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PROFESSIONAL SELF-GOVERNANCE:  
AN INTERIM REPORT

An Address by Harold M. Williams, Chairman  
Securities and Exchange Commission

AICPA Fifth National Conference  
on Current SEC Developments  
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Last spring, a Senate subcommittee chaired by Lee Metcalf held public hearings concerning the accounting profession. Those hearings, the staff study which preceded them and the Committee report which followed, are part of a broad examination of the profession. That examination has served to highlight the increasing public and Congressional interest and concern over the important role in our economic life of a profession which, in the past, has enjoyed relative obscurity. Much could -- and has -- been said about particular substantive issues aired before the Metcalf Committee. The testimony of witnesses raised concepts such as mandatory rotation of firms, federal licensing of accountants, direct governmental involvement in the formulation of both accounting and auditing standards, and other steps which would radically alter the autonomy of the profession as we know it today.

While the Committee report, issued last month, did not propose any of the more extreme measures recommended by some, it would obviously be a very serious mistake for accountants to conclude that Congressional interest in the accounting profession will relapse into the dormancy which was long characteristic. Apart from the merits of the various substantive issues discussed, the Metcalf hearings conveyed one very definite and clear message -- a sense of expectation and urgency for the profession and, as necessary, the Commission, to act to build the public's confidence in the independence of accountants, in their resolve and ability to engage in meaningful self-discipline, and in the processes by which accounting standards are established.

The hearings also conveyed a second message -- that many people in and out of Congress are critical of the Commission for what it is, or is not, doing with respect to the auditing and financial reporting of public corporations and for not being aggressive enough or responsible in the discharge of its oversight role. I have very little desire to preside, during my five years as Chairman, over increased regulation of the accounting profession. Similarly, I have no wish to see legislation passed that would place the responsibility on the Commission -- or some other government body -- to regulate accounts. Nevertheless, time is rapidly running on the opportunity for voluntary initiatives.

Congressman Moss has indicated his intent to continue this public examination of the profession by holding hearings, perhaps as early as this month. In addition, Senator Metcalf plans to hold follow-up hearings this spring. Senator Metcalf's recent letter to me conveys the sense of urgency which, I believe, is important for every member of the profession to bear in mind. That letter, referring among other things to the unanimity of the Subcommittee report, concludes:

"I have received disturbing reports that many in the accounting profession believe this subcommittee has completed its accounting inquiry, and that substantive changes are not necessary because we have expressed our preference for the profession and the SEC to implement reforms. I assure you that is not the case. We plan to hold follow-up hearings this spring, and we look forward to seeing substantial progress from those who told us they could do the job themselves almost a year ago."

In my own testimony at the Metcalf Hearings, the Commission undertook to submit an annual report to Congress, the

first by July 1, 1978, analyzing the progress of the profession and the Commission in addressing the challenges before them. I would like to review with you today some of the central issues which I discussed at the Metcalf Hearings and which will be the focus of the Commission's annual report to Congress later this year. Thus, in a sense, I hope to provide you with some of the pieces with which the profession can prepare its own interim report on its progress. If the interim results are not sufficiently positive, it may well be that the opportunity to prepare a final report on voluntary initiatives will never come.

### Independence

As I see them, the issues on which the accounting profession's progress will be evaluated are three: Independence; quality control, including self-discipline; and the accounting and auditing standard-setting processes. The issue of independence is the key one. It is key because everything else fits with it. In many ways the public has expectations of the profession and of what the auditor's report means that exceed reality. However, to the extent that the public views the auditing process as a wholly unbiased review of management's presentation of the corporate financial posture, I believe that the expectations are fully justified.

Independence is the auditor's single most valuable attribute. If the profession cannot satisfy its obligation to maintain both the appearance and the fact of independence, ultimately the political process will compel changes in the profession so that it is more likely to do so -- even at the risk of other shortcomings.

The objective of the profession and the Commission should be to institute those measures available to them which enhance and reinforce independence -- whether in the audit process, through standard-setting, through disciplinary actions, or otherwise. The most obvious factor which erodes independence -- or, at least, its appearance -- is the fact that the auditor's compensation -- and the continued utilization of his services -- are dependent upon the wishes of the client's management, the same group toward which the auditor is expected to be independent. The ultimate test and key to independence is the amount of pressure that management can bring on an auditor and the ability of the auditor to withstand that pressure.

In that connection, the Commission has proposed a rule amending Form 8-K to require disclosure of the reasons why an auditor was dismissed and whether the dismissal and the reasons for it were discussed with and approved by the board of directors or the audit committee. Similarly, the Commission has proposed a change in the proxy rules to require a discussion of why the auditor was terminated. The former auditor would also be given an opportunity to comment on that discussion.

In the area of management advisory services and the concern voiced about the impact of those services on independence, the Commission has proposed a rule to require proxy disclosure of all services the auditor provided to the registrant and a breakdown of the fees. We are also asking for comments on whether certain management services should be prohibited.

Many of the public comments on these proposals have raised serious questions concerning their real potential to improve the climate for auditor independence. On the other hand, in the letter I mentioned earlier, Senator Metcalf stated that “the proposed disclosure requirements fall far short of our views regarding the proper scope of services which independent auditors may provide.” He added that the “most simple and direct method \* \* \* for enhancing independence and preventing unfair competition would be to prohibit accounting firms from providing any management services to publicly owned corporations who are their audit clients.” The Commission will, of course, be grappling with all of the inherent issues in its pending proceedings.

In any event, while the Commission may be able to take some steps to enhance auditors’ independence, the pressures that auditors are subjected to -- in terms of audit cost, scope of audit, application of accounting principles or auditing standards, or pressure to complete the audit early -- are pressures that ultimately only the individual auditor himself can withstand. The basic problem here is one of professional attitude, which cannot be legislated, although legislation will undoubtedly be resorted to if self-discipline fails.

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

I believe, fair to say that it is becoming increasingly a matter with which the AICPA, as a body, must concern itself. The Institute must instill in the public and in Congress confidence that it is an independent, professional organization -- not a trade association in the sense of being a promoter of the financial interests of its members and not a lobbying arm for its members' corporate clients. If the Institute is unable to do so, Congress will surely -- and properly -- demand that a different body assume the self-regulatory responsibilities for the accounting profession.

I would like to offer one important example of what the profession should do to stimulate confidence in its own independence. As I have stressed, and as my predecessors have stressed for many years, one of the avenues readily available for strengthening auditor independence is the formation of audit committees composed of independent corporate directors. 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. Stated differently, the absence of an audit committee may diminish or impair the ability of an auditor to be independent. Determining, as a legal matter, the independence of an auditor can be a cloudy issue at times, and the lack of an audit committee tends to make the determination of an auditor's independence that much cloudier; it clearly is a negative factor in arriving at the ultimate judgment. Not all audit committees will function effectively. Many will, however -- particularly if auditors

recognize the critical role they can play in helping make the audit committee a meaningful and effective tool.

For these reasons, I believe that public companies should establish independent audit committees. The Commission will watch with great interest the work of the AICPA special committee organized to study whether and how the AICPA should promulgate an ethical or auditing standard which would require that an audit committee, composed of outside directors, be established as a condition to an accountant's accepting an audit engagement with a publicly-owned company. The profession should and can move forward in this important area. I strongly support the AICPA's effort -- indeed it is long overdue -- and am hopeful that the special committee involved in this project will recommend a standard which will require independent audit committees in public companies.

Independence is, most appropriately, primarily a concern of the profession itself. The profession must take whatever steps are reasonably available to it -- such as insisting that their clients maintain audit committees -- to insure and enhance its independence. If the profession is reluctant to take steps of that nature voluntarily and of its own accord, the Commission will need to understand why and how that reluctance can be reconciled with a profession which desires to maintain the initiative for self-regulation and self-discipline.



### Self-Regulation and Self-Discipline

A second important area about which there is a sense of expectation and urgency is the need for enhanced professional self-regulatory and disciplinary mechanisms. Those mechanisms are vital, not only for the sake of disciplining those who have failed in their professional undertaking, but to reinforce independence. If the profession's own disciplinary proceedings are more effective, and more visible, it will strengthen the independence of the auditors, and the perception of independence, as well as warding off legislative alternatives.

I recognize the substantial strides the profession has made in a few months to develop the AICPA Division of CPA Firms as a framework for such a program. Looking to the future, we need to be realistic about what is likely to succeed and be acceptable -- to the Commission as well as to the Congress -- as a self-regulatory program.

The profession has made progress in addressing certain key issues in the context of the requirements of the firm membership program. Mandating second partner review and continuous professional education clearly will help to enhance quality control over the work performed. In addition, mandating audit partner rotation on an engagement will strengthen independence.

More broadly, however, the jury is out on whether the AICPA program on self-regulation will be successful. But clearly the key to success lies in the Public Oversight Board and its ability to function effectively. If the quality, stature, and commitment to independence of the individuals selected to the Board are

sufficiently high; if the Board can devote the time and is provided with adequate staff and budget; if it is not impeded in performing its functions and responsibilities; and if it can effectively oversee the disciplinary framework; then the overall program should contain the major necessary ingredients. The effectiveness and credibility of the Public Oversight Board depends on its independence, including its willingness to be critical when called for and its ability to make public its conclusions, recommendations, and criticism. It is this publicly that provides the board with its greatest clout in overseeing the activities of the SEC Practice Section and in enhancing its own, and the profession's, credibility.

A second key to the success of the AICPA's program of self-regulation is the effectiveness of the quality control process, including its disciplinary framework. Clearly the program needs to encompass adequate sanctioning capability. Sanctions go to reinforce both independence and quality control. The situations in which self-regulatory efforts are most likely to 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 SEC Practice Section must be used, as appropriate, against both large and small members. Conversely, if the potential sanctioning power does not have adequate substance, the program itself will not be credible.

Third, mandatory peer review of the firm's accounting and audit practice is a significant part of the quality control effort.

Several aspects of the peer review process should be considered in developing the standards for conducting such reviews. One of the principal issues is whether the review should be firm-on-firm as contrasted to being directed by a peer review committee or the Public Oversight Board. Consideration should also be given to whether the staff performing the reviews should be from one firm or whether it should be composed of individuals from several firms as well as individuals from outside the profession. The question here become one of balancing the benefits derived from the enhancement of the objectivity, or at least of the appearance of objectivity, against the increased costs and inefficiencies, if any, of such a review process.

Another principal issue is the scope of the peer review. Should any limitations be placed on the conduct of such reviews? What are the appropriate criteria? Arbitrary exclusions of particular offices, engagements, or personnel from possible review present problems. For example, automatic exclusion of cases in litigation from the scope of the review could place a major cloud over the review process. The issue is one which goes to both the substance and appearance of credibility. Possible alternatives to a full review of those engagements should be given careful study.

Another question concerning the scope of reviews is whether, to meet the expectations of the users of financial information, quality control reviews must include a review of an accounting firm's international offices. As American businesses have grown into multinational corporations, the need for achieving the same high level of auditing standards in foreign countries has

grown commensurately. Foreign operations today represent a significant portion of the business of many U.S. Corporations. Investors are entitled to expect and should receive the same level of professionalism and judgment from an independent auditor in these foreign countries as they expect and receive in the United States.

#### The Standard-Setting Process

The final area of concern is the process by which accounting principles and auditing standards are formulated. I believe that the responsibility for standard-setting belongs in the private sector, and hope that it will be able to show the resolve and capacity effectively to fulfill that responsibility. I am firmly convinced that the private sector -- the profession -- is in a much better position to maintain and assume responsibility for its own destiny than is any governmental body. The Commission's role should be one of oversight -- the prodding, guidance, and review necessary to insure that the profession meets the challenges facing it in a manner which harmonizes with our responsibilities under the federal securities laws.

There are encouraging signs that the profession is coming to grips with its responsibilities in this area. I endorse the changes in the FASB structure. Similarly, I believe that the profession should consider the recommendations of the Cohen Commission very seriously. My judgment is that those recommendations are by and large appropriate for the profession today. Furthermore, in deciding whether to adopt them, you ought to take into

consideration not only whether you believe they are appropriate, but also how those recommendations reflect public expectations.

Beyond these initiatives, accountants must give serious and careful thought to the theoretical underpinnings of the profession. One of the important -- possibly the most important -- of the issues confronting the profession in this field is the FASB's conceptual framework project. Not only is it substantively important, but the effort also exemplifies the kind of fundamental undertaking through which accountants can demonstrate to Congress and to the profession's critics their effectiveness and resolve in confronting the important issues affecting it. The fruits of that work should provide a rational framework within which to establish accounting principles and a reporting model for a disclosure system that will serve the profession and the business community regardless of the changes in the economic climate which our society may experience in the future. The project is also the logical focus for consideration of whether the FASB should restrict its scope to financial statements or whether it should expand it to cover financial reporting in general.

I would urge that, within the conceptual framework, there be both mandatory disclosure of the impact of inflation on the firm and its financial statements and the flexibility to encompass any type of disclosure which is determined to provide meaningful information to users, not only that incorporated within the traditional financial statements. Example of these types of disclosures include management's discussion and analysis of the summary of operations, forecasting, interim reporting, etc. The

inclusion of such disclosures in financial reporting is a trend which the Commission has favored in recent years.

Closely associated with this concept of the FASB assuming an expanded scope in the overall area of financial reporting is the issue of whether the auditor should be associated with such information and perform an independent review of it. Auditors must recognize that, as the Cohen Commission's tentative conclusions reflect, they are increasingly expected to review any information of a financial nature issued by management.

The degree of association that an auditor should be expected to have with the information disclosed by management and the auditing standards applicable should depend upon the hardness or softness of the data presented. The statement on auditing standards concerning replacement cost data is an example of how auditing standards can be developed to review information that is relatively less precise and therefore is softer than the traditional information contained in audited financial statements. I envision that the auditor's report could similarly evolve into one that covers all aspects of financial reporting.

### Conclusion

I hope my remarks have made clear that the Commission strongly supports the goal of fostering a strong private accounting profession capable of providing the public with independent assurance and verification of the financial information disseminated by companies. We intend to work actively with the profession and the Congress in that effort. At the same time,

however, each of you must bear in mind that there is a timetable running -- or a clock ticking -- characterize it as you will. What it amounts to is that the profession must, as it has begun to do, assume a much more aggressive role in shaping its own destiny. The profession must accomplish a number of very specific things in a relatively short period of time if, indeed, it is to maintain the initiative to determine its own future.