

78 2451  
#1120

**NEWS**

**SECURITIES AND  
EXCHANGE COMMISSION**

Washington, D. C. 20549

(202) 755-4846



FOR RELEASE: 1:15 p.m., EDT, Thursday, January 3, 1980

THE 1980s:

THE FUTURE OF THE ACCOUNTING PROFESSION

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

AICPA Seventh National Conference  
on Current SEC Developments  
Capital Hilton Hotel  
Washington, D.C.  
January 3, 1980

The decade of the 1980s has opened with the promise of a full plate of volatile and explosive issues which will test the relevancy and adequacy of many of our institutions and conceptions. For the accounting profession as well, this promises to be a period of challenge, innovation and change. Events of the past few years have spawned significant progress toward the objective of improving the profession's capability to assure that appropriate ethical and professional standards are developed and maintained timely and with a minimum of government legislation or regulation. The successful attainment of this goal will permit the accounting profession to emerge from the decade of the 1980s even stronger and more vital than it entered it.

Much remains to be accomplished if the profession is to realize this goal. During the past two years, it has faced challenges embracing the full spectrum of the profession's activities. Criticisms directed at the accounting profession from without, as well as the profession's own efforts at self-assessment -- such as the Cohen Commission -- have served as the basis for change. 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 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.

This must not happen. As I indicated at this Conference last year, a major part of the stress that the profession is under stems from its own failure in the past to recognize in a timely manner challenges to its discharge of the only responsibility which justifies its existence today -- insuring the credibility and reliability of financial reporting.

The Commission's view of the accounting profession's progress in response to the issues facing it has been described in our two reports to Congress on "The Accounting Profession and the Commission's Oversight Role." We will again report to the Congress during 1980. In the last analysis, the maintenance of an independent, private profession depends on the profession's progress, and I sincerely hope that the Commission will be in a position to be positive with respect to the profession's self-regulatory efforts. In this connection, I want to look at some specific areas which are, in my judgment, significant tests of the profession's efforts and direction.

#### Self-Regulation

The most visible change made by the accounting profession in response to criticisms directed toward it was the creation, just over two years ago, of the AICPA's Division for CPA Firms. The SEC Practice Section is the key to successful, voluntary self-regulation and the problems in implementing its programs pose the greatest obstacles to success. Therefore, rather than focusing on the progress made by the profession -- and significant progress has

been made -- I want to concentrate on three of the uncertainties which could hinder the Section's ability to meet its objectives.

The first unresolved issue relates to membership in the Section. On the positive side, it appears its 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. Unfortunately, however, approximately 600 accounting firms that have at least one SEC audit client have not yet joined the SEC Practice 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 recently taken action to reduce its insurance and dues requirements. The effects of these changes remain to be seen.

In addition, some smaller firms appear concerned about their ability to exercise influence over the activities of the Section, and, in fact, some have asserted that the AICPA and its self-regulatory effort are dominated by the larger accounting firms. In that vein, the Commission has urged greater participation by smaller firms in the self-regulatory effort. Nonetheless, because an overwhelming majority of public companies are audited by larger firms, it does not seem inappropriate that these firms have taken the lead in the self-regulatory effort. These firms have, of course, a heavy burden not to abuse their leadership to the detriment of the smaller members. The Section's Executive Committee must also

remain sensitive to the concerns of this segment of the profession and ensure that its interests are fairly represented.

We recognize that many smaller firms which audit only one or a few small registered companies may honestly be concerned that the increased costs of participating in the self-regulatory effort -- either to themselves or to their clients in the form of higher fees -- may exceed the benefits to the public interest. Perhaps they have other concerns as well. In this connection, the Commission, and, I am confident, the Section and the POB, would be pleased to hear directly from these smaller firms as to the reasons for their positions and any suggestions as to how any unjustifiable burdens could be alleviated.

If, however, the Section functions as it is intended to, there will be increasing pressure on all firms with public clients, regardless of size, to join the SEC Practice Section. Membership in the Section -- with its attendant peer review requirements -- provides a basic level of assurance of quality audits. 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 a registrant's auditors are members of the Section and whether the auditor has been subject to a peer review. The Commission's staff is presently considering this issue and may recommend that the Commission propose rules which would require disclosure on this point from issuers. Companies are

encouraged to make this disclosure voluntarily since it may be useful to shareholders and other users of financial information in evaluating the overall quality of a registrant's financial reporting.

The second important but unresolved element in the profession's voluntary self-regulatory program is the peer review concept. Commitment to meaningful, in-depth peer reviews by independent and objective reviewers is a prerequisite to the success of the profession's voluntary self-regulatory program. Accordingly, delays in the effective implementation of the peer review program are a serious threat to the whole structure of self-regulation.

In July 1979, we reported to Congress that although we remained optimistic that the peer review process would ultimately prove effective, only a few peer reviews had been conducted, and that the evidence was therefore too fragmentary to sustain any firm conclusions. At that time, we expected that a significant number of peer reviews would be scheduled during the coming year. In fact, however, only some 40 peer reviews were conducted during 1979. This small number causes justifiable concern about the profession's commitment to self-regulation.

Another factor continues to impede the Commission's ability to evaluate the peer review program. That problem -- Commission access to peer review workpapers -- must be resolved now. While the Commission can rely on the POB's supervision of the peer review process to a great degree, it is necessary for our staff to have sufficient access to permit an evaluation of the adequacy of the peer review process. If we were forced to rely

exclusively on the POB's assurances that the process is working effectively, we would simply not be in a position to satisfy ourselves and apprise Congress as to whether the SEC Practice Section is an effective mechanism for professional quality control.

The profession's leaders look upon Commission access to peer review materials with some trepidation. I believe, however, that they understand the importance of reaching an appropriate solution. Representatives of the Section and the POB have met with the Commission's staff in an effort to design a mechanism to achieve this goal. The problem is a difficult one, and we appreciate the profession's concern for client confidentiality. Further, I think it is important to emphasize that our need for access is not geared toward enforcement of the securities laws -- an area in which we have ample existing authority -- but rather to fulfill our oversight responsibilities. The Commission will maintain a position of flexibility in resolving this issue. Based upon my discussions with the Commission's staff, I am optimistic about the outcome of the ongoing efforts to resolve this issue in an acceptable manner. The Commission would look forward to being able to report to Congress later this year that a breakthrough has been achieved in this very difficult area.

I want to comment on one final peer review related issue -- the extent to which audit work performed outside the United States should be encompassed in the scope of peer reviews. This is a complex issue, and continuing efforts must be made to seek an effective resolution. While a worldwide peer review process

concentrating on each firm's quality control system -- regardless of the physical location of that firm -- may be the ideal way to provide investors with assurance of audit quality, I recognize that differing legal and professional environments make progress toward this goal difficult. As we have discussed with the AICPA's and POB's staffs, one way to address the issue of worldwide peer review would be an engagement oriented focus. That is, a U.S. firm, as part of its quality control or audit standards, could be required to perform certain procedures where a significant portion of the audit work was performed outside the U.S. These procedures -- which would be documented -- should be designed to provide assurance, at least to the extent of that particular engagement, that: (1) the quality of financial reporting is consistent, (2) audit quality with respect to all phases of the audit is uniformly high, and (3) all aspects of the audit were conducted by independent accountants based on professional and regulatory standards applicable to U.S. firms. Using this approach, the peer review process would concentrate on the U.S. firm's overall policies and procedures for reviewing audit work done outside the U.S. In my view, this would be a satisfactory interim resolution to a difficult issue.

The third area of uncertainty surrounding the self-regulatory initiative relates to the disciplinary measures which the Section will invoke against members which deviate from the profession's standards. As the Commission noted in both of its first two Reports to Congress, the Section's sanctioning process and procedures are

not yet in place and are untested. Thus their timeliness, fairness, evenhandedness and efficacy remain to be demonstrated.

### Independence

I want to turn now to the issue of safeguarding auditors' independence. Like self-regulation, this subject occupied the profession's attention during the 1970s and will continue to be a focal point of debate during the 1980s. Two issues -- independent audit committees and the scope of services which the auditor provides his client -- are particularly important.

The audit committee issue is, of course, one I have addressed repeatedly in my prior appearances at this podium. Last year, I referred to the AICPA's then-recent response to our suggestion that it approach the issue from the perspective of adopting an ethical or auditing standard. As you will recall, the AICPA, on the recommendation of the special committee which it chartered to analyze this question, declined to establish an audit committee requirement. In my view, even if the AICPA were justified in rejecting such a standard, the accounting profession can and should contribute more leadership than the special committee's report recognizes. The profession should be in the forefront of the movement for institutional changes, such as independent audit committees, which can serve to reinforce auditor independence.

It is my firm belief that the 1980s will see audit committees functioning as an integral part of all public companies. The forces of public and peer pressure are presently working toward this goal. For example, the American Stock Exchange recently

recommended that all AMEX-listed companies have audit committees consisting entirely of directors independent of management.

While the AMEX initiative is only a recommendation, it will add to the existing pressures for the formation of independent audit committees. Whether direct Commission action is necessary to further this process remains to be determined.

The ultimate value of audit committees, however, depends on how well they actually function, rather than whether they simply exist in theory. And, in turn, whether or not they function effectively will depend on the combined efforts of the accounting profession, the corporate community and individual audit committee members. This is the ultimate goal toward which we must all be working. Auditors are obviously the focal point of audit committee operations, and I urge the accounting profession, in its own self-interest, to continue its efforts to help create more effective audit committees.

A second issue bearing directly upon auditor independence is the scope of services performed by independent accountants. The Commission has addressed this area principally in two releases. First, in 1978, the Commission promulgated Accounting Series Release No. 250, which requires disclosure of nonaudit services performed by independent auditors in terms of their percentage relationship to audit fees. We believe that ASR 250 will serve to provide data upon which users of financial information can evaluate the relationship between companies and their auditors -- in effect, these disclosures should eliminate some of the mystique which has

historically surrounded the scope of services issue. Similarly, these disclosure requirements will enable the Commission to monitor the nature and extent of services performed by independent accountants and will assist us in developing an empirical base from which to determine any need for further action in this area.

The second facet of the Commission's consideration of the scope of services issue is reflected in ASR 264. The impetus for this release was the Commission's judgment that the awareness of registrants and their auditors to the concerns surrounding the performance of management advisory services needed to be heightened. The profession, through the Public Oversight Board, had studied the question of scope of services by CPA firms and issued a report in March 1979. Dissatisfied with the lack of more specific guidance in that report, the Commission presented its own views in ASR 264 to detail the factors which the Commission believes that management, the audit committee and the accountant should consider in determining whether a proposed engagement should be offered or accepted and invited public comments.

ASRS 250 and 264 together provide an appropriate framework within which the parties who are primarily concerned with the independence which characterizes the audit relationship may determine the scope of services appropriate in the circumstances. In developing ASR 264, the Commission consciously determined not to prohibit particular types of MAS engagements. Accountants, and not the Commission, must serve as the front line guardians of their professional independence, as their own ethics literature recognizes.

Similarly, corporate boards, and not the Commission, should have primary responsibility for the credibility of issuer financial reporting. ASR 264 seeks to guide the auditor and the issuer's board in discharging these responsibilities.

The reaction by the accounting profession to the issuance of ASR 264 has been, to put it mildly, negative. Indeed, the AICPA letter of comment to the Commission, voicing strong opposition to the release, stated that "unwarranted curtailment of nonaudit services is likely to be substantially realized simply by its issuance." While the accounting profession has not "called the SEC's bluff" as implied in a recent magazine article -- if for no other reason than that the Commission is not bluffing -- some concerns have been raised which deserve response and clarification. I would like to respond today to several recurring comments on ASR 264.

First, the Commission in ASR 264 did not seek to deprecate the benefits which may accrue from certain MAS activities. Clearly, the benefits in many cases can be significant. For instance, in view of the accounting provisions of the Foreign Corrupt Practices Act, services performed by independent auditors in assisting their clients in the review of internal accounting control systems should be very helpful to registrants. The Commission, in ASR 264, also recognized that the knowledge gained from such services often is beneficial to the performance of the audit. With that in mind, we encouraged a careful assessment of both the benefits to the registrant and the potential impairment of independence which may accrue from the engagement of a company's

own certifying accountants for internal accounting control reviews. I would expect that in most cases, after considering these factors, auditors would continue to be engaged to perform reviews of internal accounting controls.

A second issue which has arisen respecting ASR 264 concerns its relationship to ASR 250. Although we will monitor the disclosures as to the nature and extent of the particular services rendered, it never was the intention of the Commission to suggest in ASR 264 that it would question the independence of a company's auditor after the fact based solely on the percentage relationships disclosed pursuant to ASR 250. Rather, the purpose of this monitoring activity is to assist us in developing an empirical base from which to determine the need for further action in this area. Any further action would, however, be prospective.

Third, commentators have raised questions with respect to the so-called "global test" relating to aggregate revenues generated from MAS and the relationship of those revenues to total firm revenues. Some firms -- particularly smaller firms -- appear to be concerned that the Commission may have stigmatized firms that derive a significant portion of their revenue from, for example, tax work and "accounting and review services." This was not the Commission's intention. While ASR 264 uses "nonaudit" and MAS somewhat interchangeably, the Commission recognizes that the terms are different and that MAS encompasses a narrower range of services. In the context of services performed on a firmwide basis, the Commission's

principal concerns relate to the magnitude of MAS activities and the potential impact on the quality of audits.

Another point raised by commentators relates to the fact that the global test focuses on the firm as a whole and transcends factors affecting individual engagements. Many in the profession, on the other hand, believe that independence should be evaluated in terms of individual engagements only, and that independence judgments should not be colored by the magnitude of the auditor's overall MAS work. While I agree that independence is primarily dependent on the nature of the accountant's relationship with individual audit clients, I disagree with the notion that the profession may disregard the magnitude of MAS activities on a firm-wide basis. I believe that an undue emphasis on MAS could ultimately translate into an effect on the quality of audit work performed. Similarly, I am concerned about the apparent tendency of some accounting firms -- particularly larger firms -- to compete on the basis of total revenues generated and the array of MAS services offered. Like a conglomerate facing the prospect of only modest, and perhaps even nominal, growth in its primary lines of business -- audit, accounting and review services and tax work -- some firms have expanded their MAS activities into areas with greater growth potential. Under this policy, a dollar of revenue is equally valued, regardless of its source. The ultimate result of such a philosophy could be a subtle shift in emphasis -- perhaps real, perhaps apparent -- away from the auditor's primary function. It is this eventuality, and the possible consequent effect on audit

quality or on user confidence in the reliability of the auditor's report and the credibility of financial reporting -- the profession's reason for being -- that the Commission was attempting to warn against in ASR 264.

Before I leave the issue of management advisory services, I want to mention that I am somewhat disappointed by the tone and focus of the profession's response to ASR 264. While I appreciate the profession's concerns, there is significant public interest and concern surrounding this issue. This interest was most recently evidenced at the public hearings on the accounting profession conducted by Senator Eagleton in early August of 1979, as well as by the continuing controversy within the profession. Instead of attempting to explain away the concerns expressed with respect to the scope of services issue, the accounting profession should assume the initiative by focusing their efforts on meaningful action to reduce the underlying reasons for these concerns.

The Commission has not ended its examination of the scope of services issue. Rather, we view the issuance of ASRs 250 and 264 as part of a continuing examination of the relationships between registrants and their independent accountants. The Commission's staff will continue to review and evaluate ASR 250 disclosures. Over time, these disclosures will generate the data necessary to identify trends in the scope of services provided by independent auditors. ASR 264 is, of course, not a Commission rule -- rather, it is a statement of views. After reviewing future proxy disclosures, the Commission may revisit this area and we encourage comments,

particularly from the corporate community, on the factors set forth in ASR 264, and, particularly, on their application to specific decisions.

#### Standard-Setting

The final broad area I want to examine is the setting of accounting standards. The need for timely and meaningful standards established within an effective and adaptive framework has never been clearer. In this regard, a shift toward increased reporting of soft data, while retaining historical cost data in the primary financial statements, has already begun. It may 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.

The Financial Accounting Standards Board appears willing to meet the challenge of setting meaningful accounting standards in a changing economic environment. Indeed, as we have reported to Congress, the FASB has made important strides in addressing some of the most fundamental issues inherent in the standard-setting process. Nonetheless, if the FASB is to be successful, it must continue to exercise positive 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.

The FASB has made progress on its long-awaited and critically important development of a conceptual framework. It would, however, be difficult to overstate the importance of the FASB aggressively pursuing this project. While the completion of this project will not provide answers to all difficult accounting and financial reporting problems, it will provide direction for solving such problems in a timely, effective and consistent manner.

The Board's first concept statement -- Statement of Financial Accounting Concepts No. 1, "Objectives of Financial Reporting by Business Enterprises" -- establishes the objectives of general purpose external financial reporting by business enterprises. In my view, a major element of the conceptual framework should be to rethink the objectives of the primary financial statements -- and, therefore, to rethink what type of information should be included and what information should be presented outside the financial statements. Ideally, the most relevant information would be a projection of cash flows for future periods. However, such information may be highly uncertain and surrogates may have to be used. The 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. The current exposure draft of the FASB on qualitative characteristics addresses this issue. In my view, the factors involved in the tradeoff between reliability and relevance are the key to developing guidelines for the type of information that should be included in financial statements. It seems to me that a further clarification of

this issue is necessary before display issues, such as the reporting of earnings, can finally be resolved. 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.

It might be useful to look at a practical example of a problem currently facing the profession which a comprehensive conceptual framework should help to resolve. One clear application is apparent in the Board's current reconsideration of its Statement No. 8 on accounting for foreign currency translation -- an issue which the FASB Chairman has characterized as the most complex and difficult problem the FASB has faced. It appears that many of the issues the FASB is dealing with relate to basic conceptual questions. For example, the question of the appropriate disposition of translation adjustments has proven particularly troublesome. This question directly relates to the objectives of financial statements -- that is, once one determines the objectives of an income statement, one can more appropriately determine whether certain items, such as translation adjustments, should be included.

Another area where the benefits of a completed conceptual framework project can be clearly seen is in the determination of the appropriate accounting and disclosure standards for oil and gas producing activities. While reserve recognition accounting has been the subject of much criticism, it has the potential to provide

significantly more useful information to present and potential investors, creditors, and other users in making rational investment, credit, and similar decisions -- an important objective of financial reporting. Major standard-setting initiatives like RRA should be handled by the private sector, and the existence of a conceptual framework would help to assure that this is the case. Certainly, the Commission would benefit from the existence of a conceptual framework as it evaluates RRA. As a matter of fact, if the FASB has not made sufficient progress in this area, the Commission may have to deal with related issues on its own, as they impact RRA.

I would now like to turn briefly to the FASB's new standard on accounting for the effects of changing prices -- Statement No. 33, "Financial Reporting and Changing Prices." This statement represents a significant breakthrough in the private sector standard-setting process. However, I think we would all agree that it will not be the final resolution to the difficult question of providing useful information on the effects of changing prices on business entities.

Ultimate success in achieving this goal -- measured in part by changes in public perception of the adequacy of corporate profits and in tax policy -- will depend, in large part, on the efforts of the accounting profession and the business community in applying the standard, and evaluating and providing additional disclosures which may help users assess the impact of changing prices on particular entities and industries. With respect thereto,

the new standard should be viewed as a requirement for the minimum information to be presented to investors -- an area where the corporate community must make a positive contribution to the standard-setting process by volunteering additional information necessary to make the reporting most useful and meaningful in the particular corporate circumstances.

For example, a meaningful "management's discussion and analysis" approach is the appropriate vehicle for explaining the required information on changing prices. The additional explanation should focus on translating what some believe to be potentially confusing information into a meaningful discussion of the effects of changing prices on a particular business or segments of a business. In some cases, a company may determine that a display of data in addition to what is required by the FASB may make the overall presentation more meaningful to users. In these circumstances, companies should not focus their discussion on explanations as to why the information required by the FASB may not be entirely appropriate for them. Rather, they should take advantage of this opportunity to present the additional quantitative and qualitative information that they believe will be useful to investors in evaluating their companies. This will not only add to the usefulness of financial reports but should contribute to the evolution of standards for presenting this data.

The FASB recognized that the measurement and use of information on changing prices will require a substantial learning process on the part of all concerned. In view of the importance

of clear explanations to users of financial reports of the significance of the information called for by Statement No. 33, the Board organized an advisory group to develop illustrative disclosures that might be appropriate as a guide to preparers in particular industries. While the illustrative disclosures recently published by that group are useful, they will not obviate the need for each company to determine the most appropriate disclosures in its own particular circumstances, including those additional disclosures that a meaningful presentation will entail.

Criticism has, of course, been directed at Statement No. 33 -- criticism with which I am not unfamiliar in view of our replacement cost requirements in Accounting Series Release No. 190. As you know, the Commission believes that information on the effects of changing prices should not be limited to historical cost data adjusted for general inflation -- that any meaningful approach must encompass specific price changes. While the application of macro-economic data -- such as general price level -- is of some value, it does not serve adequately the micro-economic objective of assessing the impact of inflation and changing prices on the individual firm. The Commission has held this position despite the sometimes vocal criticism directed toward ASR 190. I believe the refinement of the replacement cost approach, as set forth in Statement No. 33, will further increase the utility and the use of this data and that the eventual results of the FASB's initiative in this area will be worthwhile.

In this connection, I read with interest the recent survey of financial analysts attitudes toward ASR 190 conducted by SRI International as part of a research project on inflation accounting financed by the National Science Foundation. The results of this survey, while not overwhelming, do indicate that ASR 190 information is not "useless" as argued by some. The researchers conclude that ASR 190 data has been used more widely than generally acknowledged, and that continued reporting of such data and increasing familiarity would be expected to add to its importance.

The 1980s will see the development of a conceptual framework for addressing emerging accounting problems. However, it is important to note that in view of our changing economic environment, such a conceptual framework will require continuing review. This period will see the continuing development of a mechanism for providing public shareholders with useful information on the effects of changing prices on business entities. Finally, I believe that the 1980s will see increasing pressure from investors and other users of financial reports for more useful information -- including more value-oriented data -- to assist them in making investment, credit and similar decisions.

#### Conclusion

I am pleased to note that most of the initiatives which I have mentioned today are from the profession, rather than the Commission. Nonetheless, the Commission's statutory responsibility for the integrity of the financial information disseminated by public companies requires our continuing concern with the accounting

accounting principles by which that information is reported, the auditing standards by which it is reviewed, and the independence and competency of the profession which performs that review. My own preference is, however, to emphasize the role of non-governmental bodies in resolving accounting and auditing issues. It is, therefore, incumbent upon the profession to face squarely and timely the difficult issues confronting it.

We are in a period of dramatic evolution within the accounting profession, and the profession deserves congratulations for the strides it has made. At the same time, however, accountants must recognize the importance of insuring that the momentum continues. The structures designed during the 1970s must stand the test of the 1980s.

I am hopeful your efforts will be successful.