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

News Release

Address to

National Association of Accountants
Annual International Conference

Nashville, Tennessee

June 25, 1986

A TIME OF CRISIS: CURRENT ISSUES FACING THE ACCOUNTING PROFESSION

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The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

I am delighted to be here in Nashville and pleased to have been invited to address this important gathering of accounting professionals. 1/ Your program heralds my presentation as a report on current developments at the SEC. However, my focus will be less on what is happening at the SEC and rather more on what is happening to, in and around your profession. There can be no doubt about the central and critical role accountants play in the financial disclosure system established by the federal securities laws. Therefore, I appreciate having this timely opportunity to explore some of the issues currently facing your profession and, by logical extension, the Securities and Exchange Commission.

The issues to which I refer are aptly summed up in the recently published Price Waterhouse position paper calling for extensive changes in the accounting profession. The departure point for the Price Waterhouse proposals is a discussion of what the firm calls the "twin crises of credibility and liability." Referring to the credibility gap, Price Waterhouse states:

> The public accounting profession today faces a crisis in public confidence in its ability to perform its independent audit function. . . .
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> Fairly or not, the public often sees business failure as audit failure. It sees allegations of false and misleading financial statements as audit failure. The public believes the auditor's mission is to prevent the publication of false and misleading financial statements from whatever source. When that fails to happen, alibis and explanations that "the auditor can't" leave no impression. 2/

1/ I wish to acknowledge and express my appreciation for the assistance of my legal counsel, Mr. David Mahaffey, in preparing these remarks.

2/ Price Waterhouse, Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence -- the Price Waterhouse Proposals 17-18 (1985).

The question before us all is how to resolve these "crises." Any solutions offered cannot ignore the fact that this is the second time in ten years that the profession of accountancy is being subjected to intense public scrutiny. Moreover, this time the scrutiny has lasted well over one year. You and your fellow professionals probably wish that this exploratory surgery would end, the wound closed and left to heal. Apparently this is not to be.

Congressman John Dingell, Chairman of the House Committee on Energy and Commerce, started his second wave of hearings on the accounting profession just last week, and it has all of the earmarks of a long siege. A number of issues will be addressed, ostensibly in the name of looking for solutions to the perceived problems. The proposed solutions include a bill introduced in late May by Congressman Ron Wyden, a member of Dingell's committee. The Wyden bill would require independent auditors to devise procedures reasonably assured to detect fraud and to report all evidence of possible illegal acts uncovered during the course of their audits to the appropriate governmental authorities. 3/ I rather expect that such a proposition does not fill auditors with an all-around glowing good feeling.

Not only is Congress looking over your shoulder, but the accounting profession itself is engaged in rigorous self-examination. In particular, the National Commission on Fraudulent

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3/ H.R. 4886, 99th Cong., 2d Sess. (1986)

Financial Reporting, set up by the AICPA and headed by former SEC Commissioner James Treadway, 4/ is currently conducting a study of the accounting and financial disclosure processes and looking for possible solutions to the problems of financial fraud by public companies.

The self-examination process has been conducted on an individual as well as collective basis. The Price Waterhouse position paper to which I have already referred is a remarkably candid and thoughtful report on the problems currently facing the profession. This report contains several proposals which are very broad in scope and merit serious consideration. Price Waterhouse recommends a significant expansion of the duty of independent auditors to search for management fraud and to evaluate issuers' systems of internal controls. It also calls for the creation of a statutory self-regulatory organization for all independent accounting firms auditing public companies and proposes ways to reduce the scope of auditors' liability to private litigants.

Price Waterhouse is not alone in its scrutiny of the operation, oversight and discipline of the accounting profession. On April 30th, a group consisting of the chairmen or managing partners of seven other major accounting firms, including Arthur Andersen & Co.; Arthur Young; Coopers & Lybrand; Deloitte Haskins & Sells; Ernst & Whinney; Peat, Marwick, Mitchell & Co.; and Touche Ross &

4/ The NCFFR's other sponsors include the National Association of Accountants, the American Accounting Association, the Financial Executives Institute, and the Institute of Internal Auditors.

Co., released a different set of proposals to revamp the accounting profession's approach to financial reporting. 5/ I shall call this group the "Other Seven"; that may not be very original, but I know you will know to whom I refer. The "Other Seven" propose, among other things, a different approach to existing rules requiring public companies to disclose, in their periodic reports, the major risks facing their operations. They also propose independent audits of management's discussion and analysis; mandatory membership in the SEC Practice Section of the AICPA for all independent auditors of public companies; and steps to enhance public confidence in the Special Investigations Committee of the AICPA's SEC Practice Section.

In light of all of the clamor of the past year, it is not surprising that the Commission itself has also devoted considerable attention to whether changes need to be made in the regulation of the accounting profession or the financial reporting process. Commission initiatives have included a roundtable discussion hosted by the Commission on June 3, 1986 and attended by partners of various independent auditing firms, management accountants, financial analysts, academics, and Congressional staff. The discussion at that roundtable, as well as that at a public meeting held on June 19, 1986, formed, in part, the basis for the Commission's testimony before the Dingell committee on June 23, 1986. I will share the highlights of that testimony with you during the course of my presentation to add a "current developments" flavor to these remarks.

5/ The Future Relevance, Reliability, and Credibility of Financial Information: Recommendations to the AICPA Board of Directors (Apr. 1986).

In its testimony before the Dingell committee, the Commission commented preliminarily on each of the proposals I have mentioned. While it affirmed its belief that our present system was generally working well, nevertheless it acknowledged that the system could be improved. The Commission did not propose any legislation or endorse any pending proposals. As the Commission indicated in its June 23, 1986 testimony, it is still in the process of reviewing the various pending proposals and gathering information on the issues. I, for one, am particularly eager to review the results of the Treadway Commission's study. Any final recommendation must take all pertinent data into account.

While I have not formed any hard and fast opinions on the appropriate solutions to the problems, I have developed a few ideas about the direction in which we should be heading. I would like to share these ideas with you this morning. While doing so, I will comment on the three proposals I have described previously and will report the Commission's position on certain aspects of those proposals. From my comments, you will see that my focus differs from that of the proposed industry solutions and the Wyden bill. Those proposals tend to focus on the role of the independent auditor in the financial disclosure process. In my view, company management, particularly the in-house accounting professional, has an equally critical role to play in ensuring the reliability and accuracy of the financial disclosures made to and relied upon by investors. Indeed, that role is pivotal.

The principal issue to be addressed, from the SEC's perspective, is how to improve the reliability of financial reporting of publicly held companies. In my view, improvement of financial reporting requires at least three elements: first, enhanced professional responsibility; second, a more effective disciplinary apparatus; and, third, a way to impose the first two elements on the preparers of financial statements, as well as on those who audit them.

Enhanced professional responsibility should include increased awareness by accountants of their obligations, not just by independent auditors, but also by management accountants. Under Section 13(a) of the Securities Exchange Act of 1934, 6/ management has the obligation to comply with the reporting provisions of that Act. Therefore, direct responsibility for the preparation of financial statements rests with management. While the Commission has continuously stressed the importance of independent auditors 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. Thus, in the first instance, the obligation to determine and apply the method of accounting which most appropriately reports the substance of a particular transaction lies with management accountants.

6/ 15 U.S.C. § 78m(a).

Unlike the independent auditor who, due to cost/benefit considerations, relies on sampling techniques and materiality factors, the preparers of financial statements should ensure that every transaction is accounted for appropriately according to its substance. Section 13(b)(2) of the Securities Exchange Act imposes a duty to do precisely that, which is crystalized by a requirement that management maintain internal controls and make and keep accurate books and records sufficient to ensure accurate financial reporting.

Section 13(b)(2) was enacted in the context of Congress' fight against corrupt payments made by U.S. companies to foreign officials, but the implications of the statute go beyond the Foreign Corrupt Payments Act. The requirement to maintain internal controls in order to ensure accurate books and records enhances the professional responsibility of the in-house accountant by focusing his attention on the importance of accurate financial reports. Vigorous enforcement of these requirements is also necessary. Since enactment of the FCPA nine years ago, the Commission has brought 73 enforcement actions in which violations of Section 13(b)(2) were alleged. In all but three of these matters, the Commission also alleged violations of one or more of the antifraud and/or disclosure provisions of the federal securities laws. Significantly, the remaining three proceedings, in which multiple charges were not made, nevertheless arose out of investigations into possible antifraud, reporting, or proxy violations which simply did not yield evidence to sustain those charges.

On this record, it is fair to suggest that the Commission's practice has been not to investigate violations of the accounting rules which do not involve violations of other provisions of the federal securities laws. That is a policy with which I do not disagree. However, I for one consider the accounting provisions of Section 13(b)(2) to be important enough to support, in the appropriate circumstances, a Commission enforcement action based solely on an intentional violation of them. Moreover, enforcement actions based solely on violations of Section 13(b)(2) would serve as a rather pointed reminder to accounting professionals of their duty to do whatever is necessary to ensure accurate financial reporting.

However, it is not likely the Commission's practice will change, particularly if Congress passes S. 430, 7/ a bill pending in the Senate that would reduce the current scope of Section 13(b). Two weeks ago, SEC Commissioner Edward Fleischman testified on behalf of the Commission before a Senate subcommittee in support of S. 430. The bill would preclude the imposition of criminal liability for violations of Section 13(b), would inject a "prudent person" standard into the liability component, and would permit an issuer to rely upon a defense that it had acted in good faith in attempting to comply with the Act. Adoption of these amendments would not alter my conclusion that the provisions

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7/ S. 430, 99th Cong., 1st Sess., 132 Cong. Rec. S1299 (daily ed. Feb. 7, 1985).

of Section 13(b) are sufficiently important to justify a Commission enforcement action, even in the absence of other violations of the federal securities laws. However, if Section 13(b)(2) is amended as proposed, it will certainly be more difficult to bring a Section 13(b)(2) claim standing alone. In doing so, we may reduce the effectiveness of a useful tool that would permit the enhancement of professional responsibility among preparers of financial statements.

The proposals offered by Congressman Wyden, Price Waterhouse, and the "Other Seven" focus on enhancing the professional responsibility of the independent auditor. As I mentioned previously, the Wyden bill does so by requiring auditors to establish procedures designed to detect fraud and to report illegal conduct to regulatory authorities. Price Waterhouse also calls for increased focus by auditors on finding fraud, but Price Waterhouse does not include a reporting requirement. Presumably, it would leave the auditor with his traditional recourse if fraud is found. The "Other Seven" propose that auditors should audit the management's discussion and analysis portion of the Form 10-K.

The Commission has reviewed each of these proposals. Generally, it is my impression that the Commission would support any cost effective efforts to detect fraud. However, in its testimony before the Dingell committee, it expressed grave reservations about the principal provisions of the Wyden bill. It is concerned, in part, about the adverse impact the bill is likely to have on the auditor/client relationship and the lack of any materiality standard in the bill. The Price Waterhouse proposal included suggested new audit standards; 8/ therefore, the Commission decided to delay formalizing an opinion on this proposal until it has the benefit of the NCFFR report and the results of the Auditing Standards Board's initiatives in this area. It adopted a similar position on the "Other Seven's" proposals. The Commission stated that it is interested in exploring the implications of auditor involvement in the area of risk disclosures; however, it expressed the view that such an expansion of the accountant's role would appear to be justified only if: (1) it can be demonstrated that the auditor could reasonably be expected to review for adequacy and completeness such forward looking information; (2) such auditor involvement would be cost effective; and (3) such involvement would not reduce the flexibility and the expansive nature of the disclosure item.

I would like to make one further personal observation about these proposals. I believe they address only part of the problem, and therein lies their weakness. For example, the Wyden bill focuses only on the independent auditor. But in the absence of meaningful legislation requiring management to establish internal controls sufficient to ensure accurate books and records and accurate financial reporting, 9/ auditors

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8/ Price Waterhouse, supra note 2, at 23-36.

9/ An express requirement of full disclosure to and cooperation with the independent auditors would also be helpful.

would be put in the untenable position of having to make judgments about what is illegal or may be fraudulent without any assurance they will have available adequate information to make these judgments. It is ironic that at the same time the House is considering the Wyden bill, designed to increase the auditor's obligations and exposure, the Senate is reviewing S. 430, which would reduce management's obligations and thus its exposure under the FCPA's accounting provisions. The present crises suggest that we must take steps to increase, not reduce, the risks associated with preparing and filing false and misleading financial statements. Otherwise, the Wyden initiative will be ineffective.

The second element necessary, in my view, to improve financial reporting by public companies is the creation of a more effective disciplinary apparatus for the accounting profession. Both Price Waterhouse and the "Other Seven" emphasized the need to enhance the credibility of the profession and consequently that of financial statements. All eight suggest that an effective disciplinary program is essential to this objective. Currently, accounting professionals find themselves subject to sanctions or discipline in several different fora. I have no doubt that you think the existing disciplinary structure is quite effective indeed -- thank you very much.

As you well know, the discipline to which accountants are subject is as varied as the conduct for which accountants may be disciplined. For example, accountants, like others, who engage in willful violations of the federal securities laws are subject to criminal prosecution. 10/ Furthermore, the SEC may bring injunctive actions in the federal courts against accountants who commit securities law violations or who aid and abet violations of others, 11/ and the Commission also has recourse to administrative proceedings under Section 15(c)(4) 12/ of the 1934 Act. In the two years during which the Commission has had this administrative authority, it has brought several cases against in-house accountants responsible for preparing financial statements or the accompanying information. 13/

10/ See, e.g., United States v. Jose L. Gomez, Indictment No. 86-6076-GONZALEZ (S.D. Fla. Apr. 17, 1986) Litigation Release No. 11115 (June 4, 1986), 35 SEC Docket 1456 (1986) (managing partner of auditing firm who accepted bribes from principals of ESM Government Securities, Inc. pled guilty to conspiracy and mail fraud). If the FCPA amendments are enacted, there will be different standards of criminal liability for management accounting professionals under the FCPA. S. 430, supra note 7, § 4(b).

11/ See, e.g., SEC v. Drysdale Securities Corp., 784 F.2d 38 (2d Cir. 1986), cert. denied, 54 U.S.L.W. 3807 (U.S. June 9, 1986) (independent auditor allegedly aided and abetted securities fraud because he failed to conduct audit of government securities dealer in accordance with generally accepted auditing standards).

12/ 15 U.S.C. § 78o(c)(4).

13/ For example, in the Oak Industries matter, the Commission instituted administrative proceedings against the company's Controller and its Senior Vice President for Administration, both of whom were CPAs. See In re Thomas C. Runge, Securities Exchange Act Release No. 23066 (Mar. 26, 1986), 35 SEC Docket 575 (1986); In re Michael R. Maury, Securities Exchange Act Release No. 23067 (Mar. 26, 1986), 35 SEC Docket 580 (1986).

Finally, under Rule 2(e) of the Commission's Rules of Practice, 14/ the Commission may deny the privilege of practicing before the Commission if an accountant is found to be lacking in competence, character or integrity or to have engaged in unethical or unprofessional conduct or to have willfully violated the federal securities laws. It should be noted that, while the Commission has brought most of its Rule 2(e) proceedings against independent auditors, or sometimes not-so-independent auditors, the Commission has also instituted Rule 2(e) proceedings against accountants holding managerial positions with public companies. 15/

Of course, the Commission is not the only source of discipline for accountants. The profession is a self-regulated industry and, to an extent, disciplines itself. Responsible representatives of the profession have recently reaffirmed their faith and confidence in the current disciplinary structure and have recommended mandatory membership for all independent auditors in that system, which in essence consists of the SEC Practice Section of the AICPA. 16/

14/ 17 C.F.R. § 201.2(e)

15/ See, e.g., In re Wright and Herman, Securities Exchange Act Release No. 23168 (Apr. 23, 1986), 35 SEC Docket 898 (1986) (Rule 2(e) proceedings against the treasurer and the de facto controller); In re Richard A. Chepul, Securities Act Release No. 6473 (July 14, 1983), 28 SEC Docket 448 (1983) (Rule 2(e) proceeding against a CPA acting as vice president and secretary-treasurer).

16/ See The Future Relevance, Reliability, and Credibility of Financial Information: Recommendations to the AICPA Board of Directors 6 (Apr. 1986).

How disciplinary proceedings are handled has a significant impact on the public's perception of whether accountants are currently subject to adequate supervision. This was recognized by the "Other Seven" in their recommendations to the AICPA. Recommendation 7 states:

> The SEC Practice Section should continue its efforts to obtain the SEC's endorsement of the Special Investigations Committee in order to enhance public confidence in the process even beyond the confidence that results from the extensive oversight and public reporting on the process by the Public Oversight Board. 17/

Unfortunately, I am not persuaded that the Commission's endorsement of the Special Investigations Committee is enough to close the credibility gap so long as the SIC conducts its work in private. The Public Oversight Board, which monitors the activities of the SEC Practice Section, has concluded that the SIC is operating efficiently and in the public interest, a conclusion which I accept. Nevertheless, I believe that more public disclosure of the SIC's activities would significantly enhance the profession's public credibility and would assure the public that the profession is willing to and does police its own adequately. Indeed, it is imperative that the public be aware of the profession's response to potential problems, particularly now that the profession is subject to intense public examination.

For similar reasons, I think that the SEC's Rule 2(e) proceedings should also be opened up to the "sunshine." By

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17/ *Id*. at 10.

conducting private Rule 2(e) proceedings when the Commission's administrative proceedings against securities professionals, corporations and management are in a public forum, we are setting the stage for the public to conclude that accountants are a protected species not subject to the same strictures as others. Furthermore, I believe 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 in the public interest for the Commission to identify, in a timely fashion, practices which the Commission deems violative of accepted accounting and auditing principles and standards. Others are put on notice and can reexamine their own policies and thus avoid potential pitfalls and liabilities.

Price Waterhouse has suggested an alternative to the "Other Seven's" recommendation of mandatory membership in the existing disciplinary structure. Price Waterhouse calls for the creation of a statutory self-regulatory organization under the oversight of the SEC. 18/ The proposal would make membership in the SRO mandatory and would require registration with the SEC by all firms and sole practitioners who practice before the Commission. A newly created Board of Public Accountancy would govern the new association and regulate and discipline its members. In its recent testimony, the Commission declined to comment on the concept of a statutory SRO pending further study of the issue. However, the Commission did indicate it would not support a

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18/ Price Waterhouse, supra note 2, at 50-56.

limited SRO with a "Chinese Wall" built in between the Commission and such an SRO.

While this concept of a statutory SRO is very interesting, I, like my fellow Commissioners, am not prepared at this time to say whether I favor or oppose it. I would like, however, to identify what I consider should be the essential characteristics of a statutory self-regulatory organization if one is created for the accounting profession. First, any self-regulatory organization must have the power to discipline its members. This means that the SRO must have the explicit authority under its charter to impose sanctions <u>and</u> that the SRO be sufficiently independent to have the will to do so.

Second, as I stated earlier, the SRO's disciplinary proceedings must be subject to adequate public scrutiny. I should add that I do not consider the Public Oversight Board's supervision of the proceedings of the Special Investigations Committee to be sufficient <u>public</u> exposure to take care of <u>perceived</u> problems and thus the present credibility crisis.

Third, I think that any SRO's authority must extend not only to independent auditors but also to preparers of financial statements if it is to be more effective than our present disciplinary system in ensuring accurate financial reporting. In my opinion, current proposals have failed to consider adequately the central role in-house accounting professionals, or, more broadly put, preparers of financial statements, play in the financial disclosure process. Increased regulation or supervision of independent auditors without any corresponding increase in regulation or discipline of the preparers of financial statements would ignore an all important factor in the present crises of credibility and liability facing the profession of accountancy.

I hasten to admit that this hypothetical SRO would require a significant, perhaps even radical, change in our regulatory system. Moreover, I acknowledge that requiring all preparers of financial statements for reporting companies to register with an SRO would probably result in persons not currently licensed being required to be so before becoming associated with the financial reporting process. If such a system were created, it would impose an additional burden on the individual's ability to obtain employment. Furthermore, it may impose additional burdens on management or limit its options in hiring. These are not insignificant incursions into individual and corporate liberties, not to mention the possible federal preemption problems that would be raised.

The extent to which we are willing to devise and implement far-reaching solutions to our current problems will reflect the importance we attach to the reliability of the financial disclosure process and the seriousness with which we view the current crises. In order to avoid repetition of today's problems tomorrow, the profession, the Commission and Congress must be ready to make changes that make a difference.

I would also like to address one final matter. As you are all aware, there is another source of discipline on accountants, namely disgruntled investors who have a private right of action under the federal securities laws against independent auditors and against management accountants under certain circumstances. Recently, representatives of the profession have been quite vocal and persistent in arguing that the discipline from private litigation has become too burdensome and threatens to overwhelm the industry. This leads to the question of whether Congress should limit the liability of independent auditors for their failure to detect financial fraud by their auditing clients. The proposals range from placing a cap on liability to restructuring the concept of privity to limit those who may sue an accountant for negligence.

I cannot endorse the notion of a cap on accountants' liability. If a firm is willing to accept the revenues from rendering auditing services, it should accept the full measure of liability to that company's shareholders resulting from its performance of the audit. However, I would be willing to consider other limiting concepts. For example, I see some merit to introducing a system of proportionate liability in which the auditors' liability would be proportionate to their degree of fault for the losses incurred. The concept of making liability several rather than joint also warrants consideration. In addition, there is always the notion of awarding attorneys fees to prevailing defendants where plaintiffs have made frivolous claims.

Although the Securities Exchange Act of 1934 gives the Commission plenary authority to determine the accounting principles to be used in reports filed with it, the SEC has generally looked to the private sector to establish accounting principles. The Commission has also, in the main, deferred to the private sector in the setting of auditing standards. Congressman Dingell and others have subjected the SEC to considerable criticism for permitting private groups to devise accounting principles and auditing standards. However, I think the Commission's policy in this regard is the correct one. Having said that, I must point out that accountants are unlikely to achieve relief from scrutiny and criticism as long as Congress and the public have a low regard for how well they do their jobs. I believe, therefore, that accountants should continue to subject their profession and their professional standards to exacting self-examination. I have already mentioned some of these efforts. There are others, such as the NAA's adoption and continuing elaboration of a code of ethics for management accountants, 19/ that also deserve mention. These efforts convince me that accountants and the accounting profession will maintain their central role in ensuring accurate financial reporting by public companies. You have my best wishes in this endeavor.

Thank you.

19/ See National Association of Accountants, Statements on Management Accounting: Standards of Ethical Conduct for Management Accountants, Statement No. 1C (June 1984), reprinted in Management Accounting, Jan. 1986, at 42.