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News Release

# PUBLIC ACCOUNTING AT THE CROSSROADS

Remarks to

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

Good afternoon. It is an honor to be asked to speak at your 1986 SEC Accounting Conference. In preparing my remarks to you today, I was told that you would be interested in my views on the CPA's proper role in practice before the SEC, and also in current initiatives underway at the Commission in the areas of standard setting, regulation, and discipline. This request reminded me of the Commission meeting at which we debated the responses which corporate officers should make when queried about impending but as yet nonpublic developments in the company's business such as takeovers or other business restructurings. The end result of this meeting was the now famous -- or infamous -- "Carnation" release. We concluded that the safest response in order to avoid liability for misstatements or omissions was "no comment." Now, there is much under consideration at the SEC regarding the future of public accounting. Most of our plans are incipient at best. As a Commissioner, I am often the last to know what the staff is planning in certain areas of disclosure or regulation. Therefore, in order to avoid leaving you with misleading impressions or incomplete information, my proper statement should be "no comment." However, that would make for a pretty short speech. So, keeping in mind that, unlike public accountants in their daily practice, I do not face any potential liability for misleading or incomplete statements, I will venture forth.

I have titled my remarks today "Public Accounting at the Crossroads." I believe that your profession now faces a road with a number of alternative courses, each of which could significantly redefine the roles of the accountant and auditor. At this intersection are a myriad of hawkers urging you down each different path. Before I look in more detail at how we should venture forth, I would like to discuss briefly how we got here.

In a speech at the beginning of this year to the AICPA in Washington, I reflected on what 1985 had meant for the accounting profession, and speculated about what the major issues would be for 1986. I noted that 1985 had been a watershed year for public accounting. Pressure was mounting from Congress, the courts, your customers and the SEC for accountants to solve their own problems and recapture public confidence. Today, I believe that the pressure is still there, but it is no longer mounting. I believe that the prospects for further major blood-letting on Capitol Hill are now remote. Congressman Wyden has introduced a bill which would create a major new role for the auditor as a preventer of fraud. Although the bill was met with strong opposition from the profession and was not initially supported by the Commission, Mr. Wyden has indicated a willingness to modify some of the bill's provisions in response to those concerns. I have not lately heard remarks directed at the accounting profession with dark thunderous undertones, ultimatums and thinly-veiled threats.

I mention all of these developments at the risk of invoking the so-called "unspeakable law." As you may know, that's a corollary to Murphy's Law which states that if you mention something and it's bad, it will happen, but if it's good, it will go away. That notwithstanding, I believe that the storm has passed for public accountants. The profession seems to have "gotten religion" and taken to heart the need to recapture public confidence.

I believe that we stand at this fork in the road having gone through a dramatic catharsis. Now everyone recognizes what the problems are -- and that's the first and most important step toward solving them. We've seen some significant initiatives proposed from many different groups: from the Congress, as I just discussed; from the profession, in the form of proposals from Price Waterhouse and from a group of seven other major public accounting firms; 1/ and most recently from the Commission on Fraudulent Financial Reporting by its Chairman, James Treadway, in his speech last month at the AICPA Annual Meeting in Kansas City. 2/ Each of these alternatives merits further consideration -- to the extent possible, we should peer as far down each alternative path as we can before deciding which to follow. If you will indulge me, I'd now like to do a little bit of that "pathfinding" or reconnaissance. Let's consider the different paths from two different perspectives: first, the CPA's function in SEC practice, and secondly, the SEC's function in the CPA's practice.

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1/ The proposals of Price Waterhouse and the other accounting firms were discussed by the Commission at a roundtable on auditors' responsibilities and by Chairman Shad in testimony before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce on June 23, 1986.

2/ James C. Treadway, Jr., "Initial Conclusions of the National Commission on Fraudulent Financial Reporting," an Address to the American Institute of Certified Public Accountants 99th Annual Members' Meeting and Exposition, Kansas City, Missouri, October 21, 1986.

The CPA's Function in SEC Practice

The public accountant's practice involving public companies -- the "SEC Practice" -- has two parts: your relationships with your clients, and your relationships with your peers.

In your relationship with your clients, I'd like to discuss the major problems which have resulted in cases which we have seen at the SEC. Mr. Treadway, in his recent remarks, noted that the recurring problems in practice seem to be questionable revenue-recognition policies and valuation of related-party transactions. These are not areas in which accounting or auditing standards are unclear, but I believe they remain the most fertile ground for financial statement fraud. The year-end pressure to report favorably to stockholders and creditors falls heavily on the management of public companies, but it is not pressure which should be transferred to the auditor. This pressure often results in sales campaigns which have results which seem too good to be true. On further reflection, we sometimes find that the results are indeed too good to be true. This pressure also often results in sales of assets or other restructurings which strain to appear as bona fide deals, but are made with related parties or are given questionable valuations.

I'm sure that these are familiar practice problems for you, even if you don't have a "Fortune 500" client. To a certain extent, the pressures are greater on small companies struggling to report their first favorable year as a public company. But whether you're a sole practitioner or a "Big Eight" firm, you are subject to the same standards. The accounting standards on recognition of revenue, on recording of liabilities, and valuation of asset-for-stock exchanges are not novel. The auditing standards requiring sufficient competent evidential matter and a skeptical approach by the auditor also come as no surprise. However important, it appears that they are often lost or at least temporarily misplaced in the "heat of battle" with an important client over a critical transaction or series of transactions.

These areas were stressed by Mr. Treadway, and I would echo his concerns. We both can speak with the experience of having reviewed several cases brought to us by the SEC staff involving these problems. I would like to mention another not focused on by Mr. Treadway, however. This involves the obligations of a multi-service accounting firm when it puts on its auditors' eyeshades. In at least one recent case, 3/ the Commission alleged that a multi-service firm should have seen "red flags" in its tax practice that could have prevented a deficient audit. The Commission indicated its belief that the failure of tax practitioners to bring audit-related questions to the attention of the partners conducting the audit is contrary to their professional responsibilities. 4/ This is a potential problem which can arise in any size multi-service CPA firm, and I believe it is one which deserves your close attention. You may recall that several years ago, the Commission addressed the problem of independence of a multi-service firm in looking at the scope of non-audit services. After much study, the Commission concluded that the auditor's independence did not appear to be seriously affected by non-audit services. 5/ Although this conclusion has been subject to close scrutiny in the recent past, the scrutinizers have not provided anything more than anecdotal evidence to support their conclusion that independence may be compromised. The Commission has not changed its position on non-audit services. However, this most recent case indicates to me that multi-service firms need to remain on the lookout for ways in which wearing several hats creates special responsibilities, which if not met can cause serious problems for their firms and their public clients.

I'd like to turn now from your relationships with your clients to your relationships with your peers. The front-burner issue in this area is membership in a peer-review organization. Such membership has been recommended for many years by the SEC and other groups, but now stronger initiatives are underway. The AICPA submitted to its membership a recommendation of the Special Committee on Standards of Professional Conduct for Certified Public Accountants, known as the Anderson Committee, that all AICPA members with public clients be required to join the SEC Practice Section of the AICPA's Division for CPA Firms. The SEC recently deferred consideration of a proposal to require disclosure in proxy solicitation materials of an auditor's membership in a self-regulatory organization when

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3/ SEC v. Grant Thornton, No. 86-6832 (S.D. Fla. Oct. 16, 1986), Litigation Release No. 11263, 36 SEC Docket 1443. Grant Thornton and four individuals consented to the entry of final judgments of permanent injunction without admitting or denying the allegations in the Commission's complaint.

4/ Id., 36 SEC Docket at 1446.

5/ See Accounting Series Release No. 296 (Aug. 20, 1981).

management is soliciting proxies for ratification of the firm's independent auditor. And Mr. Treadway indicated that his Commission will likely recommend that the SEC directly require membership in such an organization for all auditors of SEC registrants. I will discuss later the SEC's role in all of this.

I suspect that these initiatives are causing each of you to reexamine your role in self-regulation of your profession. I was told that this audience was likely to include both members and non-members of the SEC Practice Section, so I believe this is a good forum to discuss the mandatory membership question. Both inside the Commission's headquarters and outside, there has been much consternation, pondering, and hand-wringing over the issue of mandatory membership. In informal discussions with AICPA officials and in public meetings, the problem has been stated as an issue of sanctions. The Commission has been told that any self-regulatory organization will find it impossible to impose meaningful sanctions so long as its members retain the option to leave the organization rather than comply with those sanctions. We have been told that one member has actually been expelled from the organization for failure to comply with Section directives, but we have not been presented with evidence that this "leave rather than face sanctions" problem is a pervasive one.

It is difficult to properly address this problem when it appears to exist only in the speculations of the self-regulators. As an economist, I would note that the notion of requiring membership in a group which purports to confer benefits on its members seems counter-intuitive. It seems to me that an effective self-regulatory organization -- one which requires quality controls and good practices on the part of its members -- would be able to stand or fall on its own merits. If a particular firm were faced with sanctions or what it believed were unacceptable limitations on its practice, resignation from the self-regulatory organization would presumably carry a negative stigma that would have to be balanced against the costs of compliance with those sanctions or limitations. If the self-regulatory organization is viewed as good, wholesome and effective, presumably many reputable firms will choose to stay in the organization despite sanctions or limitations. And if many firms choose to leave the organization, then it would be based on their judgment that the costs of membership exceed the benefits. This "free-market" type analysis appeals to my common sense. If a self-regulatory organization serves a valuable purpose, then I would expect firms to remain members despite occasional significant costs. It is not readily apparent to me that mandatory membership would improve the performance of the self-regulatory organization.

I believe that the proposal to require disclosure of a company's auditor's membership in a self-regulatory organization was an attempt by the AICPA to improve the public image of the SEC Practice Section, or alternatively, to increase the negative stigma of non-membership. In effect, the AICPA wanted the Commission to do what it has been attempting in its recent advertising campaigns. It was not clear to me, nor to a majority of the Commission, that this was a proper role for the Commission to assume at this time. 6/ Rather, we determined to revisit the suggestion "after the completion of related private sector initiatives and review of the concept of mandatory peer review." 7/

I suspect that each of you, in your decision to join or not to join the SEC Practice Section, has engaged in the type of calculus which I described above. Membership has its benefits, but also its costs. These are value judgments which you as professionals are qualified to make. In the first instance, it should be your business judgment. You are subject to professional standards independent of any self-regulatory organization, and I believe this is an important distinguishing factor in separating the accountants' self-regulatory program from others with which the Commission is familiar.

In short, I believe that you as individual practitioners have addressed the mandatory membership issue as you have seen fit. The overwhelming majority of public firms, weighted by sales, are audited by SEC Practice Section members. Those of you who have chosen to remain outside this organization have done so for your own reasons. I do not believe that this is a balance which should be lightly interfered with in the name of 100% participation or the unrealized fear of a large-scale defection from the SEC Practice Section.

The SEC's Function in CPAs' Practice

I'd like to turn now from looking at the ways in which you as public accountants are involved in the work of the

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6/ Commissioner Peters dissented from this decision, and would have imposed the disclosure requirement as suggested by the Commission's Chief Accountant.

7/ Securities Act Release No. 6676, Fed. Sec. L. Rpt. (CCH) No. 1203 Extra Ed. 5-6 (Nov. 10, 1986).

Commission, and look at the ways in which the Commission affects the work of public accountants. I just finished looking at self-regulation from the standpoint of the public accountant; I'd like to look at it now from the Commission's perspective.

Self-regulation is not a new idea to the SEC. Since 1934, the Commission has dealt with many forms of it. However, that doesn't mean that it's a uniform concept. The mixture of self-regulation, SEC-supervised self-regulation and reliance on disclosure instead of regulation varies among the entities involved. I'd like to take just a brief minute to review each of the types of entities regulated by the SEC, and the degree to which we rely on disclosure or regulation to get the job done.

The SEC enforces five major regulatory programs, and I believe they can be placed on a scale from least to most intrusive in terms of the amount of direct regulation involved.

Lowest on this scale of direct regulation are sellers and purchasers of securities as regulated under the Securities Act of 1933 and the Securities Exchange Act of 1934. In this area, the Commission places almost exclusive reliance on full disclosure. The Commission is not a merit regulator of securities; so long as all material information is disclosed to investors, anything can be sold or bought.

Second on the scale of direct regulation are investment advisers as regulated by the Commission under the Investment Advisers Act of 1940. I would characterize this as largely a disclosure statute. The Commission imposes few substantive regulations on advisers, and relies primarily on the disclosure by the adviser to the client of background, experience, investment theories, and the like. There are statutory and administrative prohibitions intended to prevent overreaching on the part of the investment adviser, such as limitations on certain performance-based compensation arrangements. 8/ Unlike the current arrangement by accounting self-regulatory organizations, investment advisers as well as issuers of securities are specifically prohibited from suggesting that their regulation and oversight by the Commission implies any kind of merit endorsement. 9/

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8/ Section 205 of the Investment Advisers Act of 1940.

9/ Section 23 of the Securities Act of 1933, Section 208(a) of the Investment Advisers Act of 1940.

Third on this scale of direct regulation I would place brokers, dealers, transfer agents, clearing agencies, and other participants in the securities trading industry as regulated under the Securities Exchange Act of 1934. Although the Commission relies on self-regulatory organizations -- indeed, it requires each broker/dealer to be a member of a national securities exchange or national securities association -- it imposes specific requirements intended to insure financial responsibility, 10/ fair dealing with customers, 11/ and effective self-regulation. 12/ The Commission does require public disclosure from entities regulated under this Act, but relies more on direct regulation and closely-supervised self-regulation.

Fourth on this scale I would place investment companies and related organizations as regulated under the Investment Company Act of 1940. The Commission relies on disclosure when investment companies sell their securities to the public, as it does with any other issuer. But beyond that, the Commission directly regulates the internal structure and operation of investment companies, and imposes strict fiduciary duties. Congress' judgment in passing the Investment Company Act was that large pools of liquid assets were sufficiently vulnerable to require extensive direct protection by the Commission. 13/

Fifth and last on this list, the entities that are subject to the most pervasive direct regulation, are a now-largely-forgotten group regulated under the Public Utility Holding Company Act of 1935. In this Act, Congress went far beyond the requirements which it later imposed on all other holding or investment companies in the Investment

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10/ Section 15(c)(3) of the Securities Exchange Act of 1934 and Rule 15c3-1, the Commission's "Net Capital" Rule.

11/ Section 15(c)(2) of the Securities Exchange Act of 1934 and Rule 15c2-1; Section 10(b) of the Act and Rule 10b-5.

12/ Sections 6, 15A and 19 of the Act.

13/ See Section 1(a) of the Investment Company Act of 1940, which indicates Congress' findings regarding the importance of investment companies, and Section 1(b), which details some of the abuses found by the Commission in a congressionally-directed study which preceded the Act.

Company Act. Congress specifically directed the Commission to disassemble these holding-company empires, and to limit each to a single integrated system. 14/ And for those companies which remain, the Commission must specifically approve their securities and financing transactions and sales of assets. 15/ The enforcement of the 1935 Act is not the bulk of the Commission's work as it once was, but I believe it is an important "conceptual" marker. In an era when we're considering the proper scope of regulation of an industry, the 1935 Act should be remembered as the "outer limits" of the regulatory authority which has been granted to the Commission by Congress.

So you see that the Commission runs quite a spectrum, from the largely disclosure-based regulation of issuers to the directive to disassemble utility holding companies. And I don't think that the Commission has yet resolved where public accountants should fit on that spectrum. So if the profession is at a crossroads, that problem is shared by the Commission in determining what its proper role should be in the regulation of accountants and auditors.

Are auditors like issuers? Should the rule of *caveat emptor* with full disclosure apply to the purchaser of auditing services as it does to the purchaser of securities? The answer to this question depends on how capable you believe that fully-informed individuals are to select appropriate audit services. If full disclosure would be adequate to ensure that public companies made responsible decisions in their selection of auditors, then this might be the correct approach. However, I do not believe that this would be a realistic approach. Both the Commission and Congress have insisted on maintenance of specific substantive accounting and auditing standards, and this is not a position from which we are likely to retreat. In essence, we do not apparently believe that public companies or their shareholders should be entitled to accept and "ratify" unprofessional conduct. Something more than full disclosure is needed.

Are auditors like investment advisers? Can we rely on disclosure supplemented with a few specific provisions to prevent overreaching? Investment advisers have fiduciary obligations to their clients as do auditors. However, the Commission has not imposed specific substantive

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14/ Section 11(b)(1) of the Public Utility Holding Company Act of 1935.

15/ *Id.*, sections 7, 9, 10 and 12.

requirements for entry into the investment adviser business. To the extent that we believe that public companies should not be permitted, even with full knowledge, to select a substandard auditing firm, the investment-adviser model, too, does not go quite far enough.

Are auditors like broker-dealers? Are audit clients like brokerage clients, who depend on the business judgment of the professional they've hired, and may entrust that professional with custody of their funds? This begins to look more like a useful analogy. The Commission allows any customer to select a broker-dealer which meets specific financial requirements and is a member of a particular self-regulatory organization. And the Commission, in turn, closely regulates the self-regulatory organizations. They are required to have certain standards and prohibitions, and the Commission must approve each of their rules and can write additional rules for them as it sees fit. Does this mean that the Commission should regulate the SEC Practice Section as closely as it does the New York Stock Exchange or the National Association of Securities Dealers? Mr. Treadway for one apparently believes so. In his recent address, he spoke at great length about self-regulation. The model which he held the public accounting profession up to was that which I just described -- the exchanges and the NASD. 16/ If the Commission believes that this is the appropriate method of regulation, then disclosure alone will not suffice. In a similar context, the Commission's Advisory Committee on Corporate Disclosure studied the use of disclosure in 1977, and concluded that "[t]he Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct." 17/

However, this does not mean that I believe the Commission should rush headlong to require membership in an SEC-supervised accounting self-regulatory organization. For although accounting regulation may fit the broker-dealer model, there are as many differences as similarities. Independent of any self-regulatory organization, public accountants are subject to professional standards -- to follow generally-accepted accounting principles and auditing standards, to maintain independence and to serve the public interest. If those

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16/ Treadway, supra, at 17-18.

17/ Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission 305, 318-19 (Comm. Print 1977).

responsibilities were not clear before the Supreme Court's Arthur Young decision, they are now. In that case, the Court did not rely on the existence of any regulation by the Internal Revenue Service of the tax services of accountants, but looked directly to the profession's responsibility to the public. This is a critical distinction between public accountants and other groups regulated by the Commission.

Are auditors like investment companies or utility holding companies? Should the Commission directly regulate the internal functions of CPA firms which audit public clients, and specify particular quality assurance controls and procedures they should follow? This, too, provides a useful analogy, because the Commission does prescribe such standards indirectly in enforcement proceedings under the securities laws and under Rule 2(e) of its Rules of Practice. The Commission thus indicates in specific instances when it believes that particular auditing standards have not been met. However, I believe that here there are as many or more differences than similarities. The acts regulating holding companies of all sorts were passed in response to various abuses which were prevalent in the 1920s and 30s in these areas. Although Congressional investigations have suggested there are problems in the way accounting services are rendered, no one, I believe, has suggested they compare with the perils of the giant utility holding company empires of fifty years ago.

Even the best of these analogies is imperfect. As I've said before, public accounting firms are a type of organization that is very different from any other which the Commission oversees or regulates. Before we can proceed with a proper program of regulation, we need to more carefully state what the goals of that regulation should be, and how the Commission's specific powers best meet those goals.

Another important lesson to remember in looking at the proper scope of regulation of accountants is that management has primary responsibility for the disclosures made about their business. This is an oft-stated platitude, but one which is given short shrift when attention turns to audit failures. Mr. Treadway and his fellow Commissioners on the National Commission on Fraudulent Financial Reporting have taken a balanced approach in this area, which is worthy of a closer look. Mr. Treadway indicated that the Commission will have a number of specific recommendations concerning the reporting entity, the public accountant, and the SEC. More important, however, I think, is his conclusion that "[t]he most influential single factor in deterring and preventing fraudulent financial reporting is the tone and atmosphere set at the top." 18/ The frauds perpetrated on the investing public are not solely the fault of the auditors, although the rhetoric invoked on some occasions might so suggest. It must be difficult for the profession to know when the sins of management are being visited upon the auditors.

Conclusion

In conclusion, I would note that many who have spoken about accounting in the recent past have indicated that it is an era of crisis or "brinkmanship." Commissioner Peters gave an address this summer to the Annual Conference of the National Association of Accountants entitled "A Time of Crisis: Current Issues Facing the Accounting Profession." The Price Waterhouse proposal which I referred to earlier was predicated on the accounting profession's "twin crises of credibility and liability." Perhaps you are tiring of a trade which is continually in "crisis" mode. But a crisis, properly resolved, can leave you better positioned to face the future. I believe that the bulk of the "crisis" is now behind the accounting profession. However, in no way does that mean that most of the work is done. On the contrary, I believe the hardest decisions still lie ahead. We've identified the problems, the source of the problems, and most importantly, a range of solutions to be considered. The solutions ultimately adopted may be a mix of self-regulation and direct regulation. None of them involve federal conscription of accountants or other draconian measures. We stand now at the crossroads to choose the regulatory course which best suits the needs of the investing public. I believe that it is those needs which we must all keep in mind. The last time that the Commission and the accounting profession undertook a redesigning of the profession's responsibilities, a study group concluded that:

> Substandard performance by auditors may affect large segments of the public as well as the client who engages and pays the auditor. * * *. Although regulation of a professional service cannot assure that the desired level of quality will always be reached, all professions develop systems of regulation to reduce failures. Indeed, one characteristic of a profession is

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18/ Treadway, supra, at 11.

> that it seeks to regulate and improve the quality of practice. 19/

That was the Cohen Commission's conclusion almost ten years ago -- its timeless quality is evident in its relevance to the decision-making which lies ahead.

Having looked down the several alternative paths which lie ahead, I look forward to venturing with you as professionals down the chosen one in the near future, as always, in pursuit of the public interest.

Thank you for your kind attention.

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19/ The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations 141 (1978).