

**NEWS**

**SECURITIES AND  
EXCHANGE COMMISSION**

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It is always a pleasure to meet with the accounting profession in California and this time it is doubly a pleasure to come back to California to be with you.

I have not yet started my speaking circuit as Chairman of the Commission. My first priorities are to learn my job, get things organized and decide what it is I want to talk about. But when Lorin called me and asked me to come speak to this group, I felt an urgency to do it because I did not feel that I had the luxury of waiting for six months or a year. My concern is that it might well then be too late.

As I appear before you today, I feel a very real sense of urgency on behalf of the profession. From a personal viewpoint, I feel like the guy in the middle. I have very little desire to preside, during my five years as Chairman, over increased regulation of the accounting profession. I have no wish to see legislation passed that would place the responsibility on the Commission to, in effect, assume responsibility for regulating the profession.

I have yet to see a government body that establishes accounting rules with great effectiveness, and I think we have many examples of the problems that are created when they try to do so. I am firmly convinced that the private sector -- the profession -- is in a much better position to maintain and assume responsibility for its own destiny than is any governmental body.

Nevertheless, time is running out.

I know as do you that some of the recent criticism of the profession has been inaccurate or overstated.

I know as do you that accounting is more complex now than it has ever been and that the profession in many ways is more competent and more proficient now than it has ever been.

I know as do you that the public has expectations of the profession and of what the certificate means that exceed reality.

I know as do you that, with the rapid growth in the size of accounting firms and the demands of the profession, each year we are bringing into the profession large numbers of people, and that the task of orienting them to the policies, practices and disciplines and the profession is much more difficult than it used to be.

I know as do you that many of the positive accomplishments that we talk about today stem from action by the profession itself. For example, the FASB was a product of the Wheat Commission which in turn was created by the profession. The Cohen Commission was appointed by the profession. The Structure Committee was selected and appointed by the profession. So the profession is making efforts to be responsible and is acting on its own initiative.

I know as do you that the financials are the statements of management -- not the statements of the accountant.

And, I know as do you that the profession is not structured in a way that enables it to respond quickly to new problems -- not structured in such a way as to be able to set standards in a timely fashion or conduct the disciplinary proceedings necessary for the profession to keep its own house in order.

Now, we all know that we ought to be doing a better job of making sure everybody understands all these things -- public, legislators, etc. But at the same time, if we focus our time and attention only on communicating and explaining these things and correcting the misunderstandings, we are going to lose. And we are going to lose because there is a certain expectation out there. There is a timetable running -- or a clock ticking -- characterize it as you will. What it amounts to is that the profession must, in the immediate future, assume a much more aggressive role in shaping its own destiny. The profession must accomplish a number of very specific things in a relatively short period of time if, indeed, it is to continue to determine its own future.

I am sure most of you kept track of the Metcalf Committee Hearings. I hope you have the flavor of those Hearings and not just what your firm's representative might have said at the Hearings, because the Hearings conveyed a definite tone, and a sense of expectation.

The tone of the Commission's position at the Hearings recognized the anxiety, if you will, of many members of Congress and many members of the public and the fact that the timetable is running. It also recognized that the SEC also is being criticized for what it is or is not doing, and for not being aggressive enough or responsible in the discharge of its oversight role. The Commission has committed to file a report with the Metcalf Committee and with its own oversight committees, including Congressman Moss' Committee, by July 1, 1978, on specific progress that has been made by the Commission and the profession. Congressman Moss told you this morning that he wants a sense of progress by this Fall. I think therefore that both the profession and the Commission have got to get some things done before this Fall if we are to continue on our own course.

The issues, as I see them, are three: independence, the accounting and auditing standard setting process, and quality control, including self-discipline. The issue of independence, I suspect, is the key one. It is key because everything else fits with it.

Let me start off by mentioning some of the things that the Commission expects to be doing over the next period of months that will have some impact and supportive value in terms of independence.

Obviously one of the keys to independence is the amount of pressure that a client can bring on an auditor and the ability of the auditor to withstand that pressure. We shortly will be proposing a rule to amend Form 8-K to require disclosure of the reasons why an auditor was dismissed and indication of whether the dismissal of the auditor and the reasons for it were discussed with and approved by the board of directors and the audit committee of the board.

Secondly, we will be proposing a change to the proxy rules to require a discussion in the proxy material of why the auditor was terminated with the expectation that the auditor would also be given an opportunity to comment in the proxy material.

Thirdly, moving into the area of management advisory services and the concern about the impact of management advisory services, we will be putting out for comment a proposed rule to require disclosure in the proxy material of all services provided to audit clients and a breakdown of the fees. I recognize that the Cohen Commission Report indicated that there is no evidence of specific instances in which the providing of audit services impacted independence. I respond to that in two ways. First, I think such evidence does exist, but second, whether or not it does, the appearance of lack of independence in today's context is every bit as important as the reality of independence or lack thereof.

We will also be asking for comments on whether certain management services should be prohibited. And,



we will be continuing to support audit committees of truly independent directors for all publicly-held corporations. I would very strongly urge for your consideration the recommendation of Arthur Andersen at the Metcalf Committee Hearings that the professional standards of the profession be revised to require an independent audit committee for any public client whose assignment is to be undertaken by a member of the profession. I believe this is an interesting approach and a unique opportunity for the profession itself to help shape the client and help assure for itself the kind of buffer and support of independence that an effective audit committee of outside directors can provide.

The proposal that financial data of the accounting firms be publicly disclosed was also presented to the Metcalf Committee. The Commission, at this point, has taken the position that we can see no specific, tangible value to be achieved by the proposal and therefore do not support it.

Similarly, we are not supporting the proposal that auditors be arbitrarily changed every five years -- at least not at this time. We recognize the problems the proposal addresses, but we believe that there are less costly ways of achieving the same result. In many cases, the audit partners and audit teams are being rotated, as I believe they should be. We urged in my testimony that the second partner review be more broadly and more intensively implemented as a way of reinforcing independence.

Now, the Commission can take some steps to enhance auditors' independence. But many of the pressures that auditors receive in terms of audit cost, scope of audit, application of accounting principles or auditing standards, or getting the certificate out early, are pressures that only the auditors themselves can withstand. The basic problem here is one of professional attitude which cannot be legislated, although legislation will be resorted to if self-discipline fails.

What we are dealing with is a sense of professionalism and judgment which must exist if accounting is to continue to be viewed and treated as a profession. That sense of professionalism has to exist at the top of each of the firms, and in the profession as a whole, and it obviously has to permeate the entirety of the firm and of the profession. And it is the essence of each of your responsibility individually.

The second area of concern is accounting principles and auditing standards. We want to continue to look to the collective efforts of the private sector to provide leadership in establishing accounting principles and auditing standards. We are not satisfied, as many are not, with the progress made by the FASB. We strongly support the recommendations of the Structure Committee, and would urge that you implement them promptly.

We would urge that you consider the tentative recommendations of the Cohen Commission very seriously.

My judgment is that the recommendations of the Commission are by and large appropriate for the profession today. Furthermore, in deciding whether to adopt them, you ought to take into consideration not only whether you believe they are appropriate, but also how those recommendations reflect public expectations.

The larger problem though, as Al Sommer indicated to you this morning, is not so much with accounting principles and auditing standards, as it is with the lack of uniformity with which those standards are applied. The problem is not so much with the standards as it is with the individual case of poor professionalism, or poor judgment, in applying the standards. We recognize, all of us, that the profession, by and large, does apply the standards well, is professional and is independent. But there are exceptions. So, what we must develop within the profession is a peer review process that enables the profession itself to review not only the adequacy of the auditing procedures of the firms, but the actual implementation of those procedures and the application of accounting standards.

A voluntary peer review process probably does not go far enough, and the concept of having firms review each other will, over time, not be satisfactory. It may be only a matter of appearance, but if the firms continue to review each other, over time doubt will arise whether the firms can truly review each other objectively and with the necessary independence. What is called for is a more institutionalized approach such as a peer review process conducted by appointed committees, probably including members outside of the private practice of the profession.

Coupled with peer review, the profession needs a much enhanced mechanism to discipline itself. That is going to be the ultimate key, not only for the sake of disciplining those who have failed in their professional undertaking, but to reinforce independence. If the profession's own discipline proceedings are more effective, and more visible, it will strengthen the independence of the auditors, as well as warding off legislative alternatives.

I do believe that any self-regulatory process developed by the profession will probably need some federal legislative mandate. The profession now has 54 state and territorial societies, 54 licensing bodies and the AICPA. My sense is that the profession needs a national body, governed largely by the profession, to provide the kind of self-regulation and discipline that would assure the profession maintains its professional standards and would be credible in reassuring the public that it is doing so.

I am confident that resolution of the kinds of complex issues that are involved in independence, in self-regulation and in discipline of accountants would best be achieved by the profession itself, subject to a continuing oversight role on the part of the Commission.

It will not be easy. Effective solutions to the problems facing accountants will be difficult because the profession has consistently been slow to recognize its problems and unable to reach timely agreement on approaches to solving them. I have

substantial doubts whether the profession's will be timely and substantive enough.

So, you can expect during the next year a lot of prodding on the part of the Commission. You can expect that we will be indicating the kinds of issues we would like the profession to consider. You can expect that if we do not feel that the progress is adequate, we will say so and, for example, substitute ourselves, reluctantly but affirmatively, for the FASB, in those cases where we feel accounting standards or accounting principles need to be more aggressively, or more promptly resolved.

I will be available to the profession during the next year to help you respond to the challenges you face so that you can preserve for the profession its self-governance.