U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Address to

University of Southern California
SEC And Financial Reporting Institute

Los Angeles, California

May 16, 1985

THE ACCOUNTING PROFESSION: THE CHALLENGES OF THE 1980's

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Introduction

I am pleased to have the opportunity to address this distinguished group today. Not only is it wonderful to be back home in Los Angeles, but I am also pleased to be speaking to a group of accountants. I have always had a keen interest in the interaction between your profession and the legal profession in the area of securities regulation. As you may know, in my "past life" as a private attorney, I have represented some of your ranks.

All of us trying to cope with the complexities of today's business world recognize that these are times of great and exceedingly rapid change. Your profession, as one of the fundamental building blocks in our overall economic structure, has been called upon to keep pace with this change. Therefore, I would like to talk to you about three very distinct, and very important, areas of your profession that have been greatly influenced by the enormous challenges you face in today's changing financial world.

These areas are first, professionalism, particularly professionalism as it relates to the management accountant. Second, opinion shopping, a practice that we at the SEC perceive to be on the rise. Third, self-regulation and how it relates to your entire profession vis-a-vis the SEC. Let me get right to my first point -- professionalism.

Professionalism

At the risk of provoking a collective groan, I am going to repeat the Supreme Court's thoughts on the duties of the accounting profession as articulated in its unanimous decision in the in the Arthur Young case. 1/ I do so because I think the court's message goes straight to the heart of "professionalism".

> By certifying the public reports that collectively depicted a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. [emphasis added]

It is imperative that we all focus upon the need for each accountant to perform his or her tasks with the highest professional standards because the accountant's role is far too fundamental to the disclosure process underlying the federal securities laws to permit otherwise. Don Kirk, Chairman of the FASB, has called upon accountants to uphold "professionalism," which he defines as a voluntary commitment to achieve excellence, objectivity and integrity in the accounting practice.

I recognize that nothing could be easier than for the Supreme Court, Don Kirk, and me to urge and insist that accountants strive toward high standards of professionalism. I also realize that there are complex pressures making the accountant's task more difficult today than it has been in the past. For example, many commentators have observed that management is under intense pressure to achieve short-term financial results. Some speculate

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1/ United States v. Arthur Young & Co., _______ U.S. ___, 104 S. Ct. 1495, 1503 (1984).

that this short-term focus is the result of increased participation in the stock market by institutional investors who, it is presumed, have a shorter-term focus than individual investors. 2/ Others, like my former partner, former Commissioner Frank Wheat, assert that short-term earnings must be high to keep the stock price up, and thereby keep takeover raiders away. 3/ Whatever the reason, these pressures sometimes result in accounting practices specifically designed to accelerate revenue or delay expense recognition. These practices may be part of a conscious plan to "cook the books", or simply a by-product of aggressive management putting pressure on subordinates and themselves to meet ambitious goals. But whether the direct result of fraudulent intent or the indirect result of institutional pressure, too many accounting practices being used today are anything but in accordance with Generally Accepted Accounting Principles.

In light of these pressures, I would like to focus today on one particular aspect of professionalism -- namely, professionalism as it relates to managerial or in-house accountants.

2/ See Sloan, "Why Is No One Safe?", Forbes, March 11, 1985 at 137; Testimony of Andrew C. Sigler, Chairman of the Board, Champion International Corp., before the Securities and Exchange Commission, October 31, 1984.

3/ Address by Francis M. Wheat, "The SEC--An Opinionated and and Affectionate Comment on the First 50 Years and What Might Lie Ahead" (November 1, 1984). See also Behr, "Defensive Maneuvers," Washington Post, February 28, 1985, at B.1. (attributing to former Chairman of the SEC, Harold M. Williams, the following statement: "A company that lets its earnings--and stock price--slip by pushing capital into research and other long-range building blocks is asking for a takeover.").

There is presently a distinct division of responsibility with respect to financial reporting. Direct responsibility for the preparation of financial statements rests with management. Thus, managerial accountants must be prepared to support the accounting measurements used in connection with those statements. On the other hand, the auditor challenges those measurements and evaluates the adequacy of management support. While the Commission has continuously stressed the importance of the independent audit to the financial reporting process, it has by no means intended to diminish the significant role played by managerial accountants who have firsthand knowledge of the events and transactions which underlie the financial statements. Because of this firsthand knowledge, managerial accountants must apply the method of accounting which most appropriately reports the substance of a particular transaction. Unlike the independent auditors who, due to cost/benefit considerations, rely on sampling techniques and materiality factors, the managerial accountant should ensure that each and every transaction is accounted for appropriately according to its substance.

The responsibilities of the managerial or in-house accountant are often overlooked because we tend to concentrate attention on the responsibilities of independent auditors. Perhaps, because we have not focused on the role of in-house accountants as opposed to other members of management, we have failed to appreciate the conflict that can arise out of their status as professionals and their position as employees.

A February 1985 article in Management Accounting 4/ captured the essence of the problems facing in-house accountants in the following quote.

> Each day management accountants face issues testing their ethical responsibilities. A management accountant "is basically an interpreter for management and as such, has an obligation to interpret correctly and accurately. What happens when management does not accept interpretations of business affairs as presented by accountants? How should he react when told that the business wants to show a certain profit and it is in his job to juggle the books so that a profit figure can be reported? What is his duty in this situation? ..."

There is no doubt that managerial accountants, like their counterparts in public accounting, face significant pressures. In enforcement cases alleging "financial fraud" more often than not the corporate environment tolerated and even encouraged the reporting of illusory profits. How then should the in-house accountant react to demands by senior management to set aside good judgment in favor of creativity in preparing financial statements? You must remain independent and refuse to do so.

Managerial accountants have a responsibility to themselves, their shareholders and the investing public, and as noted in the Arthur Young case, to resist complying with the unrealistic goals of senior management. You must resist any temptation to

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4/ Morgan, Soroosh and Woelfel, "Are Ethics Dangerous to Your Job?", Management Accounting, February 1985, at 25.

engage in the practice referred to by Clarence Sampson as "finding a gap in GAAP." I realize, of course, that the fair presentation of financial information is a question of judgment and that is why we have Generally Accepted Accounting Principles rather than hard and fast rules. However, there are limits to the flexibility allowed. When a chief financial officer is setting those limits in the face of resistance by his chief executive officer, he can be guided by and take comfort from the Standards for Ethical Conduct for Management Accountants, as adopted by the National Association of Accountants. The standards impose upon management accountants a responsibility to be objective, to disclose fully all relevant information that could reasonably be expected to influence the user of financial information and to communicate favorable, as well as unfavorable, information and professional judgments. If everyone adheres to this standard, the risk of not being independent should be substantially diminished. After all, your company is not likely to bid you adieu if your successor can be expected to support your opinion. This leads me to my next topic relating to professionalism -- opinion shopping.

Opinion Shopping

A few months ago Forbes magazine published an article concerning the relationship between an auditor and the company that it audits. The article stated:

> Changing auditors is a big deal. For one thing, it's a major dislocation for a company to acquaint a new set of auditors with all its operations,

> officers and internal controls ... Even worse, you inevitably trigger the scrutiny of the Securities and Exchange Commission. [emphasis added] 5/

Aside from the fact that I do not view the SEC as the Wicked Witch of the West, this quote raises a number of intriguing questions -- indeed, questions that the Commission has asked itself of late. If changing auditors is so traumatic, why have so many public companies changed their auditors in the recent past? Are these changes merely a manifestation of an increased trend toward commercialization of this profession, or, do they reflect a trend among publicly-held companies to "shop" for the auditor's opinion that suits their purposes?

Just picture this scenario. The CEO of a Fortune 500 company wanders down the hall to the office of the CFO and asks if he would like to do a little shopping over lunch? After wandering around Brooks Brothers for a while, and making a few choice purchases they spot the "public accountant rack". Naturally, they try on a few for size, and finally the "perfect accountant" is spotted among the others. The CEO and CFO nod to one another knowingly -- each thinking "we've found him". After all, this accountant will surely make them look good -- perhaps even better than they should look.

Although I am being a bit facetious, there is no doubt that there has been a marked upswing in the number of auditor changes. However, many of you, given the opportunity, would try

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5/ Greene, "'If I Don't Cross the t...'" Forbes, February 11, 1985.

to convince me that the bulk of the switches can be attributed to ever increasing competitive pressures within the profession itself, rather than to a sinister motive such as trying to find an auditor unquestioningly amenable to adopting management views. I concede that many clients are switching auditors to reap the benefits of expanded services, while others are taking their business elsewhere for purely financial reasons. Let me assure you that I do not question that competitive factors drive publicly-held companies to switch auditors.

But, if I can be the hard nosed SEC enforcer for just a minute, I would like to point out a couple of things that, when taken as a whole, lead me to believe that there is not an insignificant amount of opinion shopping going on out there. Of course, given the impact on the credibility of financial reporting, even one "shopping" case is one too many.

First, the Public Accounting Report reflects that public companies, to some degree, are candidly admitting that they are changing auditors in order to secure favorable accounting treatments. That fact juxtaposed against the background of increasing competitive pressure and the occurrence of several enforcement cases in the area raises concerns about the extent of the problem. Just last month, the Commission settled a Section 15(c)(4) administrative proceeding with Broadview Financial Corporation, 6/ a major savings and loan holding company. The case involved the overstate-

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6/ In the Matter of Broadview Financial Corp., Securities Exchange Act Release No. 21949, (April 17, 1985).

ment of revenue and net income in reports filed with the Commission, overstatements that resulted from the improper inclusion in revenue of a $4 million fee which Broadview received in connection with the sale of an undeveloped tract of land. Broadview provided a loan to finance the purchase of land and the $4 million came directly from the loan proceeds. In informing its auditors of the deal, Broadview failed to disclose the true source of the $4 million. However, after the true facts became known to the auditors they indicated that a restatement was in order. Broadview resisted and "shopped" four other "Big Eight" accounting firms in search of a favorable opinion with respect to the proper accounting treatment for the transaction. The search ended, needless to say, on the doorstep of a firm that was amenable to adopting Broadview's accounting treatment for the questioned real estate transaction.

Let me just quickly mention one more case of recent vintage that involved auditor shopping. 7/ That case, a 2(e) proceeding against three individual accountants, involved improprieties concerning a change of auditor by two savings and loan institutions after there was a dispute with their former auditors over an accounting treatment for GNMA certificates. The Commission disciplined the accountants after concluding that the accounting treatment was unacceptable. The egregiousness of the case was highlighted by the fact that the successor accountants never

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7/ In the Matter of Stephen O. Wade, Ralph H. Newton, Jr., and Clark C. Burritt, Jr., Securities Exchange Act Release No. 21095 (June 25, 1984).

inquired as to why their predecessor disagreed with the company, even though they were obligated by professional standards to do so.

As many of you know, the Commission's rules require registrants to report any change in auditors on Form 8-K and in certain proxy statements. Moreover, the Commission's staff actively monitors all disclosures about changes in auditors, and investigates those which appear to indicate possible financial reporting irregularities. In fiscal 1984, 678 reports disclosing changes in auditors were filed. Historically, only a small number have indicated that auditor changes have involved accounting disagreements. However, things seem to be changing, and therefore the Commission is making this area a priority item on its enforcement agenda.

Why is the Commission so concerned about opinion shopping? Why have opinion shopping cases been targeted as an important part of the Commission's enforcement program? Why shouldn't publicly-held companies be able to change their auditors at will, regardless of the reasons for doing so? I'll be succinct in my answer. (1) Objectivity. (2) Integrity. (3) Perception. As the Commission noted recently in the Wade order, these three principles are the "cornerstones" of the accounting profession, each of which is necessary to ensure that a review of a client's accounting treatment is accepted as being fair and impartial. 8/

8/ Id.

If the manner in which the issuer changes its auditors restricts the independence of the new auditors or calls into question their objectivity, such conduct erodes the public's belief in the integrity of both the financial markets and the independent auditor function.

How then, should the Commission and your profession deal with the problem of opinion shopping, aside from enforcement procedures? The Commission's staff currently is considering a number of initiatives that are aimed at mitigating the potential effects of opinion shopping, and we welcome and seek your input.

One alternative under consideration is the adoption of rule amendments to expand the 8-K disclosure for auditor changes to include disagreements occurring during the two years prior to an initial public offering. Another option being considered is increasing the required disclosure about situations in which accountants are asked to give opinions on accounting issues outside the normal course of an audit.

The Auditing Standards Board is considering the need for guidance where an auditor is asked to provide "generic letters" to parties which are not audit clients. Also, a special AICPA committee is studying the relevancy of the Code of Ethics in today's competitive environment and is expected to recommend changes in the near future. Finally, the SEC Practice Section has a task force on professionalism to study ways in which peer review or other membership requirements could be made more responsive to the concerns raised. I applaud these initiatives and encourage the profession to constantly seek improvements that maintain and enhance professionalism.

Self-Regulation

As you are all well aware, the accounting profession is being subjected to increased public scrutiny. The limelight has been particularly glaring in the ongoing Congressional inquiry by Representative Dingell's Subcommittee on Oversight and Investigations of the Energy and Commerce Committee. Mind you, the SEC has not escaped unscathed in those hearings either. While your profession was taking the heat for alledgedly failing to remain independent of corporate clients and purportedly contributing to recent failures of major financial institutions, the Commission was publicly berated for supposedly failing to execute effectively our oversight mandate. Representative Dingell suggests the time has come for us to re-evaluate the Commission's historical reliance on the private sector in the form of self-regulation.

The SEC has always looked to the private sector to establish and improve accounting principles and auditing standards and to be the first line of defense in terms of compliance. While there may be some problems, I believe the system has worked fairly well. Indeed, I believe that self-regulation assures true responsiveness from the regulated industry, which is far preferable to resistance to government fiat. Self-regulation of the accounting profession is a multi-faceted scheme. There is of course the FASB, the AICPA, and the POB which all play a role in the process.

The AICPA Division for CPA Firms consists of the SEC Practice Section and the Private Companies Practice Section, and is considered one of the more important initiatives aimed at enhancing self-regulation of accountants. With the goal of improving the quality of practice before the SEC, the SEC Practice Section's activities include peer review and the Special Investigations Committee.

Currently, the SEC Practice Section's membership includes firms who audit 86% of all public companies, and includes all accounting firms with 30 or more SEC clients. I wonder, though, if 86% is high enough? It should be 100%. One way to enhance the self-regulatory scheme would be to encourage all accounting firms that are auditing public companies to join the SEC Practice Section. In fact, in the past few years, the Commission has settled enforcement actions against accountants with undertakings that required them to establish membership in the SEC Practice Section as a precondition to recommencing practice before the Commission.

Concern over the efficacy of self-regulation has prompted both the SEC Practice Section and the Commission's staff to consider other initiatives which would persuade accountants to join the SEC Practice Section. For example, I understand that the Practice Section has embarked on a public relations campaign that would hopefully bring all accountants into the "fold". Meanwhile, the Commission's staff is presently considering a requirement that all registrants disclose whether their accountants are members of a self-regulatory organization whose objective is to improve the quality of performance by accountants through quality control and other means, such as peer review.

Returning to the activities of the Practice Section's Special Investigations Committee, as you undoubtedly know, the committee's mandate is to determine whether allegations of an audit failure of an SEC registrant indicates the need for improvement in the quality control system of the reporting firm or whether changes in professional standards are required. The Public Oversight Board, which is comprised of prominent individuals outside of the profession and which monitors the activities of the SEC Practice Section, has concluded that the SIC is operating efficiently and in the public interest. However, I have some concerns about the committee's modus operandi. It has occurred to me that one reason our self-regulatory scheme is criticized as being inadequate and ineffectual is because no one sees it at work, at least in its investigative and disciplinary stages. SIC operates behind closed doors, but I believe its activities and investigations should be in the public spotlight. Public disclosure of the SIC's activities would enhance significantly the profession's public credibility and would assure the public that this profession is willing to police its own. Indeed, it is imperative that the public be aware of the profession's response to potential problems and that the profession is acting in the public interest, especially in light of the fallout from the Congressional hearings.

For similar reasons, I think Commission 2(e) proceedings should be opened up to public scrutiny. By conducting private 2(e) proceedings, when all other administrative proceedings are in a public forum, we are setting the stage for the public to conclude, particularly the uninitiated, that we are not enforcing the securities laws against accountants and attorneys. It appears that they have escaped scott free, despite the fact that we are prosecuting reporting companies, for example, for violations of GAAP. Furthermore, there is a definite prophylactic effect that enures to the benefit of the investing community at large from public disclosure of such proceedings. It is certainly in the public interest for the Commission to identify to the world, in a timely fashion, practices that the Commission deems violative of accepted accounting and auditing principles and practices. Others are put on notice and can reexamine their own policies and avoid potential pitfalls and liabilities.

Conclusion

These three areas, professionalism, opinion shopping and self-regulation, are just three of the many areas that challenge accountants and the SEC today. I encourage you to give me your input on the direction you believe we should be heading, because it is only through such interaction that we can continue to assure that our financial markets are both safe and efficient.

Thank you for your attention.