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THE STATE OF THE WORLD OF ACCOUNTING -- THOUGHTS ABOUT THE PAST, PRESENT AND FUTURE

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

Introduction

A new year and a highly knowledgeable audience provide an appropriate setting for reflection about the state of the world of accounting, particularly as we face the forthcoming Congressional hearings on all variety of accounting matters. Facing that, I would like to borrow from Charles Dickens and invoke the Ghosts of Accounting Past, Accounting Present, and Accounting Future and allow those Ghosts to take us on a Dickens-like tour of the past -- at least the recent past -- to see how we got to our present state; to assess our present state; and to peer into the future, perhaps even to venture some specific predictions.

Such an exercise necessarily involves much in the way of personal views. So I caution you that the next 20 minutes or so do not represent any official agency position. Since my comments are historical interpretations on one hand and crystal ball gazings on the other, I also emphasize that I am licensed neither as historian nor soothsayer.

The Past

When I set about to prepare these comments, I first re-read all the speeches I have delivered on accounting matters since I became a Commissioner. I wanted to see if I could glean that one insight which would provide heightened understanding of the past, particularly as it is the precursor of the present, would help us appreciate more keenly our present state, and would provide us a sound basis for future-gazing.

But I failed to unearth that one insight. I concluded instead that the current state of the world of accounting results from the coincidence of a number of events. Timing has made those events appear related when they are not, or at best are only loosely connected. Yet, coincidence of timing has caused each separate development to assume more significance than otherwise would be the case.

So my first exercise today is to play the Ghost of Accounting Past in an effort to identify the separate events and forces -- at least of the past two and one-half years since I have been a Commissioner -- that have brought us to the present.

Commission Atmosphere, Staff Expertise and The Economy

Our tour of the past starts by considering the atmosphere at the Commission over the past 30 months (the time I have served as a Commissioner) when it comes to accounting matters. And by "Commission," I mean not only the five presently sitting Commissioners, but also those who were serving as Commissioners when I arrived in the Summer of 1982.

Several people outside the agency have suggested to me that this Commission is less intimidated by accounting issues than past Commissions, is more willing to make accounting decisions, including those that involve judgment about esoteric issues, and is more willing to take firm, even controversial, positions when the answers may be less than crystal-clear. Comparing athletic teams of one era to those of another era is always fun, but it is inherently a flawed process. Comparisons of one Commission to another is likewise suspect, and whether Commission-to-Commission comparisons have any validity, I leave to others.

But I will say that since my arrival I have found that the Commissioners generally look forward to considering accounting issues, whether in an enforcement or rulemaking context, or merely philosophizing around a table with our feet up. Commissioners sometimes have become so interested that they have moved to the forefront on some accounting issues.

It's nice to have an interested Commission, but expertise and capacity at the staff level is another. That's where it really counts. In 1982, along with perhaps increased Commission interest, the Commission hired its first Chief Enforcement Accountant, Glenn Perry, a position now filled by Bob Sack. This brought to the Enforcement Division for the first time in-house, solely enforcement-oriented expertise and experience. Several outside auditors in turn were recruited to work exclusively on enforcement matters.

Combined with the substantial existing expertise in the Office of Chief Accountant and the Division of Corporation Finance, this expansion gave the Commission a new overall level of accounting and auditing resources. In fact, I believe this is the classic case of the whole being greater than the sum of its parts -- the addition of this expertise and capacity strengthened our existing staff capacity, which in turn supported and strengthened the new capacity.

At about the same time, the American economy was emerging from the latter stages of a recession. Instances of suspect auditing and accounting practices of prior years were beginning to emerge. Thus, interest at the Commission level and expanded staff expertise coincided with disclosures of accounting latitude on the part of certain companies.

The Impact of Some Early Cases

Against this background -- interested Commissioners, new staff expertise and depressed economic conditions -- occurred some enforcement cases, which, I believe in retrospect, caused both staff and Commissioners to home in on accounting matters. The first case that made such an impression -- at least on me -- involved McCormick and Company, Inc., the old line spice importer and distributor. */

Our complaint alleged that McCormick improperly manipulated current earnings by deferring the recognition of various expenses and increased revenues by accounting for goods ready for shipment as current sales even though not shipped until later periods. The irregular practices involved a number of personnel in largely autonomous divisions. Those who directed the improper practices believed they were the only way to meet the profit goals of central corporate management -- a "team effort." There was no evidence of diversion of corporate funds for the benefit of any McCormick employee. Found to be contributing to the situation

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*/ S.E.C. v. McCormick & Company, Incorporated, et. al., Civil Action No. 82-3614 (D.D.C. 1982)

was the fact that the accounting function was not given the same emphasis as were other functions. */

Why did McCormick make such an impression? After all, it certainly is not the worst case imaginable. But it left unanswered questions and a queasy feeling. Was it indicative of similar patterns of conduct at other well-established companies? Was it commonplace for central corporate management in such companies to issue profit goals by fiat and create an atmosphere of "failure" if goals were not achieved? Were companies of such ilk and quality allowing their corporate environments to subvert sound financial reporting? Was a cavalier attitude toward the integrity of financial statements commonplace among old-line companies? Had "deregulatory rhetoric" perhaps created an impression that the Commission was no longer an open-eyed watchdog?

While McCormick left queasiness when thinking about one type of company, some shortly following cases caused a different type of queasiness. These are what I call "major breakdowns." Recall briefly our actions against A.M. International **/ and United States Surgical Corporation. ***/ These two cases involved gross overstatements of results of operations, assets, and shareholders' equity, grossly understated liabilities, grossly misstated statements of changes in financial position, and false footnotes. In

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*/ According to a Special Counsel's Report.

**/ S.E.C. v. A.M. International, Inc., Civil Action No. 83-1256 (D.D.C. May 2, 1983).

***/ S.E.C. v. U.S. Surgical Corporation, et. al., Civil Action No. 84-0589 (D.D.C. 1984).

each case the alleged misdeeds were pervasive. For example, losses related to inventory were improperly deferred and inventory was otherwise overstated; sales were recorded although products were not shipped or were shipped on consignment; sales were inflated by deliberate double-billing, by shipping unordered goods, or by sham sales; costs of sales were manipulated; and fixed assets were not depreciated or assets that had been impaired or lost simply were not written off.

Perhaps the companies involved were not of the same lineage as McCormick, but they were not insignificant. How could they go so far astray? How could such pervasive deception and falsification occur in any public company? Were other companies candidates for doing the same?

Cute Accounting

But these "cooked books" cases, as troubling as they may have been, and even combined with Commission interest and expanded staff expertise, alone probably would not have been sufficient to lead us to our current state. After all, perhaps they were only isolated instances, and the rest of the accounting world was functioning fine.

But, at the same time, we found ourselves encountering the "cute accounting" cases. For example, in our March, 1984 stop-order proceedings against Pro-Mation, Inc., we saw the "non-subsidiary subsidiary." */ One company causes the organization and funding of

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*/ In the Matter of the Registration Statement of Pro-Mation, Inc., Securities Act Rel. No. 6522 (March 30, 1984).

another to conduct activities previously conducted by the first company. The first company (1) provides the sole means of financing the second company's operating losses; (2) effectively controls the second; (3) has the de facto power to compel an exchange of the debt owed it at any time for a substantial equity ownership; and (4) in fact does so. Under these and similar circumstances, the Commission viewed the second company as a disguised or sham subsidiary.

That's only one example. We saw others, such as one of the largest property and casualty companies in the country recognizing as current income the anticipated future tax benefits of net operating loss carry-forwards. */ This occurred despite some of the most stringent tests in accounting standards, and this insurer emerged as the only one out of 4,000 companies surveyed by a major magazine that was doing so. **/ Numerous other examples of cute accounting came before the Commission.

Depository Institution Accounting

While the effect of each of these developments was cumulative, then came another development which helped bring us to our present state as much as any single development, for it made accounting matters regular front page news. That was the deteriorating

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*/ In the Matter of Aetna Life and Casualty Company, Securities Exchange Act Rel. No. 19949, July 7, 1983 (CCH Fed. Sec. L. Rep. No. 73.410).

**/ Loomis, "Behind the Aetna," Fortune, November 15, 1982, Page 56.

financial condition of our depository institutions -- our banks and S&L's. The resulting stories were not pretty -- Penn Square, Continental Illinois, Seafirst, First National Bank of Midland, and S&L's being liquidated by the score. As reports of shaky conditions persisted, a public perception developed that many of these troubled financial institutions had engaged in accounting shenanigans.

All this publicity about troubled financial institutions had, I believe, an enormous effect on public perception. After all, depository institutions are special in our country. Go into almost any small town, and you will find an old bank that is a scaled-down model of a Greek temple. Banks are the very symbol of honesty, stability, rectitude and reliability. When adverse publicity showed that these venerated institutions were shaky and had sometimes gone close-to-the-line on accounting, or over, suspicions multiplied that our overall accounting and auditing system had simply gone ker-flooey.

Developments Involving Accounting Standards

The more technical standards-setting area did not escape negative publicity. As you know, some have criticized the Commission for not playing a more active role in the standard-setting process; some have criticized the FASB for slowness generally, particularly in concluding the Conceptual Framework; some have even charged that inadequate standards have caused some of the highly publicized, alleged audit failures. Those charges can be debated at length. But the mere existence of the charges contributed to a public perception of general flaws in accounting. And I would go further and suggest that the Commission's publicized debate, and initial split, over the FASB's approval of in-substance defeasance in December, 1983 contributed to the public perception of problems in the standard-setting area.

The Impact of Arthur Young

If we wanted to, I am certain we could expand the litany of developments in the world of Accounting Past which were combining to contribute to negative public perceptions. At any rate, with all of these negative developments, the Supreme Court stepped in and told us just how wrong it was for this to occur. The case did not involve an accounting breakdown or inaccurate financial reporting; in fact, it arose in a tax context.

In *United States v. Arthur Young & Co.* */ the Supreme Court told us that accountants had special public responsibilities:

> The independent public accountant...owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public...[t]his '*public watchdog*' function demands that the accountant maintain *total independence* from the client at all times and requires *complete fidelity* to the *public trust*. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a *disinterested analyst charged with public obligations*. (Emphasis added.)

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*/ No. 82-687 (March 21, 1984).

If that accurately describes the role of independent accountants, how was it possible for all these shenanigans to occur? Were auditors living up to their obligations as public watchdogs protecting the public trust? Surely, many in the public reasoned, something must be fundamentally wrong with the entire world of accounting.

The Present

So that's a tour of Accounting Past -- a coincidence of Commission interest, expanded staff, cooked books, cute accounting, the in-substance defeasance debate, bank failures, and the Supreme Court's proclamation in Arthur Young. While I have personally theorized that these developments are largely unconnected other than in time, the general public perception is decidedly different.

My key point for today is that while we should understand each of the separate events that brought us to the present, we must appreciate even more keenly the public perception that these events are not unrelated and acknowledge the present public perception that much about accounting is fundamentally flawed. If we do not, our planning for the future is likely to miss the mark.

So that we do not underestimate the negative public perception about Accounting Present, listen to few indications.

1. A recent BusinessWeek article was entitled "The SEC Turns Up The Heat On Cooked Books." An article in the Economist, talking of Commission accounting-related enforcement cases,

characterized the Chairman of our Commission as a "crusader." Well, I would suggest that you generally do not have crusades unless the infidel is about to take over the world -- in other words, something serious must be wrong.

2. The Wall Street Journal has reported that the chairman of a large accounting firm "seriously questions" whether the Financial Accounting Standards Board "is going to make it."

3. The number of enforcement actions brought by the Commission during fiscal year 1984 based upon accounting irregularities was four times the number of insider trading cases. From 1982 to 1983 the number of accounting enforcement cases increased by approximately forty percent. From 1983 to 1984, they increased by yet another fifty percent. It is a rare week when some accounting matter does not come before the Commission in an enforcement context.

4. Donald J. Kirk, Chairman of the Financial Accounting Standards Board, is concerned that the credibility of our entire system of corporate governance is at stake: "The long-run interests of those who believe in our economic system require recognition that responsible, credible financial reporting is inseparable from responsible corporate performance."

The Future

If that's Accounting Past and Accounting Present, what about Accounting Future? Should we be optimistic, pessimistic, or simply cautious? I suggest that the proper attitude is caution. There may be some room for optimism, but only if we are collectively prepared to recognize that public perception and confidence are the key and that we -- regulators, the accounting profession and issuers alike -- must respond accordingly. We may have the best auditing and accounting system in the world, but that is not the issue. The task before us is to recapture public confidence.

If I wanted to pontificate, I suppose I could now list all the things I think need to be done. But sermons are rarely listened to closely, and I'm no more priest than I am historian or soothsayer. Instead, I'm going to be adventuresome and simply predict specific events I believe will come to pass in light of our Past and Present. I caution, you, however, that these predictions are based essentially on my intuition, not on inside information.

1. Opinion Shopping. My first prediction involves opinion shopping. I predict that, whether of its own initiative or due to external pressures, the Commission will take concrete steps to do substantially more to deal with opinion shopping. The mere fact that opinion shopping occurs -- and I hear responsible people claim that it is on the rise -- encourages a belief among issuers and disgruntled executives that this form of pressure is an effective, legal and acceptable way to bludgeon accountants into submission on disputed accounting issues. But public perception will not, I suggest, tolerate that result. Remember what Arthur Young said:

> It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional.

2. Sham Transactions. My next prediction involves sham transactions. I predict that both the Commission and the profession will be forced to, and will, take additional steps to deal with sham transactions, particularly those which cloak a rapidly deteriorating condition -- a year-end transaction generates dramatic profits or avoids the recognition of huge losses and all is reported well -- yet total collapse shortly follows. Everytime that occurs, it has an adverse impact on the public's perception of the quality of auditing and accounting. The argument that audits do not guarantee against business failures will not overcome that perception.

3. Real Time Responses To Emerging Issues. I next predict that public pressure and regulatory demands will focus more and more on real time responses to emerging, specific issues. One project in that direction is already underway -- the FASB Task Force on Timely Guidance on Emerging Issues -- and it is one which I support. But, to the chagrin of many, I also predict that the profession of necessity will move, for the near-term, to more specific standards and rules, *i.e.*, that dreaded proliferation of specific rules. Only time will tell whether that is good or bad, or when the pendulum will swing the other way -- which it undoubtedly will at some point.

4. Self-Regulation and Enforcement. My next prediction is that we will see the emergence of an accounting self-regulatory mechanism, with an enforcement focus and capacity. Public perceptions as to whether a profession is living up to expectations is fragile at best and is constantly open to question. "Self-regulation" which means an exclusive focus on systems, or on broad institutional quality, or which is bottomed on an aspirational approach is hardly bad. But those limitations do not, I suggest, square with the common perception of the duties and obligations self-regulation implies -- a case by case enforcement focus, with sanctions. Those limitations leave a void, and something will come along to fill it.

5. Commission Enforcement Actions and Ancillary Relief. In connection with Commission accounting enforcement actions naming issuers, I predict that you will see the Commission seek more and broader forms of ancillary relief to correct the institutional flaws which led to the accounting and financial disclosure shortcomings. This will include the adoption of formal procedures, special reviews, reorganizations of Committees and Boards, and the involvement of more independent directors and advisers.

6. Bank Accounting. My next prediction is that there will be greater Commission involvement in bank accounting matters, both from a regulatory and enforcement standpoint.

7. Non-Audit Services. I next predict that the Commission will reconsider, and adopt, a rule which again will require proxy statement or other disclosure of the relative significance of

audit vs. non-audit services performed by the independent accountants. The importance of non-audit services to accounting firms is increasing, and I do not see this debate going away. A middle-ground approach of disclosure will be reinstituted as a way to avoid the more difficult question of restrictions on such activities.

8. Toward Zero Audit Failures. I finally predict that the Commission and the accounting profession will find no respite from public criticism until we, along with the issuer community, are willing to say together, without quibble or qualification, that our common goal is zero audit failures. That means no protestations of "it costs too much to achieve perfection," and no hiding behind cost-benefit equivocations. That zero audit failures may not be achievable is not the issue; the failure to make this commitment will only strengthen the existing negative perceptions.

Conclusion

Well, that's eight very specific predictions -- more than enough to make a few mistakes. But mistakes are inevitable when you play prognosticator -- that's what makes it fun -- and I will keep track of my skill as a prognosticator along with you.

I emphasize again, however, that my predictions -- particularly predictions of future Commission actions -- are not based on inside knowledge of forthcoming staff or Commission proposals, nor am I here today to float trial balloons on behalf of the Commission. These predictions are mine alone and are based principally on intuition, whatever political "sixth sense" I possess, and my personal thoughts about the direction the "winds of change are blowing" when it comes to accounting.

As I said, along with you I will be tracking my success as a prognosticator. To be candid, however, and in the spirit of full disclosure, I must advise you that I will soon be following my prognostications in my capacity as a former SEC Commissioner. I am today advising the Office of Presidential Personnel that I intend to leave the Commission within approximately the next 90 days. I will shortly be submitting my formal resignation, setting a definite date for leaving the Commission.

While I may no longer be in a policy-making role when it comes to matters of accounting, and I do not know what my future position may be, my interest in matters of accounting, my belief in its importance, and my respect for the accounting profession will not diminish.

I have greatly enjoyed the opportunity to work with the accounting profession and its various groups during the past two and one-half years. I thank you for the invitation to appear before you today and for your attention.

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