

# NEWS

## SECURITIES AND EXCHANGE COMMISSION

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### THE FIRST THOUSAND DAYS -- AND BEYOND

An Address by

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I am delighted to participate in the inauguration of the Accounting Research Center. I cannot think of a more appropriate period in the history of the accounting profession for the establishment of such a Center. Never before have the very foundations of the profession been subject to such a breadth of challenge or faced such a degree of change.

Thus, it is my hope that this Center will serve as a model of an enhanced role for the academy in addressing the important questions that face the accounting profession. I have always been concerned -- and somewhat bewildered -- by the fact that academia, although making many contributions, has not always provided the accounting profession with the significant ongoing expertise, criticism, innovation, creative ideas -- and academic conscience -- that it has provided, for example, to the professions of law and medicine. Many of the most crucial issues now before the profession -- including independence, measurement, relevance, reliability, audit technology, display of information, economic consequences, summary indicators, and particularly the conceptual framework -- are subjects which can greatly benefit from the unique contributions and perspectives associated with scholarly research and thought. This Center and similar institutions have a very important opportunity and responsibility as timely, effective and constructive contributors and critics in shaping the future character of the accounting profession and the discipline it practices.

To the extent that "the past is prologue" and that those who do not learn from history are destined to repeat it, the developments in the first thousand days of my chairmanship might appropriately be viewed as an indicator of what the future holds for the profession. This evening I would like to discuss some of these developments -- and my sense of how they will affect the accounting profession. In talking about the future, I will, of necessity, be focusing on the challenges, problems and unfinished business. I should begin by acknowledging the very significant progress the profession has made in recent years in its standard-setting process, self-regulatory efforts, and the quality of auditing.

#### The Accounting Profession's Responsibilities

Let us start our assessment with a point on which I would hope that most of us would agree. The accounting profession exists to ensure credibility and reliability in reporting financial information to users of that information -- indeed, this is the only responsibility which justifies its existence. In the private sector, this information provides the basis upon which the marketplace -- meaning the aggregate of investors and lenders -- allocates economic resources. Thus, efficient capital formation requires that the economic decisionmakers who are users of financial information have access to useful reports on which they can rely.

But, in recent years, a number of events have shaken the using public's confidence in the credibility of financial reports. Indeed, a major part of the stress which the profession has been under stems from its own failure in the past to recognize in a timely manner challenges to the discharge of its only responsibility. And, if the 1970s were a period when the profession itself was called to account -- by the Commission, by Congress and by the public -- the 1980s will be the period in which the accounting profession's response to these concerns -- or lack of a meaningful response -- will determine its future character and whether it will remain independent of governmental domination.

I wish to emphasize that I am hopeful -- and occasionally optimistic -- that the accounting profession will respond effectively and forthrightly to these concerns. And, I appreciate that the profession, the American Institute of Certified Public Accountants and the Financial Accounting Standards Board have undertaken important steps to respond to the changing expectations of the financial environment.

But, while the profession can justifiably derive a sense of confidence and satisfaction from its ability to conceive and implement significant changes, it must guard against the tendency to become complacent, or to develop an attitude that enough, or too much, has already been done -- or that much of what is being done is not substantively necessary or cost justifiable, but rather a mandatory tithe to keep powerful, but misguided, external forces at bay.

Therefore, I must continue to remind the accounting profession that the credibility of financial reporting, and its effect on the depth and the efficient allocation of this Nation's capital resources, is a matter too critical to the public welfare to be ignored or to settle for halfway measures. Therefore, one should expect that if the profession does not continue to expeditiously and adequately address the challenges before it, increased governmental intervention may well be invoked. That intervention would not likely happen tomorrow. But when the next wave of corporate failures occurs -- and occur it will -- the profession needs to be able to satisfy the public that it did its job -- that it had the standards and systems in place, that they worked, that failures were not system failures, and that substandard professional performance was appropriately dealt with. Thus, in the last analysis, the maintenance of an independent, private profession depends on the profession's own progress and performance.

#### Challenges Facing the Accounting Profession

Many of these necessary developments will involve implementing, evaluating and improving two systems. One is a system of regulation and the other a system of reporting. It is the successful maintenance of these two systems that will discharge the profession's share of the responsibility to provide to users

financial information useful in evaluating the future of the reporting company and the necessary level of confidence in the credibility of the information to be able to rely on it.

The system of reporting includes a number of components, including an internally-consistent set of accounting principles coupled with a procedure for establishing and timely modifying them, an integrated view of financial information, hard and soft, an integrated format of financial statements and supplementary data for displaying it, and, finally, a comprehensive and appropriate program of auditor association with the information and explicit reporting.

The components of the system of regulation were described in the Cohen Commission report to consist of standards of competence to practice, technical and ethical standards, quality control policies and procedures, and sanctions for inadequate performance. A failure in any of the components, when viewed in a systems context, is a failure of the entire system, and the response that three of the four components worked well is of little avail. As a strategy to avoid the removal of the process from the private sector, the profession should expeditiously adopt a systems approach in which it could address, in a logical and consistent manner, the substantial changes necessary in the existing systems.

Conceptual Framework

In meeting these challenges in relation to the reporting system, the accounting profession would benefit significantly from a sound conceptual framework. This framework would provide a discipline for the FASB's and profession's own decisionmaking process, that is, a frame of reference within which board members and practitioners alike can relate and evaluate personal views as well as the various alternative positions advocated. Decisionmaking within such an established framework would provide an element of predictability that, in turn, would make it less likely that the profession or the reporting community would be unprepared for -- or alarmed by -- any particular decision made in that context.

Thus, I was pleased when, in 1978, the Financial Accounting Standards Board issued its statement of Financial Accounting Concepts No. 1 -- called "Objectives of Financial Reporting by Business Enterprises." And, I am anxiously -- indeed impatiently -- awaiting further, follow-up developments. To my mind, a major element of the conceptual framework project should be to rethink the objectives of the primary financial statements -- and, therefore to reconsider what types of information should be included in, and what types should be presented outside of, the financial statements.

I note that the Statement does not limit the scope of financial reporting objectives to financial statements exclusively.

Instead, it properly focuses on users of reported financial information and their interest in evaluating future performance. Hopefully, this realistic conceptual framework means that we have heard the last of the increasingly anachronistic emphasis on management's stewardship.

Given the importance of future performance to users, the most relevant information would involve such matters as future cash-generating ability -- a matter not adequately communicated by traditional financial reports. I recognize, however, that such information may be highly uncertain and that surrogates may have to be developed. In my view, this admittedly difficult balancing of tradeoffs -- between relevance and reliability -- may be the core challenge of the conceptual framework project. I expect that this process will, while retaining much of the grounding in historic cost, eventually necessitate substantial changes in the total reporting model with which we are all quite familiar -- an idea that many accountants and businessmen seem to abhor. This decision as to what that relevant information is, and whether it should be included in the primary financial statements, will be influenced by its measurability. I am certain that many of you are aware that the current exposure draft of the FASB on qualitative characteristics addresses this issue.

Further clarification of these factors is necessary before display issues, such as the reporting of earnings, can finally be resolved. Moreover, the development of the recognition



criteria phase of the project will be critical to the Board in its search for a definition of "earnings." I hope and expect that the Board will give appropriate attention and priority to these important issues.

Additionally, in clarifying this process, thought needs to be given to the status under the disclosure requirements of the federal securities laws of certain information which is considered highly relevant but too "soft" for inclusion in the financial statements. What implications flow from a Commission determination that certain financial information is material? As the FASB broadens its activity into financial information outside the scope of financial statements, we must be sensitive to the potential overlap of -- and any possibility of interstices between -- FASB standards and Commission requirements.

#### Oil and Gas Accounting

The Commission's own efforts to deal with the absence of an adequate conceptual framework -- and its willingness to sanction experimentation in resolving difficult reporting problems -- is evidenced by the manner in which it addressed the issues relating to accounting for oil and gas producing activities. The Commission's direct involvement in this area resulted from the unique requirements of the Energy Policy and Conservation Act of 1975, which required the Commission to ensure the development and observance of uniform accounting practices for the oil and gas industry.

Many of you undoubtedly remember that the Commission held an extensive series of public hearings at which the relative merits and deficiencies of "successful efforts" and "full cost" accounting were presented. In the end, the Commission concluded that neither of these historical cost-based methods adequately portrays the financial position or operating results of an oil and gas producer.

Rather, in this industry, the value of the primary asset -- oil and gas reserves -- is likely to have little relationship to its historical cost. Thus, the Commission determined that the failure to recognize the value of this asset, and the crucial importance of a company's success or lack of success in adding to its reserves, severely limits the relevance of the standard measures of financial position and results of operations.

The Commission's conclusion was not unprecedented. For years, thoughtful members of the accounting profession and frustrated users of the information had expressed the shortcomings of existing reporting methods applicable to oil and gas producers. Some had vainly advocated proposals for experimentation and change. The Commission, concurring in the need for more relevant information, and concerned with the lack of adequate momentum in the private sector to develop methodologies to provide such information, decided to seek the development of reserve recognition accounting -- a method which would involve a recognition of valuations of proved oil and gas reserves in the primary financial statements.

Although unique in view of the requirements established by specific Congressional legislation, the process by which the issues surrounding oil and gas accounting were approached does represent an example where the Commission determined that an FASB standard did not fall within a range of acceptable solutions. However, the fact that the Commission reached an independent judgment in this proceeding that differed from that of the FASB does not represent any change in the Commission's basic policy of looking to the FASB for the initiative in establishing and improving accounting standards.

The Commission has now determined to postpone indefinitely a requirement that supplementary information on oil and gas resources be audited. The requirement is being delayed until a decision is reached on mandating inclusion of RRA information in the primary financial statements. By delaying the requirement, the Commission is hoping to encourage experimentation in producing the most effective approaches to developing and presenting the information.

### Accounting for the Effects of Changing Prices

#### A. Efforts at Standard-Setting

While RRA has not met with great enthusiasm on the part of either the industry or the profession, recent innovative efforts to address the effects of changing prices have had, in the end, a more receptive response from the private sector. In my opinion, this innovation serves as a model for future efforts to resolve difficult accounting issues.

First, I would like to spend a few minutes describing the history of the Commission's and the FASB's involvement in this subject. Its significance, as with oil and gas, is in what we can learn and generalize from it. In 1974, the FASB issued an exposure draft proposing supplemental disclosure of specified financial information stated in units of general purchasing power. The Commission, however, believed that the development of useful data on the impact of changing prices would not be achieved if limited to the mechanical act of adjusting for changes in general price levels. Therefore, in March 1976, the Commission announced the adoption of its replacement cost rule in ASR No. 190, which called for supplemental disclosure by some 1,000 large, public companies of the replacement cost of productive capacity and inventories, and of the related depreciation expense and cost of sales based upon these measurements.

But, these disclosure requirements -- which were met with no greater enthusiasm than RRA -- were often criticized because of their subjective nature, and the Commission was accused of unrealistic assumptions regarding replacement. As a result, issuers typically included this information only in financial reports filed with the Commission and often surrounded their disclosures with disclaimers and caveats. These reactions to ASR No. 190 appeared to reflect a deeply engrained notion that only "hard" data should be recognized in financial statements. And, they also seemed to reflect a concern for any serious reexamination of traditional

accounting conventions -- especially when it might lead to greater volatility and lesser predictability of reported earnings.

The promulgation of ASR No. 190 had the unintended effect of temporarily preempting the FASB from assuming its primary role in providing guidance in this area. Later, recognizing that certain modifications to ASR No. 190 were necessary, the Commission urged the FASB to resume the initiative in addressing this subject.

Last September, the FASB issued its Statement No. 33, called "Financial Reporting and Changing Prices," which requires large, public corporations to report certain supplementary information on both a constant-dollar (that is, general price level) and a current-cost basis. Statement No. 33 makes a significant contribution to the evolution of the supplemental disclosures started by ASR 190. Significantly, Statement No. 33 calls for a computation of "income from continuing operations" in annual reports to shareholders. As a result of this welcome private sector initiative, the Commission deleted its replacement cost rule, while at the same time taking action to extend a safe harbor from liability for the disclosures required by Statement No. 33.

This Statement represents an extraordinary milestone for the accounting profession -- and not merely because it departs from the profession's exclusive reliance on historical cost-based accounting. Rather, its greatest importance is in its message of the profession's willingness to address difficult issues in an

innovative, conceptional mode. For example, Statement No. 33 is not held out as a definitive standard on inflation accounting. Instead, it represents an experimental effort in recognition that the state of the art does not permit a definitive standard, that experimentation is called for, and such important issues cannot await formulation of a perfect solution. Statement No. 33 recognizes that at times one must allow for the experimentation that is the only practical source of necessary experience and empirical data.

B. The Experimental Period

This experimental period will assist significantly in refining the standards for disclosure of information about the effects of changing prices. And, it also should contribute to resolving issues fundamental to the entire conceptual framework project. These include, for example, whether the theory of capital maintenance should be premised on physical or financial capital; whether the appropriate measuring unit should be nominal or constant dollars; what attributes financial reporting should measure; and whether the income concept should be viewed from the sole perspective of equity owners or from that of creditors as well.

In addition, Statement No. 33 has importance beyond its emphasis on experimentation and "soft" analyses. Statement No. 33 -- by specifying only minimum information -- places important

responsibility on each company's management to consider and report the significance of the data in the context of the company's own business activities. Thus, if it is to be meaningful, this standard for "soft" information, in turn, imposes a requirement for even "softer" information. I believe that the business community's response to these requirements will demonstrate whether it recognizes its responsibility and the need to confront the problems created by changing prices. If the business community lacks this sensitivity, a more prescriptive standard is the likely alternative. While I have not completed an exhaustive review, I am very encouraged by what I have seen.

Similarly, smaller companies, not subject to Statement No. 33's reporting requirements, should give serious consideration to voluntary disclosures about the effects of changing prices. Steps of that nature would add to the utility of their financial reports, while at the same time contributing valuable empirical evidence to the FASB's ongoing evaluation of its standards.

C. Lessons from the Process

In retrospect, while the standard-setting process has been slow, the issues are difficult and the effort has been an open and participatory one. The FASB appears willing to meet the challenge of setting meaningful accounting standards in a changing economic environment. Indeed, as the Commission reported to the Congress last June, the FASB has made important strides in

addressing some of the more fundamental issues inherent in the standard-setting process. Nonetheless, if the FASB is to be successful, it must continue to exercise positive and timely leadership. Moreover, the Board must be able to rely on the support and encouragement of the accounting profession and the corporate community -- regardless of the effect of particular Board decisions on particular reporting companies, and regardless of whether those companies and their auditors fully agree with the Board.

Leadership in standard setting cannot emerge out of consensus; by the time a consensus emerges on an issue of any significance, considerable damage to the credibility of financial reporting is likely to have been done. Yet, the private sector remains the best source of such leadership. The accounting profession and the business community must give a high priority to keeping this momentum for new initiatives in the private, rather than the public, domain.

### Auditors' Responsibilities

#### A. Importance of the Audit Function

Any discussion of recent developments and future trends in financial reporting would be incomplete if it did not address the role of the auditor. The independent accountant and his audit function are crucial to the full and accurate disclosure which is the hallmark of the federal securities laws and indispensable to our system of capital formation. And, possibly even more significantly, auditors -- both outside auditors and internal auditors



-- are major contributors to the effective corporate accountability process which is an alternative to further governmental intrusions into the private sector's decisionmaking process.

The modern corporation is an extraordinarily complex system in which, among others, managers, directors, lawyers and auditors play important roles. The aggregate of their often subtle sociological interrelationships determines the quality of corporate accountability. In this system, the audit function, both directly, and indirectly by monitoring other controls, advances the corporate accountability process. The audit helps set the tone for the corporation's financial discipline and ensure the integrity of the financial information upon which management makes its decisions. To facilitate an effective audit function, management, in turn, has the responsibility to establish, implement, and maintain a strong, effective system of internal controls and internal audit system. And, the audit committee's independent directors, who represent an important link between the corporate entity and larger society, have a critical role in overseeing the corporate audit process.

B. User and Public Expectations

By virtue of his unique role in this system, the outside accountant shoulders certain specific responsibilities which might not exist if the auditor-client relationship were purely one of private concern. Under the antifraud provisions of the

federal securities laws, where the independent auditor believes that material matters are omitted from the financial statements, the material should be included in [the independent auditor's] report and he should appropriately qualify his opinion. \*/. In a broad sense, the public looks to him to ensure the disclosure of all material information of which he is aware. Any abdication of these responsibilities substantially diminishes the reliability of the audit process, as well as the credibility of the audit report. In short, the private auditor, in certifying financial statements under the federal securities laws, performs a kind of quasi-public function.

I have no simple answers to the question of how the auditing profession should address these tasks, nor, in the final analysis, can government be expected to provide those answers. Indeed, in my judgment, one of the factors which serves to obscure the auditor's proper role is confusion between the level of conduct which the law demands, and the level of conduct called for by changing economic conditions and by user and public expectations. Increasingly, we tend to conform our conduct to the law and ignore the latter. Yet, I believe that, at the same time the courts are responding to the increased litigiousness of our society by drawing what

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\*/ Statement on Auditing Standards No. 1, Section 430.02, The Third Standard of Reporting (1972).

may seem to be arbitrary and often inconsistent lines to define the auditor's exposure, users, the public and its representatives in the Congress are raising their expectations of financial information and the role of the accounting profession.

For example, the United States Supreme Court's decision in Ernst & Ernst v. Hochfelder \*\*/ may have confused some regarding the role and responsibilities of the independent auditor. As you may know, in that case, the Court held that an accountant was not liable for monetary damages under the Commission's general antifraud rule -- Rule 10b-5 -- to a third person absent a showing of scienter -- that is, intent to defraud. The Court's underlying message there, I believe, is that it would not countenance monetary liability which seemed to be wholly disproportionate to the task which the auditor had undertaken. In essence, it rejected what it considered to be an unreasonable and unfair imbalance between the auditor's responsibilities and the penalty to be incurred when those responsibilities are not satisfied. The point was not that the auditor's duties to the users of his audit -- in that case his client's customers -- are any the less. Those who take comfort from the decision should study the transcript of my most recent appearance before a Subcommittee of the Senate Governmental Affairs Committee, at which Senator Thomas Eagleton urged the Commission to formulate a legislative response to

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\*\*/ 425 U.S. 185 (1976).

Hochfelder and inquired whether any other professional in the United States was sheltered from liability for the consequences of his negligence.

Thus, the profession must be cautious in interpreting superficially conflicting signals concerning its role and responsibilities. The objective of each accountant should be to ensure that the profession's standards and the conduct of its members comports -- not merely with the letter of the law -- but with the changing expectations and needs of users of financial information and the public. Those expectations tend to change more quickly than does the law. The signals which the legal system gives off tend to lag seriously behind the emerging expectations in response to which the profession's performance will tend to be measured.

In my opinion, it was the profession's failure to recognize such changing expectations that led to the criticism directed at accountants during the 1970s. And, the profession's enhanced visibility in the 1980s will make the necessity of responding to these public demands even the more urgent. This means that the profession needs to maintain an effective program of quality control in addition to ensuring that its standard-setting process is adequate to satisfy the public's expectations. While we are all committed to the profession's continuing existence as a private entity, the events of the last decade illustrate that the public will not tolerate much slippage in the accountant's responses to a changing financial environment.

C. Financial Reporting

In addition to ensuring that public expectations are met by high quality audit performance, the profession is facing the additional challenge of increasing expectations regarding its role in the broader area of financial reporting. The AICPA has, for example, recently considered the issue of financial reporting standards for information presented outside the confines of the financial statements. In the spring of 1979, the AICPA Council approved a resolution designating the FASB to establish standards for the disclosure of financial information outside of financial statements. As a result, the AICPA's Auditing Standards Board has adopted Statement on Auditing Standards No. 27, which requires the independent accountant to apply certain limited review procedures to supplementary information required by the FASB.

SAS No. 27 appears to be a positive step. First, it is applicable to any supplementary information required by the FASB, and thus seems to encourage future requirements for disclosure of information outside the financial statements. Second, the limited SAS No. 27 review procedures reflect the need to tailor the auditor's role to fit the supplementary information which companies are now required to provide. The relative imprecision of such information probably means that it is not currently

susceptible to traditional audit certification at a reasonable cost.

However, I am concerned that present standards do not require that auditors report on the nature and results of their reviews of supplementary information. Reporting the nature of the auditor's procedures and how they differ from an audit, would provide an important communicating channel between the profession and the users of financial statements.

C. Section 11(a) Liabilities

The issue of auditor liability under Section 11(a) of the Securities Act for limited reviews is troublesome and complex. I understand that the Auditing Standards Board has deferred the question of requiring explicit reporting on supplementary information, in large part due to uncertainty over the applicability of the liability provisions of the Securities Act of 1933 to such a report when it is included in a registration statement. As you may be aware, Section 11(a) imposes liability on an accountant for misstatements or omissions of material facts in a registration statement which includes his report, unless he had, after "reasonable investigation," grounds to believe that the information was true. The problem raised by this standard, of course, is that limited reviews contemplated by the Auditing Standards Board do not afford the auditor a sufficient basis to judge the "truth" of the supplemental data reviewed.

Therefore, the staff has recommended that the Commission propose a rule to remove reports on supplementary information dealing with the effects of changing prices and with oil and gas reserve information from the liability provisions of Section 11(a). This rule would be similar to the Commission's recent action with respect to accountants' reports pursuant to SAS No. 24 on unaudited interim financial information. There are some who assert -- and I might add, fairly persuasively -- that accountants should not be given a blanket exemption of this sort from liability under Section 11(a). Thus, I anticipate that the Commission may, in the near future, request comments on alternative approaches to the issue. The result of that process could be liability for failure to comply with the applicable professional standards.

In any case, I fully expect that the liability question soon will be clarified and that requirements for accountants' reports expressing limited assurances on the basis of reviews of supplementary information will be resolved. This process reflects the Commission's belief -- similar to that suggested by the Hochfelder decision -- that there must be a fair and reasonable balance between, on one side, the need to ensure responsible auditing services, and, on the other, the burdens and liabilities placed on the accounting profession.

E. Foreign Corrupt Practices Act

Another difficult area in which questions of auditor responsibilities have arisen is the controversy over internal

accounting controls and implementation of the accounting provisions of the Foreign Corrupt Practices Act. The Commission recognizes fully the substantive issues involved in this subject, although it has not yet concluded its deliberations on the proposed rule.

Personally, I am receptive to arguments that private sector initiatives, such as that proposed by the Financial Executives Institute and by various public accounting firms, should be given the opportunity to work. The Commission, of course, is watching developments on this subject with interest, and where these initiatives conform to the objectives of the new Act, will take them into account in determining its course of action.

F. Professional Independence

Finally, in considering the audit process -- and the public's perception of its credibility -- it would be unrealistic to ignore the subtle but significant pressures on independence that may be brought to bear by an important client. Although auditor independence has been strengthened, the pressures to avoid a confrontation with a client -- rather than risk the loss of business to competitors -- is still substantial. These pressures, at times, mean that an auditor may be tempted, consciously or unconsciously, to reach for ways to support his client's position, and conversely, the strength of the position



of those auditors who refuse to compromise on professional integrity may be undermined.

These pressures are, of course, amplified the more important the client is to the firm and the individual office -- an importance that must be calculated according to their total business relationship, including fees generated by both audit and nonaudit services. Therefore one argument often made in response to ASR 264, that is, that there have been no proven cases in which nonaudit services have compromised independence is not compelling. Rather, proven or not, the profession would not be credible -- or human -- if it contended that there were no instances where the firm's response to a confrontation with a client was not influenced by the importance of the client to the auditor's total business mix.

Moreover, there are other practices which relate to finding and keeping business clients that threaten to erode the public's confidence in the profession. For example, no accounting firm should tolerate being professionally compromised by participating in a selection process in which a potential client openly is attempting to change auditors and select an accountant whose opinions will be more compatible and primarily based on the client's -- rather than users' -- needs. Additionally, while I certainly endorse fee competition -- I doubt that users can have confidence in accounting services based on below-cost fee

commitments -- particularly multi-year arrangements -- and particularly where no provision is made for any increases to cover previously unanticipated problems. To a large extent, the resolution of these concerns depends on the commitment to independence and professionalism of the particular firm or office, and the partner in charge of the engagement -- the most important individual in the process -- and the discipline the firm brings to bear. It is not universally impressive. But, here again a response by the profession as a whole is also required. The profession should revisit this entire area and determine whether revisions to its code of ethics and disciplinary process are necessary to insure professional independence by exerting the maximum counterpressure against these practices.

#### Professional Self-Regulation

Many of the private initiatives that I am advocating this evening can be effected best -- or even exclusively -- in the context of a professional self-regulatory organization. Considerable progress has been made. The process of implementing a self-regulatory structure is not an easy one. The profession has no model to follow, and thus the implementation process is essentially one of trial and error. Indeed, during the course of implementing its self-regulatory program, the profession has encountered, and will continue to encounter, both conceptual and

practical obstacles. Thus, the successful resolution of these difficulties will demand strong leadership.

Perhaps most crucial to the success of the profession's efforts will be the effectiveness of the role designed for the Public Oversight Board, an oversight body composed of distinguished members of the public. The Commission believes that the POB is in a position to perform a necessary leadership function. However, the POB must be sufficiently detached from the accounting profession to guide the effort objectively and to ensure that the profession does not lose sight of the goals which it must achieve. While the Board's authority is advisory only, it can and should -- by virtue of its stature -- serve as a conscience, critic and leader. But, it is not yet clear whether the POB is prepared to assume this responsibility.

In this regard, the Commission has three remaining structural concerns regarding the AICPA's self-regulatory program, apart from the basic question of how well the process actually functions. These issues are membership, the ability to evaluate the peer review process, and the effectiveness of disciplinary mechanisms. With respect to the membership issue, on the positive side, the SEC Practice Section's 230 member firms audit almost 9,000 public companies, including virtually all companies listed on the national stock exchanges and a significant portion of NASDAQ-traded companies. However, approximately 600 accounting firms that have at least one SEC audit client have not yet joined the Section.

The AICPA has undertaken to identify these firms and to ascertain the reasons why they are not yet Section members. In response to concerns raised about cost, particularly for smaller firms, the Section has taken action to reduce its insurance and dues requirements. The effects of these changes remain to be seen. If the Section functions as it is intended to, however, there will be increasing pressure on all firms with public clients, regardless of size, to join. Membership in the Section -- with its attendant peer review requirements -- should provide a basic level of assurance of the quality audits the public has every right to expect.

Accordingly, the onus is shifting to the firms with SEC clients which have elected not to participate in the self-regulatory program. Inevitably, as time passes, either their clients or others will raise questions as to why they have not yet joined. Moreover, it may be important for investors to be informed as to whether the auditor of a given issuer has been subject to a peer review.

An unresolved element in the profession's voluntary self-regulatory program is the effectiveness of 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 voluntary self-regulatory program. To date, however,

too few peer reviews have been performed to formulate any definitive conclusions about the program.

An open issue which hampers the ability of the Commission to evaluate the peer review process is its lack of access to the reviewer's workpapers. While the Commission can rely on the POB's supervision to a great degree, it is necessary for the Commission's own staff to have sufficient access to permit an overall evaluation of the adequacy of the peer review program. If the Commission were forced to rely exclusively on the Board's assurances that the process is working effectively, it would not be in a position to satisfy itself, and apprise the Congress, as to whether the SEC Practice Section is an effective mechanism for professional quality control.

Finally, an effective, timely and credible system of professional self-discipline will be key to the success of the accounting profession's self-regulatory efforts in the United States. It is yet to be fully designed, implemented and tested.

The process of demonstrating that accountants themselves, rather than government, should retain primary authority to regulate their profession, ensure and instill confidence in professionalism and objectivity, maintain control over the quality of its work and discipline those of its members who fail to adhere to its standards, is one which will continue to demand

the continued commitment of both accountants and the Commission. The need for leadership regarding these essential issues is greater than ever. The Commission stands ready, however, to consider any reasonable alternatives to achieve the essential objectives of this process.

### Conclusion

In conclusion, let me summarize some of the developments of the last thousand days and their likely impact on the accounting profession of future decades. First, the profession has taken the first steps toward establishing the conceptual framework necessary to develop and continuously monitor a rational and responsive body of accounting standards. And, within this framework, the profession should be able to continuously identify, and advise users of, the inherent limitations of the financial accounting and reporting process -- for example, the unavoidable imprecisions of forward-looking data. But, such limitations should no longer be cited to deprive users of otherwise relevant information.

Additionally, increasing recognition has been given to the different standards of verifiability applicable to different types of information to accommodate greater reporting of highly relevant "soft" information. And, I foresee an increasing use of such information in financial reports.

Thirdly, the profession is becoming more comfortable with its developing role in disseminating useful but nontraditional

financial information, particularly as the Commission grapples with the troublesome liability issue. I believe that, in the near future, we will see auditors issuing explicit reports which explain their level of association with financial information presented outside the financial statements.

In my view, these developments all point to increased reporting of "soft" information, including more future-oriented data. In turn, the increased availability of soft information will encourage the disaggregation of financial information -- that is, less emphasis on the "bottom line" and earnings-per-share, and greater concern with the key components which better reflect the operating results and cash flow of a business entity. As a result, accounting methods will more appropriately and more usefully reflect the economic substance of a business entity. And, to ensure that such useful information will be disseminated in a timely manner, there must be a greater emphasis on continuous reporting of financial information.

Finally, the structure and continued independence of the accounting profession will depend on the degree to which the profession is receptive to the public's concerns for responsive accounting standards and quality controls over practicing accountants. To a large extent, that means a strong, effective program of self-regulation.

These issues and developments are enormously important to the future of our financial reporting system. The opportunity and responsibility for all sectors of the profession, including the academic community, to contribute to this effort is virtually limitless. I hope that the Accounting Research Center, as an institution, and each of you, individually, will accept this challenge.

Thank you.