with the commission, primarily the larger public corporations. The list of companies has been expanding in the past several years as the SEC has spread its influence. It would be a simple matter for the Congress to extend SEC jurisdiction to virtually every business entity in the country. Even if this were not done, the fact that the SEC would be setting the rules under which the larger businesses operate would result, in the long run, in the smaller units also adopting these rules as has happened in similar government moves in France.¹² It would not seem very logical to have differing sets of GAAP or procedures. One could even envision the SEC moving into areas other than business reporting; for example, the not-for-profit entities. The accounting profession might well regain its lost public esteem and grow in stature with the leadership provided by the SEC.

SEC Could Aid CPAs in Lawsuits

By setting a rather definitive list of standards and procedures within which business reporting would take place, the SEC would give public ac-

A new order need not stifle creative thought, or prohibit the development of new or more sophisticated theories.

favorable SEC comments; however, the survey results showed far more respondents favor keeping the standard setting in the private sector. It must be noted that private sector favoritism declined as the survey moved from CPAs to lawyers and those classed as financial reporters. One can obviously understand the bias of the CPAs. In a recent article, former SEC Commissioner A. A. Sommer, Jr. said the increasingly predominant American public opinion looks for a reduction in government regulation.⁸ This is such a sweeping statement that one can doubt its validity. If we can judge American public opinion, we will find the public wants government regulation in pension planning, occupational safety, health research and a host of other areas. The public reporting of financial data of major businesses has an impact on securities markets, public and business confidence and expectations, and the entire economy as a whole.

SEC Regulation Means Loss of "Liberty"

Obviously here is an irrational argument that tries to evoke visions of Patrick Henry, Nathan Hale and the colonial fight for freedom. However, it is mentioned because it has been known to arise in heated discussions at professional meetings. The point is stressed that as our society evolved from colonial days to its present complex form of natural and business relationships, we have had to accept the idea that the federal government is best suited to handle national defense, many public health and safety programs and various other matters that used to be our individual concern.

countants a stronger foundation for financial statements and opinions thereon. By exercising the power it already has in the area of overseeing quality control in CPA firms and exercising prompt and firm punitive measures against those who do not measure up to professional standards, the SEC, should be able to weed out the inept and aid in the development of more knowledgeable, more sophisticated professional firms. The foregoing should have the effect of reducing or eliminating "nuisance lawsuits" and give the CPA a stronger defense than in the past. John C. Burton, former Chief Accountant of the SEC, takes one step further in suggesting the possibility of limiting recovery against the accountant to ten times the fee received from the client; he was, however, not suggesting the SEC set this limit.¹³ In a rebuttal argument A. A. Sommer, Jr., says Dr. Burton's objective, "... has the appearance of a piece of peppermint candy extended to the profession . . ."¹⁴ Mr. Sommer says no damages may now be assessed against an auditor for misconduct not involving intent to deceive, based on *Hochfelder v. Ernst & Ernst*.¹⁵ However, he goes on to point out that, "... The American Law Institute Federal Securities Code, which is due to be presented to Congress this year or next year, contains a limitation on damages that would remove a good deal of the terror which civil litigation presently holds for auditors . . ."¹⁶ It appears that we are moving steadily in the direction of some form of limited professional liability.

The Change To The SEC Would Hardly Be Noticed

If the irrational "loss of liberty" argument is dismissed, the advantages discussed so far appear to be clear. We also feel that we have successfully argued against the disadvantages of "myths", or perhaps "terror" of an SEC assumption of standard setting power. One more argument can be considered that may dispel the profession's doubt. While there can be no quarrel with the definition of the FASB as a private organization, it should be recognized that it functions much the same as a governmental agency or, at least, a quasi-governmental unit. The FASB receives input from the SEC and in many cases is subject to the veto power of the SEC. The FASB's "Statement of Financial Accounting Standards No. 16" (prior

period adjustments) is an example of SEC pressure. An example of the veto power of the SEC was the 1964 SEC position on accounting for the investment tax credit. In this case, the SEC sanctioned an accounting treatment previously unacceptable to the FASB's predecessor, the Accounting Principles Board (APB); in the end the APB reversed its position to accommodate the SEC. FASB Statement No. 19, a comprehensive pronouncement dealing with the oil and gas industry, was simply overridden by the SEC when it developed its Reserve Recognition Accounting (RRA). In summary one must wonder if there has ever really been (at least since the 1930's) private sector control over accounting and reporting standards. One must also wonder if functioning under a true governmental agency like the SEC would really involve any severe problems in adapting to the change to governmental control.



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Conclusion

Regulation of the accounting profession by the SEC would lend governmental prestige to financial reporting and accounting theory, standards and procedures. The perceived independence of the SEC and its exercise of regulatory power in the area of definition and disclosure would be welcome changes to users of accounting information. Investors and analysts would benefit from greater comparability, consistency and the greater disclosure for which they have long argued. CPAs would regain public confidence and possibly see a greater extension of their attest function as SEC influence grows; in addition, the implication of some form of limited liability should lift the spirits of the profession. The business community as a whole would benefit from increased public and investor confidence in business reporting which might well result in more confident and more efficient securities markets. ■

FOOTNOTES

¹"Metcalf Report", *The Journal of Accountancy*, March 1977, p.119.

²"Improving the Accountability of Publicly Owned Corporations and Their Auditors — Report of the Subcommittee on Reports, Accounting and Management of the Committee of Governmental Affairs United States Senate", *The Journal of Accountancy*, January 1978, p. 95.

³J. Ronen and M. Schiff, "The Setting of Financial Accounting Standards — Private or Public?", *The Journal of Accountancy*, March 1978, p. 70.

⁴"Professional Responsibilities in a Time of Change", *The Arthur Young Journal*, Special Edition, Spring/Summer 1977, p. 35.

⁵Ref. 2 above, pp. 88-96.

⁶R. E. Palmer, "A Perspective in Accounting Standards and the Role of the FASB", *The Accounting Forum*, May 1978, pp. 14-20.

⁷Ref. 3 above, p. 67.

⁸A. A. Sommer, Jr., "The Lion and the Lamb; Can the Profession Live With 'Cooperative Regulation'?", *The Journal of Accountancy*, April 1978, p. 73.

⁹J. J. Willingham and D. R. Carmichael, "Auditing Concepts and Methods", 3rd Ed., 1979, McGraw-Hill, p. 45.

¹⁰R. K. Mautz and H. A. Sharaf, "The Philosophy of Auditing", *American Accounting Association*, 1961, pp. 204-231.

¹¹"Report of the Committee on Research Impact" (American Accounting Association, 1978z pp. 7-12.

¹²T. H. Beeny, *European Financial Reporting: France*. (London: Institute of Chartered Accountants in England and Wales, 1976) p. 39.

¹³John C. Burton, "The Profession's Institutional Structure in the 1980s", *The Journal of Accountancy*, April 1978, p. 69.

¹⁴Ref. 8 above, p. 75.

¹⁵Ref. 8 above, p. 74.

¹⁶Ref. 8 above, p. 74.