

THE SEC AND THE ACCOUNTING PROFESSION:
RESPONSIBILITY, AUTHORITY AND PROGRESS

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Prepared for

ACCOUNTING COLLOQUIUM III

University of Kansas

May 10-11, 1973

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For nearly forty years the Securities and Exchange Commission and the accounting profession have constituted a highly effective partnership for progress in improving the quality of public information about the economic activities of corporations who came to the capital markets of the United States for financial resources. As a result of their joint and several efforts, investors in the United States have the most comprehensive and well-understood financial data base that exists or has existed anywhere in the world. This data base is one of the pillars of our capital market system which is without peer.

While it is true that neither our system of financial disclosure nor our system of financial measurement is without fault, it is incumbent upon critics to view the accomplishments of the accounting world as well as to emphasize the failures and deficiencies which currently exist. It is easy to point to the dramatic fraud or misstatement, the accounting aberration, the case of the undisclosed asset or liability and even, in a few limited cases, the case of the disclosed asset which isn't. As long as such situations exist, efforts at reform continue to be needed as do enforcement actions when appropriate. It is important, however, to place these actions in the perspective of a system of reporting which is largely successful and to be certain that attempts to improve do not destroy the strength of what does exist. The creation of a few waves is healthy, even if they produce a temporary queasy feeling in the stomach, but a full scale storm does not seem to be needed.

If it is concluded, as I do, that our reporting system has evolved in a largely satisfactory manner, it is perhaps worthwhile to examine the past to see why this has occurred and to study the roles of the various participants. From such a review, it may be possible to gain an

understanding of the institutions which have developed and to predict the ways in which they may interact and change in the future.

Perceptions of the SEC-Profession Relationship

There are a wide variety of perceptions as to the way in which the SEC and the accounting profession have related to each other, although most agree that they have been the principal players in the drama of developing reporting standards for the past forty years. Some see the Commission as the top manager in this process while the members of the accounting profession are subordinates who may be occasionally allowed to manage a decentralized "profit center" under the broad control of the top manager.^{1/} Others view the profession and the financial market place as the principal advocates of change and improvement, responding to the demands of the investing public, while the Commission unwittingly serves as a check on the good deeds that could be done by establishing a floor which becomes a ceiling and generally contributes to the inefficient bureaucratization of the reporting environment.^{2/} Still others view the accounting profession as the leader (or laggard) in developing reporting standards while the SEC largely stands aside and ignores its statutory responsibilities, having been "captured" by the profession in this important part of its activities so that it regulates primarily for the benefit of the regulatees rather than for the public good.^{3/}

In most cases, when an effort is made to describe this relationship, resort is made to analogy. This is an attempt to liken the interaction between the Commission and the profession to other better understood relationships. The danger in analogy is that while some part of a relationship may be accurately reflected thereby, other parts may not. Yet if the analogy catches on, there is a strong tendency to apply it totally and

thus misunderstand the reality of the institutional environment that is being described and analyzed. This is particularly the case when the analogy is made to a formal power structure with well-defined line authority.

One of the great strengths of the American political and economic scene is its pluralistic nature. There are many decision centers which operate with large degrees of autonomy. Even the governmental structure is formally pluralistic with the constitutionally directed separation of powers. Where independent decision makers make determinations which impact on other groups, conflicts inevitably will arise which must be worked out among the parties involved. On other occasions, actions are taken by one group which reinforce the goals of others and a series of floating and informal coalitions arise.

While government in the broadest sense is the ultimate arbitrator since its source of power is the collective will of the people, this power is not easily applied, nor can it be realistically viewed as simple line authority.

The relationship between the SEC and the accounting profession must be viewed in this framework. The fundamental goal of the Commission--a fair and efficient capital market--and that of the accounting profession--the existence of a prosperous and respected group of professional practitioners--are generally consistent. Thus, it is likely that coalition will exist between the SEC and the profession far more frequently than conflict. The groups can generally rely upon each other since their interests are likely to be similar. Where parties are moving in concert, the question of which will be the more dominant force generally is answered in terms of the particular individuals involved and on the basis of the relative importance of individual issues to the ultimate goals of each organization.

While accounting and auditing issues are of great importance to the Commission, they are not as dominant to its objective as they are to the accounting profession. Thus, it is not surprising to see the Commission devote fewer resources to these areas than does the profession and to observe that the profession has generally been in a leadership position in these areas. While Congress assigned statutory authority over many aspects of accounting and financial reporting to the Commission in the Securities Acts, the delegation of this authority to the accounting profession has been consistent with the goals of both groups.

Some authority was assigned directly to the accounting profession under the Securities Act of 1933. This was done in the provision that requires financial statements to be certified by independent public accountants. Thus, the responsibility of the profession arises from authority delegated both by the Commission^{4/} and directly by Congress. Such delegation is quite real, and has been reinforced by the actions and attitudes of the Commission over the years. Any assertion that responsibility was assigned without authority is inconsistent with the historical record.

The Pre-1933 Era

It is also not appropriate to suggest that the responsibility and authority of the accounting profession came solely from the SEC or the Congress. As early as 1909, when the accountant was primarily a bookkeeper, the profession made its first attempt to gather and define accounting terms in usage.^{5/}

In 1914 the newly created Federal Reserve Board and Federal Trade Commission both indicated interest and concern over the diversity in

quality of financial statements. The FTC in particular expressed the desire to set up uniform accounting systems for all principal industries. The FRB's interest stemmed from the facts that banks in their lending capacity were in the position of relying on financial statements.

As a result of these pressures the American Institute of Accountants (now the American Institute of Certified Public Accountants) agreed to prepare a memorandum on auditing procedures. This was published in the Federal Reserve Bulletin^{6/} as a tentative proposal and was later revised and published in booklet form. This statement, which was updated on several occasions, was the first semi-official pronouncement as to the meaning of audited financial statements.

As it emerged as the spokesman of the profession the Institute sought alliances to further its aims. Cooperation with the New York Stock Exchange led to the formulation of five broad principles of accounting which had won general acceptance. Members of the Exchange were required to submit financial statements which were in conformity with the basic principles of the Institute.^{7/}

Thus, before the Securities Acts, the Institute had taken its first steps to formulate generally accepted accounting principles and had gained recognition by the leading Stock Exchange as to the authority of its role.

Responsibilities in Developing Accounting Principles After 1933

At the time when Congress was considering the Securities Act of 1933, Col. Arthur Carter, representing the accounting profession, testified that the bill should include a requirement that financial statements be audited and reported on by independent accountants. Such a provision

was ultimately added to the Act before passage. In addition, the Act did not follow the example of companies acts throughout the world which generally define required financial statements in considerable detail but rather gave authority to an independent agency to set forth accounting and disclosure requirements. Thus Congress created the necessity of the partnership between agency and profession that has since existed. In the years since its creation, the Commission has looked to the profession to assume the leadership in setting accounting principles. Authority and responsibility have been delegated and have been accepted by the profession.

The view of the first Chief Accountant of the SEC, Carman Blough, expressed the position of the Commission in its early days as well as the present. He argued that the development of accounting principles should be left to the accounting profession. He recognized that the accountants faced the problems of the profession on a daily basis and thus should be responsible for their solution. At the 50th Anniversary of the American Institute of Accountants in 1937 he stated the following:^{8/}

"As a matter of fact I think I have emphasized at numerous times that the policy of the Securities and Exchange Commission was to encourage the accountants to develop uniformity of procedure themselves, in which case we would follow. We expected to be able to follow the better thought in the profession and only as a last resort would the Commission feel the necessity to step in."

Throughout its existence the Commission has been active in supporting the efforts of the profession to articulate principles. It supported the Committee on Accounting Procedure and when it became apparent that a new approach was needed, the Chief Accountant of the Commission served on the committee which recommended the creation of the Accounting Principles Board in 1958. Fourteen years later when the institutional structure was changed again, a former SEC Commissioner, Francis Wheat, was chairman of the task force established by the profession to recommend a new framework.^{9/} The Commission endorsed the proposals made by the task force which led to the creation of the Financial Accounting Standards Board. In each of these cases, the Commission's role was supportive of the efforts of the accounting profession.

Perhaps more important than its assistance in the establishment of institutions for defining accounting principles have been the actions of the Commission in support of principles established by these bodies. Long before the accounting profession bound its members to support pronouncements of its own principle producing bodies, the Commission was enforcing these statements. With only one significant exception, the Commission indicated by word and deed that it would not accept financial statements in filings which were prepared in a fashion not in conformity with the authoritative pronouncements of the profession. The conspicuous exception--accounting for the investment credit--was one in which the Commission concluded that it would not support an opinion when representatives of leading accounting firms had not only voted against it but indicated that they would not require their clients to abide by it. In this

case, the Commission was not enforcing a contrary view to that of the Board but rather refusing to enter a dispute among major firms on the side which the Board favored. In retrospect, it is the judgment of most parties involved that the Commission made an error in declining to support the Board. It is certainly clear that neither the profession, the Board or the Commission benefited from the episode which ultimately culminated ten years later in an act of Congress which enshrined the diverse practices which had been used. Since that time, both groups have worked to avoid recurrence.

The means by which such situations have been avoided has been a carefully developed program of communication between the Accounting Principles Board and the staff of the Commission. This is the process which has been identified by some as the means by which the Commission works its will on the Board. Such an analysis reveals a misunderstanding of the decision-making process in a pluralistic society.

Where two groups, both with elements of responsibility and authority over a field of endeavor, and both with a similar overall view of the objectives of the field, seek to exercise their authority, coalition is the natural result. In such a situation, each group recognizes the power and authority of the other but does not seek to test it because conflict under such circumstances nearly always represents a negative sum game. Thus it is with the SEC and the accounting profession. In setting accounting principles, neither side wishes to put the authority of the other to the test. This does not make the authority of both groups any less real. In those situations where conflict has developed, each group

has won its share. The recent example of land sales accounting is only one case where the Board has had its way against the expressed wishes of the Commission. In that case, communication broke down and confrontation developed. Other less publicized cases could be cited where strongly expressed views of one or the other group caused a full or partial surrender.

Much more frequently, however, the two organizations work in harmony. The Commission staff provides input to the Board's deliberations on the basis of their continuing experience with individual problems of registrants. They express their views on the accounting issues informally as an opinion is being developed. These views are seldom in substantial conflict with those of most Board members and differences are usually compromised.

An analysis of this process does not lead to the conclusion that authority rests on one or the other side. Both groups have real authority but neither wishes to push the other to the extreme. At such an extreme, each group could inflict much damage on the other but at substantial cost. It is far more efficient to exercise authority jointly. Successive Chairmen of the Commission have articulated this approach. Chairman William Cary, responding to a 1964 congressional question as to who had the primary responsibility for determination of accounting principles, said:^{10/}

"I think I can say quite truly that we have cooperated with the accounting profession very carefully on this subject over a period of years. I would take it as a joint responsibility."

Similarly, Chairman William Casey identified the relationship as a partnership in his 1972 speech to the AICPA annual meeting.

As we now move into the era of the Financial Accounting Standards Board, there seems little reason to expect any basic change in relationships. The Commission supported the creation of the Board and in a letter to the AICPA on May 4, 1972, set forth its views as follows:^{11/}

"The Commission believes that the structure for the development of standards of financial accounting and reporting recommended in the 'Report of the Study on Establishment of Accounting Principles' will foster the continuation of the longstanding policy of cooperation between the Commission and professional accountants. Of equal importance, the recommended structure appears to be responsive to the need expressed in many quarters for improvement of investor confidence in accounting principles and in financial reporting generally."

* * *

"In conclusion, we wish to reaffirm our strong conviction and our policy, dating back to 1934, that the development of accounting principles within the private sector is consistent with the public interest."

To the extent that the FASB is able to obtain more inputs from diverse groups and undertake more meaningful and controlled research, its authority will increase since it will be able to defend its viewpoint in the ongoing dialogue on accounting principles. The Board and the SEC, however, will have to operate on the principle of mutual non-surprise if their joint efforts are to be maximized. It appears that both entities are moving in this direction in their early contacts.

Auditing Standards

The relationships between the accounting profession and the SEC are by no means limited to the establishment of accounting principles. A second area that requires attention is auditing standards.

In many respects, the relationship between the Commission and the Committee on Auditing Procedure (now the Auditing Standards Executive Committee) parallels that with the bodies responsible for accounting principles. The Commission's statutory authority over the auditing process is not so clearly defined except in terms of the form of audit reports which will be considered acceptable. Nevertheless, the Commission staff and the Auditing Committee have generally cooperated in the creation of published standards, with the profession again in the leading position.^{12/}

The Commission's approach to auditing standards was put to its most rigorous test in the McKesson & Robbins case in 1938. The record in this case raised many questions as to whether or not the generally accepted auditing procedures in use were adequate to assure accuracy of financial statements. It was revealed that an elaborate set of records had been forged by corporate officials (using fictitious names) and that a substantial amount of recorded assets were fictitious.

In the SEC hearings regarding the case the testimony of many accountants acting as expert witnesses revealed weaknesses in the auditing procedures. Several professional groups immediately took steps to correct these weaknesses, including the Institute which issued Extensions of Auditing Procedure. This statement became the first of a series on auditing practice.

In recognition of the profession's attempt to strengthen auditing standards, the Commission concluded its report as follows:^{13/}

"We have carefully considered the desirability of specific rules and regulations governing the auditing steps to be performed by accountants in certifying financial statements to be filed with us. Action has already been taken by the accounting profession adopting certain of the auditing procedures considered in this case. We have no reason to believe at this time that these extensions will not be maintained or that further extensions of auditing procedures along the lines suggested in this report will not be made. . . Until experience should prove the contrary, we feel that this program is preferable to its alternative--the detailed prescription of the scope of and procedures to be followed in the audit for the various types of issuers of securities who file statements with us--and will allow for further consideration of varying audit procedures and for the development of different treatment for specific types of issuers."

In the last decade, public accountants have again come under criticism for defective auditing. There are several dimensions to this criticism. One group of cases causing doubts about the effectiveness of audit work is where auditors have done a defective job of fact finding in terms of professional auditing standards currently in existence. Here the Commission has undertaken disciplinary procedures under its Rule 2(e), sought injunctions and made criminal references depending on the seriousness of cases involved. In addition, the Commission has cooperated with the disciplinary

and quality control efforts of the AICPA and has sought the cooperation of the Institute in applying sanctions which will have a preventive rather than punitive impact on the accountants involved.

Another set of problems relate to cases where the audit-fact finding was adequate but poor judgment was used in appraising the measurement principles used by the client. As a result, presentations inconsistent with accounting or economic reality were blessed with unqualified auditor's opinions. In one such case (Penn Central), the staff of the Commission has publicly criticized the auditors^{14/}. Some disciplinary actions have also been undertaken. The staff of the Commission, in its review of documents filed with it and in conferences with registrants and their auditors, attempts to reduce the incidence of such items before they become part of the final financial statements. In many cases, items of this sort have indicated areas of weakness in the application of accounting principles currently in existence and have led to Accounting Series Releases (as in the case of real estate--ASR 94; pooling of interests--ASRs 130 and 135; and leasing--ASR 132) or to actions by the Accounting Principles Board.

A third type of case which has led to criticism is one in which accepted auditing procedures have not proved adequate to uncover a serious problem with financial statements. Here the question that must be dealt with is whether the situation is so unique that it constitutes an aberration that does not warrant a change in basic procedures or whether it reveals a significant weakness in procedures which the profession should seek to remedy. The Allied Crude Vegetable Oil fraud led, for example,

to new auditing procedures for goods in public warehouses (Statement on Auditing Procedure 37). The Equity Funding debacle is also leading to a re-examination of auditing standards in the areas of fraud detection, computer auditing procedures and insurance auditing although it is too early in the investigation of this case to draw conclusions as to why the fraud was not uncovered.

In each of these situations, the profession has been responsive to the public need and the joint efforts of profession and Commission have led to improvement. Once again, both responsibility and authority have been delegated. The relationship is a legitimate partnership, not a superior-subordinate relationship.

Areas of Commission Leadership

There are some areas in the partnership where the Commission has definitely played a leadership role and is likely to continue to do so even though cooperative efforts with the profession are important in these cases as well. One is the area of independence of accountants. Congress provided that financial statements shall be "certified by an independent public or certified accountant." While the profession has dealt with independence as an auditing standard, it has been slow to impose firm rules and guidelines. This is partly due to the structure of the profession which includes many small practitioners who service their clients in many ways and have been concerned with the implications of a number of specific rules directed primarily toward the appearance of independence which the Commission has felt essential in dealing with auditors of public companies. The Commission has, therefore, set forth

specific rules on independence in Regulation S-X and it has publicized in three Accounting Series Releases a number of individual decisions of the staff on particular independence problems. The AICPA Ethics Committee has taken an active role in developing independence standards for the profession and in most respects the profession's standards are now consistent with those of the Commission. It seems likely that cooperative effort will continue to narrow areas of difference.

A second major area in which the Commission has taken a leading role in the partnership is in the development of standards of disclosure. In the various registration forms and in Regulation S-X, the Commission has fulfilled its legislated responsibility of defining information required by investors. Both accounting principle making and other professional bodies have worked closely with the Commission by providing informal inputs and public comments on proposals, and in some cases by including disclosure requirements in APB opinions. However, the Commission has not hesitated to take the first step. Recent proposals on disclosure of details of unusual charges and credits to income, liquidity and compensating balances, quality of earnings, impact of alternative accounting principles and components of tax expense indicate that the Commission remains willing to innovate in the disclosure area.

Commission Support in Individual Cases

The Commission's partnership with the profession cannot be viewed simply on a profession-wide basis. An important part of the relationship must be examined in the framework of the responsibility and authority of individual firms in fulfilling their auditing and reporting functions in

individual client situations. The responsibility of representing the public while being paid by a client was assigned by Congress at the behest of the profession which said that their members could handle the difficult problems posed by the economic relationships involved.

The Commission has traditionally taken all possible steps to support individual auditors in resisting client pressures. This has been done informally in meetings and telephone conversations where the client has been advised of staff support for the position taken by an independent auditor. While the Commission staff does not like to be used as a no sayer in cases where an auditor knows the right answer but prefers not to be the one to tell it to the client, it is supportive in cases where the auditor is prepared to exercise his authority and responsibility.

Even beyond individual situations, the Commission has sought to improve the position of the auditor in dealing with his client. For example, the Commission's traditional refusal to accept "except for" opinions or opinions which indicate major scope qualifications in filings has strengthened the hand of the individual auditor in difficult situations. In addition, Accounting Series Release 123 advocated the establishment of Audit Committees which would create a direct relationship between auditor and board of directors and thus improve the auditor's situation.

In 1971 the issuance of a revised Form 8-K requirement called for timely public disclosure of all auditor changes together with letters from both client and auditor indicating whether or not in the past eighteen months there had been any disagreements between auditor and client on accounting or auditing matters which would have led, if not resolved, to a qualification in the auditor's report. This requirement was designed

to discourage clients from employing new auditors simply to obtain a more favorable accounting treatment by exposing such changes to the cleansing light of public disclosure. In addition, the Commission staff routinely follows up in cases where significant disagreements are reported to determine the full facts and to be sure that the interests of investors are being protected.

Summary

In summary, the record indicates that the Commission and the accounting profession exist in a legitimate partnership for the protection of investors. Both have authority and responsibility. This partnership is a logical and expected result of a social setting in which parties with authority and related objectives are created or develop. Because this result is a natural one and because it is generally perceived to have worked effectively, it is highly likely that the relationships established will endure and will continue to serve the best interests of investors, accountants and an efficient capital market.

FOOTNOTES

- 1/ Charles T. Horngren, "Accounting Principles: Private or Public Sector?," The Journal of Accountancy, Vol. 133, No. 5 (May 1972), pp. 37-41.
- 2/ George Benston, "The Value of the SEC's Accounting Disclosure Requirement," The Accounting Review, Vol. XLIV, No. 3 (July 1969), pp. 515-32.
- 3/ Homer Kripke, "The SEC, the Accountants, Some Myths and Some Realities," New York University Law Review, Vol. 45, No. 6 (December 1970), pp. 1176-88.
- 4/ The Securities Exchange Act of 1934 provides that reports filed with the Commission should be ". . . certified if required by the rules and regulations of the Commission by independent public accountants. . .," Section 13(a)(2).
- 5/ Stephen A. Zeff, Forging Accounting Principles in Five Countries: A History and Analysis of Trends [Arthur Andersen & Co. Lecture Series] (Champaign, Illinois: Stipes Publishing Co., 1972), pp. 112-3.
- 6/ "Uniform Accounting by Bank Borrowers," Federal Reserve Bulletin, Vol. 3, No. 4 (April 1, 1917), pp. 270-84.
- 7/ Zeff, op. cit., pp. 237-47.
- 8/ Carman G. Blough, "Roundtable Discussion: Developments in Accounting Theory and Practice Since 1929," Fiftieth Anniversary Celebration (New York: The American Institute of Accountants, 1937), p. 190.
- 9/ Establishing Financial Accounting Standards: Report of the Study on Establishment of Accounting Principles (New York: The American Institute of Certified Public Accountants, March, 1972).
- 10/ "Statements in Quotes," Journal of Accountancy, Vol. 117, No. 6 (June 1964), p. 56.
- 11/ Securities and Exchange Commission News Digest, No. 72-85, May 4, 1972, p. 1.
- 12/ The most notable exception is in the auditing procedures relating to broker-dealers and investment companies. Due to the nature of the business concerned the SEC has taken a more active position.
- 13/ U. S. Securities and Exchange Commission, In the Matter of McKesson & Robbins, Inc.--Summary of Findings and Conclusions, Accounting Series Releases 1-112 (Washington, D. C.: U. S. Government Printing Office), p. 24
- 14/ U. S. Securities and Exchange Commission, Staff Study of the Financial Collapse of the Penn Central Company; Vol. 1 (Washington, D. C., 1972), p. 135.