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THE ACCOUNTING PROFESSION AND THE CHALLENGES AHEAD

An Address By

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INTRODUCTION

It is indeed a pleasure for me to appear before two such distinguished groups as are gathered here tonight. In my nearly four years as Chairman of the Federal Securities and Exchange Commission, I have taken a very active personal interest in the accounting profession and the challenges which it faces. Perhaps more than most Chairmen, I have felt close to the profession, appreciating the importance of its role, the extent to which government can, should or should not become involved in its affairs, and the capacity which the profession has to respond meaningfully to the demands placed upon it.

In many ways, accounting is unique among the professions. It does not advocate, heal, or counsel; nor does its primary obligation run to those who retain its services. Rather, it applies a coherent system for communicating financial status and position and certifies to its presentation. That is, it seeks to assure users of financial statements that the statements are meaningful, and that they can be accepted as credible and relied upon. As such, if the profession's work is to have value, it must rest on the profession's ability to maintain and justify a high degree of public trust and confidence.

Given the importance and public nature of the accounting profession's work, it is one which is clearly embued with the public interest. Accordingly, over the nearly 50 years since enactment of the first federal securities laws, the federal government has played a sometimes restrained -- but nevertheless always attentive -- role in the activities of the profession. This governmental interest has not, in my view, hampered the profession and its work. Indeed, the development, sophistication, and financial rewards of the profession are, at least in some measure, attributable to the critical importance placed upon financial reporting and disclosure -- as well as the certification process -- under the securities laws. Moreover, it may be argued that, without the discipline instilled by actual -- or potential -- governmental involvement in the standard-setting and auditing activities of the profession, advancements in the profession might not have proceeded as rapidly or responsibly as they have, and the public might not now perceive the profession as being accountable and credible.

During the last decade, however, much has occurred to challenge the credibility and trust which the profession has cultivated and enjoyed. For example, the relevance of traditional accounting principles has come into question in our chronically inflationary environment. Moreover, we have witnessed the collapse of major corporations on the heels of financial reports, reviewed by respected auditors, which did not communicate the threat of impending insolvency. Revelations of off-book payments to foreign officials, political candidates, and others further caused doubt as to the effectiveness of the profession's work. And, the increasing emphasis which many auditors have placed on management advisory services as a revenue source has led some to question whether the role of adviser is consistent with the independence so essential to the audit function.

Whether these concerns were valid or not should not obscure the fact that they underscore convincingly the need for the profession to be viligant in maintaining the public's trust. In the past, when such trust has been threatened, calls for a greater governmental role in the profession's affairs would almost inevitably be heard. I do not, however, believe that government can provide an effective program to establish accounting standards, or to regulate and discipline professional conduct, without doing considerable damage to the vigorous and strong accounting professionalism which is so important to our Nation's maintaining a healthy, trusted, and efficient marketplace for securities and mechanism for allocating capital resources.

Some of you may feel, however, that any risk of expanded government authority over accountants is slight at this time. Clearly, the American public is becoming increasingly skeptical of the benefits of greater governmental regulation of the private sector.

A critical self-examination of the appropriate role and function of government is fully appropriate. As a free society, we need to ask ourselves more critically than we have in the past how much government we can afford, what purposes government can and should accomplish, and what risks we run in sapping the vitality of the private sector through excessive governmental involvement and dependence.

Nevertheless, this wave of skepticism towards government and what it can accomplish may provide an undue degree of comfort -- a sense of relief which may be misplaced. The crucial question for the accounting profession is not the current attitudes of the federal government as to the appropriate degree of regulatory involvement with the private sector. Rather, the real issue is the critical importance to the profession -- and to our capitalist economy and democratic society -- of the strength of the public's trust in the corporate sector and the accounting profession. And, doubts about the efficacy of regulation or the appropriate role of government will not protect the profession's function and independence if that trust were to be lost.

To the extent that public trust and confidence are weak, the danger is very clear and great that the next inevitable wave of corporate failures will trigger a reaction calling for greater governmental presence in the process. This prospect underscores for me the urgency that, regardless of governmental or other external pressures, the profession itself must vigorously and responsibly continue to implement a program of effective private-sector regulation. Indeed, there are a number of important challenges facing the accounting profession today, and I would like to share with you this evening some thoughts concerning some of them.

CURRENT CHALLENGES FACING THE ACCOUNTING PROFESSION

A. Accounting Standard-Setting

Financial reporting is no better and no more coherent than the accounting standards on which it rests. Inflation, and skepticism towards the meaning and level of business profits, are today challenging many traditional perspectives on financial measurement and reporting.

The maintenance of private-sector control over accounting standard-setting must be a key priority for all those concerned with a truly meaningful system of recording and presenting economic events. As you know, the Commission has long deferred to the recognized professional bodies as the appropriate vehicle by which to study accounting issues and set accounting standards that most fairly and accurately present the true picture of an enterprise's economic activities and condition.

I have no doubt that that position is correct. An effectively functioning private-sector body is better situated -- in terms of resources, processes, and access to the necessary information and insight -- to do the job better and more timely. It is also better able to ensure that the processes and rules established are insulated from political considerations.

The Financial Accounting Standards Board appears willing to meet the challenge. Most importantly, the board has made considerable progress towards the development of a conceptual framework for financial reporting. The FASB must continue to pursue this project aggressively. While its completion will not provide answers to all difficult accounting and financial reporting problems, it will provide a coherent structure within which to resolve these problems in a timely, effective, and consistent manner.

Despite the Board's positive leadership -- as evidenced by the conceptual framework project and several individual initiatives -- the Board's future success in discharging its responsibilities should not be taken for granted. If the FASB is to be a permanent and viable feature of the accounting landscape, it must be able to rely on the support and encouragement of the accounting profession and the corporate community -- regardless of the effects of particular Board decisions on individual reporting companies, and regardless of whether those companies and their auditors fully agree with the Board.

A complete catalogue of all of the difficult accounting standard-setting issues which currently face the profession is beyond the scope of my remarks today. I would, however, like to highlight two areas -- inflation accounting and cash flow and liquidity. Each of these topics illustrates the need for coherent accounting principles to evolve in response to changing economic conditions.

1. Accounting for Changing Prices

Inflation is working a revolution in many facets of our society. Most importantly for this group, it is seriously undermining the meaningfulness and utility of conventional historic cost-based financial measurements and reporting. The profession needs to come to grips with this fact or it may find itself reviewing and certifying financial statements which are of everdeclining practical utility in business and investment decisionmaking. And, statements which are seriously misleading in important respects could lead not only to erroneous business and governmental decisions, but also to questions about private-sector standard-setting itself and the role and function of the accounting profession in general.

Let me illustrate the importance of this issue. Analyses by various national accounting firms show that inflation-adjusted 1979 corporate income among selected industrial companies is, at most, 60 percent of the figure reported under traditional accounting methods. And, as a result, taxes and dividends are a much higher percentage of real income than traditional measures reflect. For example, one study shows that the effective tax rate in inflation-adjusted dollars is 55 percent as contrasted to the 39 percent of income computed on the basis of historic cost accounting. Indeed, the aggregate of taxes and dividends approaches -- and in many industries exceeds -- inflation-adjusted corporate income. Therefore, much of the corporate community is unconsciously distributing more than its real income to shareholders and the tax collector. And, for all practical purposes, a substantial part of American industry -- the creator of our national wealth, and the keystone of our prosperity and our liberty -- has begun to liquidate.

The FASB's Statement No. 33 is a significant step towards coming to grips with the distortions which inflation works on financial reporting. Ultimate success in this area will depend to a large extent on the efforts of the accounting profession and the business community in applying Statement No. 33 and in providing such additional disclosures as are necessary to enable users to assess the impact of changing prices on particular companies and industries. The corporate community has an obligation to contribute both to the private-sector standard-setting process, and to better user understanding of financial data, by adequately disclosing all additional information which will make such reporting more meaningful and more complete.

In this connection, the Commission has restructured the management discussion and analysis requirement of its annual report on Form 10-K to elicit better information concerning the effects of inflation and changing prices. Thus, all registrants, including those which are not required to present Statement No. 33 information, should make some textual presentation with respect to these matters. A meaningful response to the Commission's requirement by smaller companies -- which are not subject to FAS 33 itself -- would particularly add to the utility of their financial reports.

2. Cash Flow and Liquidity

Another fundamental change in financial reporting -- which takes on much greater significance as a result of chronic inflation -- is the need for better and more meaningful disclosure concerning cash flow and liquidity. In part, liquidity issues have become more significant as a result of inflation and its impact on the utility of net income as an analytic tool. In addition, the increasing use of novel and often complex financing arrangements -- such as various types of off-balance sheet financing -- seems to be straining the capacity of the historic cost framework to provide meaningful disclosure.

With the impact of inflation and the higher interest costs of debt financing, users have become increasingly concerned with solvency, as well as income, measurements. Such information is also vital for assessing the company's ability to maintain or increase its dividends. Historically, dividends have been considered in the context of creditors and corporate growth. Today, they need also to be assessed in light of whether the company is maintaining its basic productive capacity. As a result of these factors, it is clear that the financial reporting system must be supplemented by information which conveys the adequacy of a company's cash resources.

The FASB's vehicle for addressing these issues is the "Funds Flow and Liquidity" phase of the conceptual framework project. This aspect of the project is now under increasingly active development. Major improvements in financial reporting will take time, however, and will involve some basic challenges to traditional patterns of accounting thought.

While the FASB addresses these questions, the Commission will need to play a role in ensuring that investors receive the basic information which they need. At present, the Commission's revised management discussion and analysis requirements present both the specific opportunity and the obligation to the corporate community to provide meaningful information about liquidity position and capital resources --

although the registrant has substantial flexibility in determining the actual content of the discussion.

This flexibility carries with it, however, increased responsibility to provide an effective presentation. Financial reporting must not be dominated by a bottom-line obsession; it needs to be more balanced. And that, in my view, requires greater emphasis on cash flows and enterprise liquidity.

B. Scope of the Auditor's Role

I would now like to turn to the role of the auditor. As I stated at the outset, the independent auditor's job is to lend added credibility to corporate financial information in order that users -- who may well never know or see the corporation's officers or its assets -- can justifiably rely upon it. Auditors must keep that objective constantly in mind as they structure their professional emphasis, standards, and opinion. To the extent that the profession focuses, instead, upon protecting itself from legal liability, it may win the battle, but ultimately lose the war. If users conclude that the audit process and opinion do not afford a sufficient additional measure of credibility to management's financial representations to be worth their costs, the profession will not survive as we know it. This is something which the profession needs to keep in mind in many contexts.

More subtly, both outside and internal auditors are also major contributors to public confidence in the effectiveness of the corporate accountability process -- confidence which is the key to avoiding governmental intrustions into the private-sector's decisionmaking process. To state it simply, many feel that the audit serves as a discipline inhibiting improper conduct which might prove very tempting were it not for the knowledge that the transaction in question would some day likely come to the attention of the auditor.

Today, I would like to touch on two of the current challenges facing the profession in its role as auditor. First, I would like to discuss a new challenge which has arisen for the profession as a result of the 1977 Congressional enactment of the accounting provisions of the Foreign Corrupt Practices Act. That challenge is how to contribute meaningfully to issuers meeting the internal accounting control and corporate accountability purposes of the Act in order to help ensure continued private-sector responsibility for those important processes. Finally, I will close with some comments on the challenge of effective self-regulation which the auditing profession is today facing.

1. The Accounting Provisions of the Foreign Corrupt Practices Act

One of the most recent -- and perhaps most critical -- challenges facing the corporate community and the accounting profession today comes as a result of the enactment of the accounting provisions of the Foreign Corrupt Practices Act of 1977. With a little over three years' experience under the Act -- and after considerable review and study -- I recently delivered a Commission policy statement concerning the Commission's interpretation of the Act and its enforcement policies and priorities under it. In brief summary, I stressed the following points as fundamental to the Commission's analysis of the Act:

-- Recordkeeping. The Act's recordkeeping provision requires that a company maintain records which reasonably and fairly reflect the transactions and dispositions of the company's assets. This provision is intimately related to the requirement for a system of internal accounting controls, and we believe that records which are not relevant to accomplishing the objectives specified in the statute for the system of internal controls are not within the purview of the recordkeeping provision. Moreover, inadvertent recordkeeping mistakes will not give rise to Commission enforcement proceedings; nor could a company be enjoined for a falsification of which its management, broadly defined, was not aware and reasonably should not have known.

-- Internal accounting controls system. The Act does not mandate any particular kind of internal controls system. The test is whether a system, taken as a whole, reasonably meets the statute's specified objectives. "Reasonableness," a familiar legal concept, depends on an evaluation of all the facts and circumstances.

-- Deference. Private sector decisions implementing these statutory objectives are business decisions. And, reasonable business decisions should be afforded deference. This means that the issuer need not always select the best or the most effective control measure. However, the one selected must be reasonable under all the circumstances.

-- State of mind. The accounting provisions' principal objective is to reach knowing and reckless conduct. Moreover, we would expect that the courts will issue injunctions only when there is a reasonable likelihood that the misconduct would be repeated. In the context of the accounting provisions, that showing is not likely to be possible when the conduct in question is inadvertent.

-- Status of subsidiaries. The issuer's responsibility for the compliance of its subsidiaries varies according to the issuer's control of the subsidiary. The Commission has established percentage of ownership tests to afford guidance in this area.

-- Enforcement policy. These views reflect Commission policy and practice in implementing and enforcing the accounting provisions and are consistent with the cases brought by the Commission over the last three years. During this period, the Commission has addressed these areas prudently and with common sense. Similarly, the Commission has not sought out violations of the accounting provisions for their own sake; indeed, we have not chosen to bring a single case under these provisions that did not also involve other violations of law. The Commission, instead, places its greatest emphasis on encouraging an environment in which the private sector can meet its responsibilities in complying with the Act meaningfully and creatively.

The philosophy expressed in that policy pronouncement again clearly emphasizes the Commission's view of the importance of corporate accountability in America, and the wisdom and necessity of maintaining primary reliance on private-sector initiatives and decisionmaking in achieving that end. It was for the same reasons, as you may recall, that the Commission last June withdrew its proposal to require management reports -- and eventual auditor involvement with them -- on the internal accounting control systems of corporate issuers. As stated in that withdrawing release, the Commission clearly recognizes the significant progress being made in the area by corporations and the accounting profession alike, as well as the potential for stifling such private-sector initiatives that might arise if the government were to act preemptively or precipitously in this area.

Nevertheless, here too, the Commission has no intention of abdicating its ultimate responsibilities, or of defaulting on the obligation which it has to guide and encourage private-sector developments in promoting and improving record and internal accounting control systems for public companies. But, primary reliance must remain on the private sector. Thus, the profession is in a unique position to provide a needed measure of discipline to ensure that progress is made -- short of governmental involvement.

The primary thrust of the Act's accounting provisions, in short, is to require those public companies which lack effective internal controls or tolerate unreliable record-keeping to comply with the standards of their better managed peers. The ultimate goal must, of course, be the design and implementation of appropriately conceived and maintained systems of internal accounting control. Crucial to such a result is a proper overall control environment that involves senior management, audit committees, and the entire board of directors where necessary or appropriate; that will not allow an atmosphere which encourages or condones falsifications or circumventions to exist; that will encourage prompt detection and correction when such problems do arise; and that will focus on a forward-looking effort to constantly monitor, enhance, and improve internal accounting controls.

Central to that analysis is the realization that the key to truly meaningful and effective corporate record-keeping and internal accounting control systems lies in the conscientious and good faith exercise of business judgment by management and boards of directors. Accordingly, the Commission intends to give a wide degree of deference to those judgments. Equally important, however, is the unique role which the accounting profession can play in assisting corporate America to devise, maintain, and review systems of internal accounting control to ensure that they are sufficient to provide reasonable assurances that management and the board of directors can effectively manage the enterprise and control the transactions and disposition of the assets of the issuer; that the corporation can generate fair, accurate, and meaningful disclosure and financial reports; and that an audit of its financial statements can be performed in accordance with generally accepted auditing standards in a timely and cost-effective manner.

Any argument that it falls to the legal profession to determine whether a given issuer's system complies with the Act is not entirely consistent with the need to develop a cost-effective and efficient system to ensure the continuing smooth functioning of the enterprise and to meet the corporate accountability objectives of the Act. Indeed, as a practical matter, all that legal counsel is likely to be able to opine about is whether the company's processes -- including appropriate documentation of the steps involved -- in establishing and evaluating its system are likely to withstand scrutiny as satisfying the requirements of the Act.

Rather, it falls to the accounting profession principally to provide issuers with substantive advice and review. And, the constructive progress being made by various accounting firms in providing that systems guidance -- as well as the initiative of the Auditing Standards Board in providing guidance for auditor reviews of internal accounting control systems under Statement of Auditing Standards No. 30 -- offers, in my mind, a solid basis for optimism that the responsibility of fulfilling the purposes of the accounting provisions of the Foreign Corrupt Practices Act will be shouldered adequately by the private sector.

2. Self-Regulation and the Accounting Profession

Finally, the accounting profession has one clear advantage as government enters an era of possible "deregulation": The structure for a potentially effective self-regulatory mechanism for the profession has been put in place in the form of the AICPA's SEC Practice Section. For the public's -- as well as the profession's own -- sake, it is important that this intiative be maintained and strengthened regardless of short-run Congressional and Commission attitudes. When additional corporate financial and accountability failures occur in this Country -- and, if experience is any guide, they are inevitable -- the profession must be in the best position possible to demonstrate that a meaningful self-regulatory mechanism is already in place; that such additional failures are not symptomatic of broader regulatory problems; and that, accordingly, no major, governmental regulatory initiative is called for in order to "improve" the system further or "remedy" a systemic concern.

The Section is the lynchpin of successful private-sector self-regulation, and its birth was a major accomplishment. The question now is whether the Section will be effective in practice. In my judgment, there are three areas -- the peer review process, the Section's disciplinary mechanisms, and the extent of its membership -- which demand special attention to help ensure the success of the self-regulatory program. I want briefly to focus on each of these issues.

The first element which calls for special attention is the peer review concept. Commitment to meaningful, in-depth peer reviews by independent and objective reviewers is a prerequisite to the success of the profession's self-regulatory efforts.

Experience alone will tell whether the peer review program is adequate to meet its objectives. The Commission is, however, encouraged by the effective leadership which the Public Oversight Board recently displayed in facilitating the Commission's and the Section's successful efforts to reach an accommodation on the issue of Commission access to peer review workpapers. Moreover, it appears that the Section's leadership and the POB are committed to making the peer review process an effective mechanism for addressing and correcting member quality control or other deficiencies. While questions concerning the effectiveness of the program certainly remain, I am very optimistic.

The second area for special attention relates to the disciplinary measures which the Section will invoke against those members which deviate from the profession's standards. Again, as in the case of the Section itself, a framework has been put in place. The sanctioning process and procedures have not yet been fully tested, however, and their timeliness, fairness, evenhandedness, and efficacy remain to be demonstrated. Yet, in the final analysis, the profession's resolve and commitment in sanctioning its own members is likely to be the acid test of meaningful self-regulation.

The third important area for attention relates to membership in the Section. On the positive side, the Section includes among its members 245 firms which have Commission registrants as clients. Together, these firms audit almost 9,000 public companies -- including virtually every company listed on the national stock exchanges and a significant portion of NASDAQ-traded companies. Unfortunately, however, approximately 600 accounting firms with at least one SEC audit client have not yet joined the Section.

If the Section functions as intended, there will be increasing pressure on all firms with public clients -- regardless of size -- to become members. Membership in the Section -- with its attendant peer review requirements -- provides a basic level of assurance of quality audits. Accordingly, the onus has shifted to those firms which have elected not to participate in a self-regulatory program to justify their continued failure to do so.

Moreover, it may be important for investors to be informed as to whether a registrant's auditors are members of a self-regulatory effort and whether the auditor has been subject to a peer review. Companies should consider making this sort of disclosure voluntarily; clearly, it may be useful to shareholders and other users of financial information in evaluating the overall quality of a registrant's financial reporting.

CONCLUSION

Today, I have touched on only some of the vital issues impacting accounting, financial reporting, and auditing. The coming decade will surely witness innovative and important changes in these fields. Most importantly, there is an unmistakeable trend -- recognized in the Report of the Commission on Auditors' Responsibilities, the Congress' scrutiny of the profession, and the FASB's first statement of financial accounting concepts -- towards an increasing emphasis on the needs and expectations of users of financial information. Accountants must be sensitive to this trend and how it affects their work.

In the area of financial reporting, the trend towards a user orientation should lead to the reporting of financial information that is more relevant, but perhaps less reliable; more reflective of the impact of inflation; more forward-looking; and more disaggregated. Consequently, there should be less emphasis on the "bottom-line" and earnings-per-share, and more emphasis on the key components of operating performance and cash flows.

Similarly, in the area of auditing, as the social, business, political, and business environments continue to change, and new and different approaches evolve, there will be increasing pressure on the profession to alter and expand its role. It seems clear that, in the future, auditors will be associated with disclosures which are more subjective and less precise than has been traditional. Auditor involvement with certain supplementary financial information, such as the effects of changing prices, has already come to pass. Similarly, as I noted, auditors are increasingly being called upon to play an enhanced role in the corporate accountability process. Auditor involvement with management reports on internal accounting controls is part of that trend.

The lesson which I draw from these developments -- and the theme which I want to leave with you today -- is that the accounting profession must be sensitive to the importance of maintaining public trust and confidence in its work, and of adjusting its traditions and goals to meet fully the growing needs and expectations of the economy and the broader society, if it is to retain in the private sector the primary responsibility for accounting matters. And, this is true regardless of changes in administration or shifts in regulatory mood and philosophy.

When the public -- most often speaking through government -- makes demands which are unrealistic or counterproductive, accountants must work to inform, educate, and change the attitudes and views which gave rise to those demands. But, if the profession loses sight of the public interest which it serves, ignores the wider view of the responsibilities with which its critics seek to charge it, or takes solace from the fact that direct government regulation may not be a realistic threat, accounting as an independent profession will suffer.

During the 1970s, the groundwork was laid for a restructured and vigorous profession. Your obligation -- each of you -- is to ensure that the 1980s witness the completion of that important effort.