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THE CHANGING WORLD OF THE ACCOUNTANT: WHERE THE NEXT STEPS SHOULD LEAD

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During most of this century, the accounting profession has grown and flourished in the safety of relative obscurity. "Historically, Congress and the public have," as one recent study of the profession put it, "regarded accounting as an arcane subject better left to accountants themselves." */ This tendency to view accounting as a mysterious and incomprehensible art -- graspable only by mild-mannered initiates clad in green eye-shades -- carried with it a corollary misconception: To the extent that they thought about it, most of the public probably believed that the hallmark of accounting was a sort of mechanical precision or unquestionable exactitude. Once an accountant had placed his imprimatur on a financial statement, it could safely be accepted as correct, as objective fact, verifiable down to the last penny -- a misunderstanding which accountants and others helped to fuel by expressing earnings per share in just that two decimal-place form. The notion that the application of accounting principles and the selection and

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*/ The Accounting Establishment, A Staff Study, Senate Document No. 94-34, prepared by the Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations, United States Senate, 95th Congress, 1st Session at 2 (March 31, 1977).

scope of audit procedures might sometimes require a sophisticated exercise of judgment -- about which reasonable accountants might disagree -- was one which occurred to few not intimately familiar with the profession.

This public misconception of infallibility may, I suspect, have brought many accountants no small measure of secret inner pleasure. After all, the Academy of Motion Picture Arts and Sciences chose neither doctors nor lawyers to deliver the sealed envelopes and thus to lend an air of unquestionable integrity and reliability to its award-conferring ceremonies. But the gap between the accountant's understanding of the limits of his craft and the public's exaggerated view of the precision of financial reporting and of the purpose and meaning of the auditor's certificate lead inevitably to a reaction -- the placing of the blame for perceived shortcomings in the business community upon the accounting profession. As the Congressional study I mentioned earlier stated,

> "Continual revelations of wrongdoing by publicly-owned corporations have caused a new awareness of the importance of accounting practices in permitting such abuses to occur. * * * Accounting practices ultimately involve

> social issues that effect the nation's economic welfare. * * * Accounting issues are too important to be left to accountants alone." */

The implications and consequences of this new public and Congressional scrutiny are not yet fully resolved. Approximately seven weeks ago, the Securities and Exchange Commission sent to Congress a 1200-page report on the accounting profession and its responses to the challenges confronting it. That report, both by its content and its sheer volume, reflects the complexity and scope of the changes which have engulfed the profession. Only one thing is fully clear. In response to both internal and external questions and criticisms, accountants are now engaged in a re-examination and a restructuring which will almost certainly result in a profession which, five years from now, is governed and practiced in a fashion different from that familiar today.

This morning I want to focus on two of the most central and far-reaching of the profession's initiatives -- the

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*/ *Id.*

Financial Accounting Standards Board's conceptual framework project and the AICPA's development of a self-regulatory apparatus for accountants who audit public companies. These efforts encompass the two most fundamental questions facing accountants today. The conceptual framework project seeks to provide a comprehensive and coherent definition of the nature and function of accounting principles -- principles which have subtle and profound impact on our economy and our society. And, just as the conceptual framework will provide a theoretical foundation for the profession, the AICPA's SEC Practice Section seeks to create a basic structure and framework for the practice of accountancy, including the discipline and quality control of independent auditors who play an essential role in the application of accounting principles. Thus, if these initiatives succeed in fulfilling the expectations which many inside and outside the profession hold for them, the foundation will be in place for a profession which can continue to enjoy the trust and integrity which has characterized accounting in the past. If they fail, the result will be a leadership vacuum which government will undoubtedly fill. For that reason, I urge each of you to make a personal commitment to the success of both of these undertakings, and want to offer you my perspective on some key aspects of each of them.

The Conceptual Framework Project

I will turn first to the ongoing examination of the profession's theoretical foundations -- the FASB's conceptual framework project. That initiative exemplifies the kind of important and fundamental task which the profession can perform best. It is, along with the development of the SEC Practice Section, an excellent opportunity for accountants to demonstrate to the profession's critics effectiveness in confronting the important issues.

The conceptual framework must be -- as I think the Board recognizes -- much more than merely an attempt to catalog the premises and assumptions which are implicit in accounting as it exists today. The project must rather constitute an exercise in leadership -- an effort to create a set of principles which can serve as a goal, a visionary guide, for the profession to work toward as it develops and refines disclosure principles and methodologies. It is a safe prediction that, during the coming decades, the economic, political, and technological changes in this country and the world -- and their impact on the nature and methods of American business -- will be enormous. The accounting profession must have a conceptual framework sufficiently flexible and broad to accommodate those developments.

For that reason, a meaningful and successful statement of the conceptual framework cannot possibly be produced in an atmosphere of compromise, aimed at reconciling theoretical differences and conflicts with current practice. On the contrary, the conceptual framework -- if it accomplishes its purposes -- will quite naturally reflect the gap between present accounting methods and the precepts reflected in the framework. The process of filling that gap will be a separate task to which accountants can turn after the framework, the profession's constitution, has been established.

A. The scope of the conceptual framework

In order to attain these lofty objectives, the project must address and resolve several crucial issues. The first is assuring that the conceptual framework has sufficient scope. In December 1977, the Board issued an exposure draft of its "Statement of Financial Accounting Concepts" which spells out the Board's view of the scope of financial reporting objectives and of the elements of financial statements. This proposed statement is particularly important to the future direction of financial reporting in the United States, and I want to take a moment to review some of its highlights.

First, the Board has not limited its scope to financial statements, but rather has -- wisely, in my view -- elected to define its task in terms of financial reporting in general. That premise, if reflected in the Board's final product, will bring the accounting profession closer into step with the needs and expectations of the users of financial information and with the realities of the way business must communicate in a complex and sophisticated economy. Second, and just as significantly the exposure draft reflects the philosophy that financial information is not simply a record of past occurrences, but is equally of value in enabling users to assess the future. Again, that principle is one which harmonizes with the realities of modern financial reporting.

Both of these concepts are responsive to shortcomings which numerous critics have attributed to our present system of financial reporting. Until very recently, the focus of financial disclosure has been much too heavily on accounting questions within the context of traditional financial statements. Unfortunately, the approach has tended to be an "all or nothing" one. That is, information not perceived as being part of historical cost financial statements has frequently been regarded as wholly outside the discipline of accounting and has thus received inadequate attention, regardless of its utility, from either the practicing or academic sides of the profession. And, correspondingly, disclosures which users have demanded and which are "financial" in nature -- such as segment information and geographic operating data -- have been forced into the mold of the financial statement, even where the information involved does not fall squarely within traditional financial statement concepts.

The Board's recognition that the accountant's domain can extend to disclosures outside the four corners of the balance sheet or income statement will alleviate the anomalies and misunderstanding which the "all-or-nothing" approach has engendered. The broader area of financial reporting is an appropriate frame of reference within which to grapple with conceptual problems, and the FASB's recognition that the financial statements are only one element in the complex of financial disclosure is a positive sign. For example, it provides management with the opportunity to distinguish between measurable results typically presented in financial statements and other information which may be equally meaningful to users, but less precise. Further, this expanded perspective should also encourage the auditor to lend the credibility of his independent expertise to useful, but nontraditional, data of this nature.

B. "Soft" information

For these reasons, it is important that the FASB continue in the direction of the broad philosophy marked out in its exposure draft. Implementation of that concept would, in my view, help pave the way for rational responses to a number of difficult issues. Consider, for example, the need for the model to recognize and support types of disclosure which are sometimes labeled, perhaps disparagingly, as "soft" information. The inclusion of such disclosures in financial reports is a trend which the Commission has favored in recent years, and the FASB conceptual framework project appears to be the logical stepping-stone for consideration of the overall issues which these kinds of disclosure requirements raise.

The Board's formulation of the proposed objectives of financial reporting, which I mentioned a moment ago, strongly suggests the need to bring forward-looking and other "soft" information under the conceptual framework umbrella. For example, the exposure draft states that "financial reporting should provide information to help investors and creditors assess the amounts, timing and uncertainty of prospective net cash inflows." This precept, which is one endorsement of the need for forward-looking and soft information, is not new. Nonetheless, I place considerable importance on it because I recognize and share the view that cash flow is an especially important tool in evaluating an enterprise -- more important perhaps than the commonly employed concept of earnings per share. Resistance on the part of the business community and others to providing this sort of forward-looking information -- and the auditor's unwillingness to be identified with it -- has, however, been substantial.

The Board's statement should help to heighten understanding of the importance of this type of disclosure and to confirm its legitimacy as a disclosure objective.

Traditionally, information which is difficult to verify is often disseminated only with great reluctance or to a relatively small number of users. This problem has been exacerbated by the concurrent reluctance of the traditional reviewer of financial statement integrity -- the independent auditor -- to assume an appropriately responsible role in his association with such information. Hopefully, the conceptual framework will help to change this attitude. In any event, in my view, both the disclosures which management provides and the responsibilities which independent auditors assume must increasingly focus on soft information if the objectives of financial reporting, as the FASB has articulated them, are to be fully met.

Let me give some examples. First, the conceptual framework project must address squarely the need for financial reporting to mirror economic reality in an era in which annual inflation of six percent or more has been the norm. This is not a theoretical or abstract need. Explict recognition of the impact of inflation contributes to the capacity to interpret the economic future of individual companies. In the aggregate, it impacts directly on the capital formation process and on political and societal attitudes and expectations about the continued effectiveness of the private enterprise system and its ability to finance our future.

I do not mean to suggest, however, that accounting based on historical costs must or should be immediately discarded nor that the new methodology necessary to bring financial reporting closer to an economic picture of business operations should be agreed upon as part of the conceptual framework. On the contrary, I visualize the process of developing the reporting techniques necessary to implement the goals of the conceptual framework statement as an evolutionary process which may span many years. I have some serious reservations about the kinds of judgmental or subjective decisions which would be injected into financial reporting by a "current cost" system. Thus, while cost-based financial statements will probably continue to be the center-piece, the financial disclosure system should expand to accommodate other types of information as well. If the FASB's project does not result in a framework within which financial reporting can come to grips with economic realities in an economy characterized by significant inflation, then -- regardless of its other attributes -- the project will bear a very heavy burden of self-justification.

I have in the past spoken on the reasons why I believe that the failure to reflect the diminishing purchasing power of the dollar causes reported profits to be systematically distorted upward. For present purposes, suffice it to say that, in my view, traditional income statements tend to suggest that many firms are generating adequate funds to satisfy their investment demands when, in fact, they are eroding their capital. This problem is an important and serious one, and, in my judgment, one which highlights the economic and behaviorial impact of our accounting system. Consideration of the need to stimulate capital formation does not necessarily lead to the conclusion that historical cost should be discarded in favor of conversion to an accounting system premised purely on current cost assumptions. Such a choice becomes important only if one thinks of financial information as limited to that contained in financial statements -- rather than as a system of financial disclosures which is broader than, but includes, traditional financial statements.

The FASB has announced its intention to issue an exposure draft this year proposing supplemental disclosures of the effects of changing prices on a business enterprise. But, at the Board's meeting on August 2, 1978, it instructed its staff to concentrate on general price level information in drafting that document. I am concerned, in light of that action, that the Board not close the door on current cost disclosure. In my view, supplemental disclosure of current cost and present value information still needs to be considered, and the flexibility for that consideration must be maintained. Although such information is not "accounting for inflation" in the usual sense, it is important current economic information that I believe can be of substantial value. The FASB should not miss the opportunity to provide guidance in this area.

A second type of "soft" information which the FASB's recent exposure draft addresses is the need for management to explain and interpret financial information so as to help users understand it. This is a problem which the Commission has been struggling with for some time in its attempts to make the "management discussion and analysis" which accompanies operating summaries into a meaningful communication vehicle between the corporation and the investor. Although progress in this regard has at times been painfully slow, the general level of communication is at a level where I believe it would be fruitful to begin expanding the concept. This expansion should be similar in principle to the "management report" which the Cohen Commission recommended and to the recommendations of the SEC's Advisory Committee on Corporate Disclosure. That approach seems especially appropriate in light of the fact that the FASB has at least tentatively concluded that management's explanations are important in enhancing the usefulness of reported financial information. Again, the Board has a significant opportunity to exercise leadership in this area.

C. Internal control reporting

Although it is outside the scope of the conceptual framework project, I want to mention an issue which the Cohen Commission raised in connection with its discussion of a "management report" and which should be of vital importance to every accountant who audits public clients. The Cohen Commission suggested that:

> "The report by management should present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of control systems and a description of the company's response to material weaknesses identified by the independent auditor."

The enactment of the Foreign Corrupt Practices Act in December 1977 has placed this notion in a wholly new light. As most of you are undoubtedly aware, Section 102 of that Act requires every public issuer of securities to establish and maintain a system of internal accounting control which provides reasonable assurance that four specified objectives are met -- objectives which were taken verbatim from Section 320.28 of Statement on Auditing Standards No. 1.

This new statutory requirement, enforcible by the same tools as the balance of the federal securities laws, raises several complex and difficult questions -- answers to which issuers will undoubtedly seek from their accountants. For example, it is not self-evident how criteria initially formulated in order to assist the auditor in defining the scope of his audit should be transformed into standards against which the internal control systems of all public issuers can be measured. The AICPA has formed a committee which is considering guidelines to define those internal control mechanisms which will satisfy the requirements of the Act. I applaud that initiative. It is important, however, to recognize that the issue is obviously one in which both the Commission and the courts will, ultimately, also have some say.

Further, in light of both the Cohen Commission's suggestion and the traditional disclosure purposes of the federal securities laws, the question inevitably arises whether the commission ought to implement the new statutory mandate by requiring some sort of public disclosure concerning issuer internal control systems. Indeed, Congress may have contemplated that the commission would take such a step since, in testifying on the legislation which ultimately became the internal control requirement, then SEC Chairman Hills stated flatly that "Upon the passage of this legislation, we would, of course, impose a requirement upon outside auditors that they certify the adequacy of such [internal] controls."*/ While auditor "certification," as it is traditionally understood, is perhaps not an immediate possibility, a management report dealing with the issuer's internal controls is something to which the Commission will give serious attention in the relatively near future. And, some degree of auditor involvement with that report is a corollary we will have to consider in light of the traditional familiarity and expertise in this area of the accounting profession.

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*/ Prohibiting Bribes to Foreign Officials, Hearing before the committee on banking, housing and urban Affairs, United States Senate, 94th Congress, 2d Session at 3 (May 18, 1976). See also id. at 19.

D. Auditor involvement with "soft" information

Before I leave the conceptual framework, I want to touch briefly on a final point which is closely intertwined with the issue of "soft" information. Just as there are many significant areas related to financial reporting and corporate disclosure in which changes are occurring, it is clear that the role of the auditor will undergo substantial modification, both to respond to challenges peculiar to the auditing discipline and to keep pace with changes in the reporting environment. The Cohen Commission put it this way:

> "[T]he traditional association of independent auditors with annual financial statements is an obsolete, limited concept. The changing business and investment environment requires a more flexible and more timely form of association, and the audit function should evolve in that direction."

Thus, auditors should be alert to the fact that they are increasingly expected to review any information of a financial nature which management issues. I recognize that, in the litigious society in which we live, it may well be necessary to distinguish formally between the type of audit verification to which the accountant can subject the financial statements and the type of review which can be expected of nontraditional financial disclosure. This is not to suggest that either management or the auditor will be free of the burdens of due care, but simply that the responsibilities -- and liabilities -- of both are likely to be of a different nature. As this field expands, the Commission will be sensitive to the need for it to consider the desirability of safe-harbor provisions -- comparable to the one provided in the area of replacement cost data.

The AICPA's Development of the SEC Practice Section

I want now to turn briefly to the second important prong of the profession's response to recent Congressional and public scrutiny. During the past year and a half, I have spoken -- and testified before several Congressional committees -- concerning the importance of the accounting profession's initiatives at self-regulation and the progress which that initiative is making. Although the success of the SEC Practice Section is important -- critically important, if federal regulation of accountants is to be avoided -- I do not intend to discuss its structure in detail again today. Certain vital structure issues have yet to be satisfactorily resolved -- and must be promptly. Once these are resolved, the point will be reached at which the details of structure become secondary to how well the structure works as reflected by the actual results of Section operations.

As I mentioned earlier, on July 1, 1978, the Commission issued an exhaustive report to Congress concerning the accounting profession and its responses to the challenges facing it. A considerable share of that report was devoted to the SEC Practice Section and, as the July 1 Report indicates, the Commission regards the Section's creation as a major accomplishment and as a viable foundation for a meaningful program of self-regulation. The important question now is how the Section actually functions -- both substantively and in appearance -- so as to merit public confidence. The Report points out that, in the Commission's view, the structure of the Section contains some important infirmities. Those infirmities are, however, subordinate to the Section's concrete results. A perfect blue-print may fail if those charged with implementing it do not have a clear vision of what it takes to succeed and are not committed to its success. Similarly, a flawed plan may well succeed if the profession's leadership make it work

The key to achieving a meaningful self-regulatory program lies in the Public Oversight Board. The Board is capable of bringing a broad public perspective to the

Section's work. Yet, the AICPA has not afforded the Board -- nor has the Board sought -- any direct authority over the activities of the Section. Although the Commission is not prepared to conclude that this lack of "line" authority will necessarily be fatal to the Board's effectiveness, we do believe that it would increase the probability of success. In the final analysis, however, the competence, commitment, dedication and independence of the Board will determine its effectiveness as an overseer of the program. The Board members must devote sufficient time and must have adequate funds and staff at their disposal to perform their functions and responsibilities. They must be actively involved in the disciplinary process of the program. Similarly, the Board must be actively involved in overseeing the peer review process and its results. Finally, the Board must communicate in an open and effective manner with the profession, the public and, of course, the Commission so that the Commission can, in turn, fulfill its own oversight responsibilities.

With that thought in mind, I want to list briefly several of the difficult and as yet unresolved issues with which the SEC Practice Section must deal during the coming months. It is vital that accountants recognize that the Commission's July 1 Report is not in any sense the culmination or termination of the new public attention which I mentioned earlier. On the contrary, although there will be some changes in the personalities involved, committees in both the House and the Senate have indicated in the strongest terms their continuing interest in the profession's progress. Further, the Commission will, of course, continue vigorously to discharge its oversight role and will be issuing a follow-up report no later than July of 1979.

The most important single objective of self-regulation must be to strengthen and enhance professionalism and independence. In a fundamental sense, independence is a goal which can be addressed only by individual accountants in their day-to-day activities. Professional responsibility is not an attribute which can be mandated by rule or compelled by statute. There are, however, clearly some steps which accountants, as a body, can take to enhance the caliber of, and respect for, their profession. In considering such actions, the profession must work toward three major objectives: Prohibitions against relationships which may, in fact, jeopardize the auditor's objectivity and independence in performing the audit; avoidance of conduct which would depreciate the profession's credibility and respect in the eyes of the public; and, more broadly, the encouragement of conduct, on the part of both accountants and managements, which will enhance the overall integrity and credibility of corporate financial reporting. The implementation of these goals is a task highly appropriate to the profession, and there are two issues -- the scope of services which accountants should be permitted to perform for their audit clients and the establishment of independent audit committees -- which require immediate attention.

The first independence issue which must be resolved in the near future revolves around the question of the appropriate range of services -- other than performance of the audit itself -- which accounting firms should be permitted to offer to their audit clients. This question is exceedingly complex, and the difficulty of resolving it is heightened by the fact that the objectives and philosophy which should underlie limitations on auditors' services have not yet been fully articulated. The Public Oversight Board has very recently held hearings on this issue. In my view, if the Board is to fill the role in the SEC Practice Section which the Commission sees as essential, this is precisely the sort of question which it should be addressing, and to the resolution of which it can contribute importantly.

A second issue touching on independence which the profession must address promptly is the formation by public companies of audit committees composed of independent directors. As the Commission's July 1 Report states,

> "In companies where the auditors report to an independent audit committee, a potentially important buffer is provided to insulate accountants from inordinate management pressures and to strengthen the auditor in his relationship with management -- and hence his independence." */

The AICPA has formed a special committee to study whether and in what form the Institute should promulgate a standard which would require that an audit committee be established as a condition to an independent accountant's accepting an audit engagement. That committee has held public hearings, and the Commission will study its conclusions with great interest. The Commission has the authority to mandate audit committees, and some have suggested that we ought to

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*/ *Id.* at 12.

exercise that authority rather than expect the profession to grapple with this problem. In my view, however, because of the critical importance of independence to the profession, accountants themselves, in the first instance, should explore the actions which are available to them in this area. If the profession concludes that an audit committee requirement is beyond its capability, the burden is on it to so demonstrate.

I want to turn next to the effectiveness of the peer review program. The Commission regards the effectiveness of the peer review program as central to the success of the SEC Practice Section. The underlying concept of peer review is to provide a regular examination and evaluation of the work of each accounting firm which audits publicly-held clients in order to assess whether that firm's practice conforms to the high standards expected of those who assume the responsibilities of independent accountants under the federal securities laws. To be successful, the peer review program must satisfy three objectives. First, it must incorporate and apply meaningful standards of quality control to both the work of the reviewers and of the reviewed firm. Second, it must be structured in such a manner as to assure independence in fact and to promote public confidence in the credibility of the peer review process. Third, the peer review process must be sufficiently open to both the Board and the Commission's examination so that each may discharge its oversight responsibilities. */ Unfortunately, however, the important question of the ability of the Commission to reach an independent judgment as to the adequacy of the program, through sampling both the quality of the process itself and the supervision of the Public Oversight Board, remains open. While I recognize that Commission access to peer review materials raises sensitive issues, and that the Commission can rely on the Board's supervision of the peer review process to a great degree, it will be necessary for the Commission's staff to have sufficient access to enable the Commission to make an objective evaluation of the adequacy of the review process. In that connection, it is also vital that the Public Oversight Board rapidly complete its staffing in order that it have the manpower to fulfill the oversight role contemplated for it.

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*/ See Securities and Exchange Commission, Report to Congress on the Accounting Profession and the Commission's Oversight Role, prepared for the Subcommittee on Governmental Efficiency and the District of Columbia of the Committee on Governmental Affairs, United States Senate, 95th Cong., 2nd Sess. at 24 (Committee Print; July, 1978).

There is one other important component of the success of the AICPA's program of self-regulation which I want to emphasize -- the disciplinary framework. Clearly, the program needs to encompass adequate sanctioning capacity. The situations in which self-regulatory efforts typically fail are those in which serious problems surface involving one or more major firms in the self-regulated industry or professional organization. Thus, if the disciplinary framework is to be effective, the sanctioning power of the Section must be used, when appropriate, against member firms of all sizes. Conversely, if the potential sanctioning power does not have adequate substance, the entire self-regulatory program will not be credible. The disciplinary structure must be in place before it is needed. It is enormously difficult to design such a system in a crisis and then expect it to be effective, fair, and credible. I urge the Board to follow through with meaningful involvement in this area.

Conclusion

As I mentioned at the beginning, the range of the issues facing the accounting profession is very great; the conceptual framework project and the AICPA's self-regulatory effort are by no means the only initiatives which demand the profession's attention. In my view, however, those two -- representing efforts to deal with both the theoretical underpinnings of accounting and with the self-discipline and self-regulation of those who apply that theory -- are, together, the most important.

The Commission and the profession may, of course, not always see eye-to-eye on how the difficult problems which these initiatives raise should be resolved. The important point is, however, not that we agree on the details, but that the profession recognize the importance of its meeting the challenge to its leadership ability which recent Congressional and other criticism poses. If the profession is to remain under private control, it is crucial that it demonstrate its leadership and sensitivity to public policy objectives.

One vital dimension of effective self-governance is an open and well-developed capacity for self-criticism. The profession has yet to achieve that condition of openness. An essential component is what the Cohen Commission called "academic conscience." Success of the profession's efforts at self-governance depends in part on the willingness and ability of the academic community to provide the intellectual leadership and criticism necessary to stimulate self-assessment and corrective action -- something it has thus far failed to do. The profession's academic conscience is largely undeveloped. Perhaps the profession and academia need to examine the question of academic "independence" in view of the profession's importance in funding academic research.

It should be obvious that many of the areas which the profession will need to address over the next period of years -- such as independence, measurement, and auditing techniques -- can benefit from scholarly research. While these subjects may not lend themselves to the same kind of academic analysis as does, for example, the efficient market theory, the issues are of enormous importance to the future of accounting, and therefore the academic side of the profession must bear its share of the responsibility for addressing them. Indeed, the opportunity for all sectors of the profession, including the academic community, to contribute to this effort is virtually limitless. I hope that each of you will recognize that challenge and make a personal commitment to helping your profession to meet it.

Thank you.