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ACCOUNTING AND AUDITING PRACTICES AND PROCEDURES

HEARINGS

BEFORE THE

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REPORTS, ACCOUNTING AND MANAGEMENT

OF THE

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Statement of

Dr. Robert Chatov, Associate Professor of Environmental Analysis and Policy, School of Management, State University of New York at Buffalo

before the

Subcommittee on Reports, Accounting and Management

of the

Committee on Governmental Affairs, United States Senate

April 19, 1977

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My previous research in the matters before the Senate Subcommittee today are related to my interest in the formation and implementation of public policy. I am particularly interested in questions involving government regulation of the private sector, and public regulation by self-regulating, private sector groups. Both of these phenomena are evident in the Securities and Exchange Commission (SEC)-accountant relationship; those patterns, plus an interest in industrial concentration, mergers and anti-trust law and activity led me to investigate the background and operations of these groups, the results of which were published in my book Corporate Financial Reporting: Public or Private Control? in 1975, to which the staff report referred in several places as its authority for certain observations about SEC-accountant interaction.[1] I am interested in the uses of accounting, in the public policy impact of accounting information, and in the operations of the accounting profession as an example of professional group dynamics. My professional training and experience includes a J.D. in law (Wayne State University), a Ph.D. in Business Administration (University of California, Berkeley) and an M.A. in Economic History (Northwestern University). I am presently

an Associate Professor of Environmental Analysis and Policy at the School of Management, State University of New York at Buffalo. I was previously employed with Ford Motor Company for seventeen years in various management and analytical capacities involving product, marketing and financial activities. My normative orientation is toward maintenance and improvement of the free enterprise system and with making more efficient the flow of information upon which investors and the government of a highly complex, industrialized society must depend.

I. The Importance of the Subcommittee's Staff Study The Accounting Establishment

The Subcommittee's Staff Study, The Accounting Establishment is a significant step in analyzing the development of corporate financial standards and the accounting and auditing process in the United States. The importance of these hearings in considering these matters is difficult to overestimate. For the first time in nearly forty-five years, the purposes behind corporate financial reporting are being carefully examined, as is the system which controls and implements the development of financial standards. The research presented by the Subcommitte Staff carries forward, tests and validates some of my previous work; some of the study's recommendations are compatible with steps I have urged, particularly the removal of financial standards setting authority from the existing, selected groups that now control them, and, a cessation of the practice of offering management consulting and advisory services by "independent" public accounting firms. I am pleased to have the opportunity of commenting upon the Staff Study.

The subcommittee Staff Study has generated great opposition from the organizations controlling corporate financial reporting standards setting and implementation. And no wonder, considering the Study's conclusions and recommendations. The Staff Study is too extensive to permit commenting upon all its aspects, but a glance at some of the conclusions and recommendations fairly well reveals the Study's direction.

Some Subcommittee Staff Study Conclusions

1. Substantial influence of the "Big Eight" accounting firms through the American Institute of Certified Public Accountants (AICPA) upon accounting practices approved by the federal government.
2. Combining management advisory services with auditing by all of the "Big Eight", which makes questionable the independence of the auditors from the interests of their clients.
3. "Big Eight" clientele encompassing 85% of the listed corporations on the New York and American Stock Exchanges.
4. Evolution of a system of flexible, alternative accounting methods by the accounting establishment permitting both the reporting of "drastically different financial results" and great auditing flexibility.
5. Domination of the politically active AICPA by the "Big Eight" firms. AICPA control of the three-tiered financial standards-setting organization composed of the Financial Accounting Foundation (FAF), the Financial Accounting Standards Board (FASB), and the Financial Accounting Standards Advisory Council (FASAC) by appointment of FAF trustees which appoint the FASB and FASAC members.
6. SEC delegation of its authority for setting financial standards to selected private sector organizations, maintaining close relations with the AICPA and the standards setting bodies.

7. FASB operations failing to develop meaningful treatment of specific business transactions and catering to the accounting prerogatives of various special business interests.
8. The compromised independence of accounting firms due to advocacy of client interests for fees, and testimony on behalf of corporate management before state and federal regulatory commissions, as well as the Congress.
9. Lost public confidence in auditing and accounting competence of the "Big Eight" firms because of major auditing problems of recent years, resulting in doubts about the reliability of information reported by corporations.

Some of the conclusions set out by the Staff Study may, one might argue, be subject to interpretation, but it is difficult for me to see how anyone could argue with a straight face about the accuracy of points 1-6. In any event, the Subcommittee's Staff Study has some rather direct recommendations to change the existing situation.

Some Subcommittee Staff Study Recommendations

1. Stronger Congressional oversight of accounting practices, Congressionally established comprehensive accounting objectives for federal government agencies and departments, encompassing uniformity, consistency, fairness, etc.
2. Amendment of the securities laws permitting damaged individuals to sue auditors for negligence, thus overturning the Hochfelder decision.
3. Congressional consideration of methods to increase competition among accounting firms for selection as independent auditors for major corporations.

4. Federal establishment of (1) financial accounting standards for publicly-owned corporations; (2) auditing standards for independent auditors; (3) strict standards of auditor's responsibilities and conduct, with enforcement and periodic inspection of auditors by the government.
5. Requiring special reports of the nation's fifteen largest accounting firms.
6. Government-established financial accounting standards in meetings open to the public; no government contracts with accounting firms combining management advisory services with accounting and auditing functions.
7. Elimination of discrimination in disciplinary proceedings against smaller auditing firms.
8. Freedom of the Cost Accounting Standards Board (CASB) from domination by industry and accounting firm representatives. Neither should federal employees serve on AICPA committees, to remain free from real, or the appearance of, conflicts of interest.

Summarized, and taken to their crucial points, what do the recommendations propose? They propose major changes in existing structural relations for and among the several groups presently performing major roles in the development and implementation of accounting rules and auditing standards. Federal standards and surveillance are to be applied to auditors and audits; auditing and accounting operations are to be divorced from management consulting activities to prevent conflicts of interest; a reduction is recommended in the dominance of the "Big Eight" accounting firms. Finally, a federal group is recommended as the new rulemaking authority, but the Study suggests that the SEC is so sufficiently compromised by past performance and present relations with the private sector that the rulemaking task should be passed to either a CASB-like group, or to the General Accounting Office.

The importance of these conclusions and recommendations may be readily appreciated when one considers the set of structural, interorganizational relationships that are touched, and may be upset, if the Staff Study's recommendations are adopted as national policy. It is clear that the Staff Study questions the fundamental relations of:

1. the Securities and Exchange Commission to the accounting profession;
2. the accounting profession with its clients, investors, the general public and the government at large;
3. the associaced organizations affiliated in the three tiered group (the FAF, FASB and FASAC) presently working on corporate financial reporting rules;
4. the SEC's interpretation of its responsibilities under the 1933 Securities Act and the 1934 Securities Exchange Commission Act.

Clearly, the implications of the Staff Study's recommendations are complex, many-faceted, and deeply affect existing interests. They are sure to produce partisan statements and positions, and encourage a good deal of emotional rhetoric and forecasts of doom if existing relationships are altered. Almost all major institutions in the present financial standards system would have some important losses if the Staff Study's recommendations are adopted. The SEC would lose stature, authority and probably

budget; "Big Eight" accounting firms would lose clients, influence and income; corporations would lose direct access to financial standards rulemaking and could no longer use alternative accounting conventions. Strenuous opposition is therefore to be expected from these parties in interest, but that does not mean that their arguments ought to be automatically discounted. Which brings up what I consider to be the crucial consideration in these Hearings -- under what circumstances is it advisable, from a public policy viewpoint, to abandon an existing system and move to a new one, with all of the attendant risks of change and uncertainty?

The issues are two: Is the present system seriously deficient, and if so, can it reform itself? For example, forbidding accounting firms to engage in management consulting would have no effect on the economy at large in terms of the availability of services because existing or new consulting firms would fill the gap; in fact, personnel shifts to new organizations would probably occur very quickly. All that would be affected would be the revenues of the accounting firms. But unless there was real conviction that consulting and accounting services created the circumstances for serious conflicts of interest, prohibiting the combination of those services within the same firm would not be a reasonable exercise of public policy, since it would frivolously reallocate resources from one organizational group to another without any public or economic benefit.

Similarly, one must answer whether the present system of accounting is deficient. The Subcommittee's Staff Study argues that it is, a conclusion I endorse for reasons which I will go into later. In answer to the next question, can the system reform itself?, I believe the answer is that it cannot, and that the good will and integrity of the individuals involved has nothing to do with it. I believe that it is in the nature of the present financial reporting standards setting system to continue to operate as it has done for the past forty years, and that the problem is simply characteristic of the faulty operation of the federal independent regulatory commissions as a group. The issue is therefore much broader than just the development of accounting and auditing rules by selected private sector institutions and accordingly, the solution to what should be done ought to be based on an understanding of regulatory commission network operations.

II. The Federal Regulatory Commissions

At the outset I want to indicate the outline of what I believe about regulatory commission networks and how that belief relates to the matter at hand and to the SEC. Based on my own research and on a review of the literature on regulatory commission behavior, my conclusion is that they permit the institutions associated with them, which were loosely organized into an interactive network before the creation of the commission, to achieve a consensus on the matters of most importance to the network. These include decisions on which roles the different institutions, including the commission itself, will take, allocation of facilities, functions, rewards, etc. For this reason, I prefer to designate collections of institutions that focus on regulatory commissions, as regulatory commission consensus networks, and I will be using that terminology today. Because I believe that regulatory commissions are conflict-avoiding creatures, especially when faced with only one or a few sets of regulatees, and that the commissions operate as the consensus network's staff, I am pessimistic that the SEC will ever perform the responsibilities assigned to it under the Securities Acts of 1933-34 to develop rules of corporate financial reporting compatible with the intention of those Acts.

This section provides the background against which the performance of the Securities and Exchange Commission can be measured in its execution of its legislative authorities and responsibilities to develop rules for corporate financial reporting standards.

Criticism of the federal regulatory commissions has become commonplace in the last years, yet their reform has been slow to develop. If the SEC's operations have been typical of regulatory commission behavior in general, then that fact supports the Staff Study's recommendations for significant structural changes in the existing financial standards development system. What are the predominant criticisms of the regulatory commissions, and how may their behavior be explained?

Criticisms of the Federal Regulatory Commissions

Consistent, bitter criticisms have been directed at the regulatory commissions. A frequent accusation is that they have failed what many believe to be their primary purpose: to protect the consumer interest. The reasons: (1) isolation from the three major branches of government; (2) the difficulty of making "experts of political appointees", (3) vulnerability to political pressure; and (4) tending to regard its regulatees as its constituency. Kohlmeier, a Pulitzer prize-winning Wall Street Journal reporter, observed that each commission pursued a separate course as an end in itself, without direct reference to the people, frequently conflicting with other commissions, protecting industry from the federal anti-trust laws, thus making vast economic sectors subject to monopoly and price fixing. [2]

The Federal Trade Commission (FTC) in 1969 was severely criticized by the Nader Report and by the American Bar Association, both of which found it concerned with trivia, generally inefficient, and thoroughly in need of complete overhaul. Radical revision was recommended by FTC Commissioner Elman in 1970 (The Wall Street Journal,

8-12-70). FTC Chief Engman recommended sweeping changes to the Commission mechanism in general, after the FTC had enjoyed a revival in the early 1970s.[4]

Executive studies of the commissions have been equally condemning. The first Hoover Commission under President Truman and the second Hoover Commission under President Eisenhower both concluded that inefficiency was characteristic in perhaps all commissions. The Landis Report commissioned by President Kennedy said that the commissions had deteriorated in quality throughout. The Ash Commission under President Nixon recommended sweeping changes in regulatory commission organization. Other commissions and studies with roughly similar conclusions may be cited throughout the presidential administrations beginning with Theodore Roosevelt.[5] Business publications have also joined the critical consensus (Business Week, 2-28-70; The Wall Street Journal, 10-9-74, 10-15-74, 10-25-74, 1-28-75).

A wide variety of literature dealing with regulatory commission behavior has split along whether the regulatory system networks favor public or private interests. Analyses of regulatory activities by political scientists reflect the public-private interest debate, with each perspective observing the cooperative arrangements, but disagreeing on the dynamic process producing it.[6] Economists, led by the institutionalists, generally approved regulatory efforts through the 1930s, but since the 1960s their tone has been highly critical of the economic costs of regulation stemming from the close relation of regulator and regulatee.[7]

Economists accent the financial service of regulatory commissions to the regulated groups and the resulting negative cost-price effect on consumers. The early operations of the Interstate Commerce Commission resulted in "social losses of long-haul customers from cartel stabilization ... approximately double the social gains of short-haul customers due to rate reduction", and the cost of bureaucratic machinery in the Federal Power Commission has been estimated to be well in excess of consumer savings as the rationality of the regulated group leads it to seek to control industry entry through political means.[8] Historians are major contributors to regulatory studies, and have devoted much recent effort to re-examining the influence of regulatees in the genesis of regulatory commissions.[9] Legal analysts have also studied and criticized regulation, focusing on the development of highly technical, tedious administrative procedure rules that work in favor of the regulatees.[10]

A few lengthy studies have been developed that attempt theoretical treatments of the regulatory process. Sleznick[11] examined the relation of the Tennessee Valley Authority to its constituency, noting that attempts of the regulatory group to coopt the regulatees resulted in significant cooptation of the regulators themselves; Bernstein[12] developed a formal theory of regulatory commission relations with their regulatees, and Chatov[13] applied some sociological interpretations to Securities Exchange Commission-accounting profession interaction in corporate financial reporting rule-making development.

These studies generally support the view that the new commissions enter established, structured networks, toward which they are unable, partly through design, to maintain an adversary position. The regulatory commissions become part of the existing networks, in which all institutions share a similar interest in the integrity and preservation of a common purpose. What most students of regulation have observed are these networks in operation, but there are major disagreements about what makes them work. In addition, several common errors add to the confusion. In some cases mistaken analyses result from the scholar's unconscious effort to demonstrate a political philosophy; in other cases, the mistaken initial assumptions about the purpose of the regulatory commission's formation leads to erroneous conclusions about their later life; in other studies the error has lain with inadequate identification of the interactive dynamics within the regulatory networks. These errors are all, to different degrees, characteristic of cooptation, conspiracy and public interest theories of regulatory commission behavior.

Regulatory Theories and Studies

The crux of disagreement on federal regulatory commission behavior is not whether they serve the regulatee's interest but how and why. Perspectives of commission behavior include cooptation through agency exhaustion,[14] conspiracy,[15] political-financial influence,[16] and, of course, the public interest notion that the commissions will maximize the public welfare.[17] Some elements of each have their place in understanding Commission behavior, but a general theory based on any or all of these would be in error, because each of the above perspectives undervalues the compelling drive of regulatory networks to form consensus arrangements.

Cooptation theories assume commission creation resulted from a reform movement; that the commission's proper but failed mission is active control over the regulatee, and the reason for failure was the regulatee's deliberate and successful strategy to first weaken the regulator and then to dragoon it into its influence. Perhaps the most innovative and well known cooptation theory is the Life Cycle Theory, published by Bernstein in 1955, a work which precipitated much of the re-examination of regulatory commission operations that was to follow. The theory posits a transition from birth, through youth and maturity to -- not death -- but old age and capture, which for the purposes of the theory amounts to about the same thing. The commission's birth occurs from a stressful situation when efforts to reconcile opposing interests results in passage of a vague statute. In the youth stage the aggressive, eager, but inexperienced, commission is in a hostile atmosphere where well organized opponents attack it and its enabling legislation. At the same time, public attention evaporates as does congressional support, thus isolating the commission. In maturity conflict fades and the commission becomes coopted as it adapts itself to its environment. In old age the lethargic

commission devotes itself to protecting the regulatee, and deteriorates further in its servility. I have analyzed this theory in detail elsewhere[18] and will here briefly note only that the theory's vague causal relationships limit its predictive qualities, but nevertheless, the theory has some appeal as a rough, general behavioral description combining several widely held notions about the commissions. One of these widely accepted concepts, that of conflict in the creation of the commission, and anticipation of its continuance in the commission's life, is particularly important to these hearings.

<u>Conflict and Commissions</u>

Conflict assumptions are fundamental to cooptation and public interest theories, postulating that the commission's purpose is to control the regulatee, and engage with them in a persistent conflict relation. The empirical justification for this concept is almost completely absent, however, and in addition, the psychological basis for effecting regulator-regulatee conflict is very unrealistic. Several cases contradict the conflict expectation model and show commissions were given important integrative roles by the regulatees in the existing networks almost as soon as created. The origin of some commissions featured an inter-industry battle rather than a struggle among opposing, varied interests. When the Federal Radio Commission was created in 1927, public versus private conflict were absent. An Attorney General's 1926 ruling denied the Secretary of Commerce the authority to designate radio frequencies, station power or broadcasting hours, promoted free entry, and created chaos in air wave use. The desperate industry demanded government controls, with the big ensuing conflict among broadcasters about the property inherent in wave lengths and the Radio Commission's powers.[19] Much of the social stress leading to Federal Trade Commission creation occurred within the business community. The 1911 Standard Oil (211 U.S. 1) and American Tobacco (211 U.S. 106) cases announced the rule of reason prohibiting unreasonable, rather than all, monopolies and restraints of trade, thereby creating great uncertainty in the business community about future prosecutions under the Sherman Act. From 1911 on, the idea of a trade commission gained momentum, supported by both Progressives and Republicans in 1912, and Wilson and the Democrats actively supported clarifying antitrust in 1914. The alliance to support the Trade Commission included businessmen, enemies of monopoly, and federal incorporation advocates who supported the trade commission concept: Congress apparently believed the Trade Commission would be strong enough to do an adequate regulatory job.[20] Thus the principal conflict was over the form of regulation rather than a struggle between forces pro or con.

The origin of some commissions was compatible with the public versus private interest model. Holdouts against federal regulation opposed formation of the National Mediation Board and its successor, the National Labor Relations Board. After the Pecora hearings into the 1929 crash, the Federal Trade Commission emerged with extensive

new powers under the Securities Act of 1933, although a very vocal segment of the investment industry opposed regulation. Immediately afterwards, the financial sector changed its tactics and fought for a special commission which would "understand" the industry's problems, and which, incidentally, would be more susceptible to their influence. This anticipation was rewarded. When the Securities and Exchange Commission replaced the Trade Commission in 1934 as administrator of the 1933 and 1934 Securities Acts, it had a stressful beginning due to tremendous industry opposition, but its first commissioners were mainly conservatives, and tried from the outset to conciliate their regulatees[21].

Maintaining Conflict

Several examples destroy the argument that conflict modes are characteristic of the commission's youth period or that conflict is maintained with their regulatees for any length of time. The Federal Radio Commission accepted the informal industry conferences existing under Hoover's Commerce Department which had used little discretionary authority and established rules acceptable to most radio senders. The Commissioners were timid rather than aggressive, and when the Radio Commission was abolished in 1934, its powers were transferred to the Federal Communications Commission "which continued to operate along familiar lines".[22]

The Federal Trade Commission's early years showed little aggressiveness. Within a few years it was grappling with problems of secondary concern, trivial matters, and lacked orderly planning.[23] Wilson chose inefficient or business oriented commissioners,[24] and within two years, the Trade Commission sponsored permissive regulation similar to that originally requested by business.[25]

Rather than conflict, the evidence shows almost instant cooperative responses of the commissions toward the regulatees in the network into which they have been thrust. The commissions have continually been accused of almost always advancing the interests of their networks over the interests of the public. For reformers who believe that the public interest should be the consumer interest, commission behavior has been exceedingly painful to observe. Federal regulatory experience since 1887 demonstrates the regulatee's interest almost always to have been paramount in importance to the public's, but the public interest is not defined for every eventuality, thus providing regulatory commissions with great latitude. Business interests might assume first importance: so could protection of a class of individuals other than consumers. Regulated industries have usually been given significant price latitude to insure adequate return on investment and to encourage adequate supply, frequently at the consumer's cost. Finally, regulatory pricing has also encouraged excessive capital equipment accumulation by making plant investment the most important component of the rate base determining total revenue allowed.[26] The conviction that the public

interest equals the consumer interest is difficult to defend. Regulatory behavior is comprehensible, however, in terms of consensus agreements within the regulatory networks, and it is equally clear that there is a consistent trend for the organizations in these networks to develop equilibrium positions.

I will now describe what I mean by consensus agreements, and regulatory commission consensus networks, as well as network equilibrium positions, and will show how these relate to each other. Subsequently, I will show how the SEC's financial standards-setting network provides an admirable example of typical regulatory commission behavior.

Regulatory Commission Consensus Networks

Throughout society there are groups of institutions that possess compatible interests in certain objects or outcomes, and manage to achieve acceptable understandings about them. I refer to these in general as consensus networks; specifically as regulatory commission consensus networks where regulatory commissions are involved. These are the distinguishing features of a consensus network.

(1) The compelling mode of interaction within the network is towards consensus; that is, towards mutual agreement on the allocation of resources, a sharing of attitudes, and an agreement on the distribution of roles, functions and prerogatives.

(2) Interim conflicts among the consensus network members will not be seriously disruptive in the long run, and will have the positive effect of affirming their interrelational commitments and common policy perspectives.

(3) The institutions within the network will be aware of their alliance.

The consensus network's interest in reaching agreement without disruptive internal divisions will tend to produce stable conditions within the network, resulting in its structural equilibrium, unless external pressures intervene. When a disruptive member enters the network, it will be "socialized" by the members of the existing system, who will try to reduce the newcomer's autonomy and will assign it a place within the network where it receives an acceptable share of the system's outputs. These dynamics are observable in several aspects of the federal government's efforts to regulate the private business sector through regulatory commissions.

Regulatory commission consensus networks revolve around the operations of the regulatory commission, and overlapping goals and identities are characteristic.[27] A regulatory commission consensus network includes the regulatory commission, regulatees encompassed by the enabling legislation creating the commission, and associated institutions affected by and interested in the regulatees' operations. Consumers and congressional oversight committees are important to network operations, but because they usually do not participate directly in decision making, are not part of the network, as a general rule.

The regulatory commissions themselves are curious combinations of political independence and dependence, and are susceptible to outside pressures. Commissioners are presidentially appointed, subject to senatorial approval, and are tenured in their office, subject only to

good behavior. The commission depends upon the executive branch for forwarding budget requests and for the congress to approve them, making the commissions politically sensitive to both. Regulatees may influence the commissions directly, or indirectly through their political representatives. Forced to follow the highly formalized legal requirements of the Administrative Procedures Act of 1946, and subject to review in the courts, the commission's powers are significantly constrained. The commissions are also typically dependent upon their regulatees for information, and given their great influence over areas of enormous economic value, they become subjected to great pressure from regulatees, running the gamut from direct hostile action to offers of lucrative positions to key commission personnel after their departure from the commission. To further compound the difficulties of taking vigorous action, specific directions are usually absent from regulatory enabling statutes, which provides the Commissions with a great deal of flexibility in choosing policies; this leaves commission direction to the commissioner's art and the moment's exigencies. Given the day to day contacts with the regulatees, the comparative freedom from external governmental direction, and the tendency to share employment pools with regulatees, the commissions are readily adaptable to being absorbed by their consensus network.

Regulatory Commissions and Equilibrium

Federal regulatory commissions integrate divergent groups by giving them a common point of focus: they restore and/or confirm existing networks, and thereby maintain an equilibrium situation among the members of their consensus network. Providing stability for the network is the commission's main function, based on the empirical evidence of their actual behavior; that is what they do best, which also explains why the interests and concerns of other areas, like consumers and the federal government, fare less well than they might.

Noting the equilibrium function of the regulatory commissions provides a good basis for distinguishing conspiracy from cooptation theories of regulatory commission behavior. Both groups recognize the regulator's furtherance of the regulatee's interests, but the conspiracy theorists believe the commissions were deliberately created to act as a shield for the regulatees, and usually point to the creation of the Interstate Commerce Commission, the Civil Aeronautics Bureau and the Federal Radio Commission/Federal Communications Commission as examples. Under both the conspiracy and the cooptation approaches, the end result of commission action is a favorable equilibrium position for the regulatees. The difference between the theories is whether the regulatees' dominance occurs before or after commission creation, but both theoretical roads lead in the same direction and neither is amenable to rigorous proof.

The impossibility of proving either conspiracy or cooptation theories prompts asking a rather different question about regulatory commission behavior: given the best of will and performance on the part of the public sector, and assuming that the regulatees exercized no pressure against the commission during its operations, would the commission's behavior nevertheless have taken the network

toward a consensus position that ended in an equilibrium state for the network's members? I believe that the answer is yes; that for several reasons, the regulatory commissions are designed so that they can produce nothing else -- that is, that it is impossible for them to foster a perpetual adversary relationship with the other members of its consensus network. If I am correct in this opinion, it indicates that there is little chance that, specifically, the Securities and Exchange Commission will ever foster development of an accounting system significantly different from the one it has already endorsed.

I believe that regardless of creation circumstances or regulatee blandishments the regulatory commissions will create consensus positions and equilibrium situations relating to industrial and social developments and psychological factors.

<u>The Trend Toward Equilibrium</u>

The special role of regulatory commissions is to minimize system disturbances and maintain equilibrium. With increasing social specialization and greater interdependence, society's vulnerability increases if one of its parts is disrupted.[28] Increasing U.S. specialization impelled protection of its critical units, which offers a rational background for commission development and protective behavior. By defusing stressful situations, commissions may appear to become coopted, but their performance is a natural consequence of their mission and structure centering around their stabilization role within consensus networks. Commissions restore equilibrium to a system by diverting stress from the protected object to itself, so that social equilibrium will be very similar before and after commission creation. As witness, under the Interstate Commerce Commission, rail profits and consumer costs after ICC creation were similar to or higher than before; under the Federal Radio Commission/Federal Communications Commission, network distribution among the producers stabilized at before commission creation levels; under the Securities and Exchange Commission, authority for development of financial reporting conventions was relocated in the private financial sector; under the Civil Aeronautics Board, air rates and route were stabilized and involved the same carriers as before CAB creation.

Commissions as Consensus Network Staffs

Formation in centralized corporations of staffs that coordinate, plan, and control reflects both complexity of functions and rationality of objectives and directions. When consensus networks have a component unit that also coordinates, plans and controls, elements of direction and rationality of purpose can also be assumed. Coordinating agencies feature interdependence, awareness, and standardization, and the role of the commissions as coordinating operations has been noted by organization theorists.[29] The commissions have many of the characteristics of other staff organizations in various areas. For example, trade associations which govern many interrelationships and communications between firms within an industry can be considered staffs, becoming conduits of the exchange of certain price, production, and product information. Commission behavior that shows it to be operating as its

network's staff are characterized by contact with all the important network components; formal meetings and agendas; issuances of expressions of mutual concern and interest; staff action that consistently, but not always, affirms the consensus of the other network members; and direct or indirecc recognition by the members of the consensus network of the staff's importance to the network. The commissions function as the staff coordination group, for the network, and therein lies much of the network's resilience, with commissions even recommending to congress the form of legislation needed to permit the consensus network to adapt to a changing environment, probably a major factor contributing to the longevity of its consensus network.

Conflict Within Regulatory Commission Consensus Networks

The assumption of some of the early proponents of the regulatory commission system was that the expertise of its commissioners would place them in a position whereby they would aggressively champion the public interest and engage in continual adversary relations with their regulatees. However one concludes on commissioner expertise, there is little doubt that commission-regulatee adversary relations have been more benign than hostile. Several psychological and institutional factors help produce this result.

It is difficult for individuals to persist in never-ending battle with their frequent contacts. For most individuals, continually hostile encounters produce depression and the desire to avoid more contact. But in the consensus network, contact between regulator and regulatee cannot be avoided. The resulting familiarity is more likely to breed sympathy for the other's views and problems, and continual interchange under network circumstances tends to develop similar perspectives among the people involved. Much regulatory consensus network operation is based on personal contacts, understandings, as well as on formalized documents and procedures. And where regulation reduces conflict items to written forms, it produces more distortion and less chance of producing useful conflict, compared to the direct combat of the oral argument, long a tradition to the western world, and still central to the adversary procedure in the law,[30] as compared to administrative procedure.

Consensus networks operate placidly; they cannot tolerate aggression that prevents ultimate agreement; they harmonize, smooth differences, and thus tend to discourage the discussion and criticism necessary for a clear view of reality. Bureaucratic, consensus type personalities thrive in such circumstances in both the public and private sector organizations involved, and the compromise that is fostered can be unfortunate because some aggression and hostility is necessary for the development of adversary procedures which can adequately thrash out complex, controversial issues. A regulatory commissioner's interest is to keep network battles from going to external theatres, and will "try exhaustingly to find a conflict-avoiding compromise ...", a process that will be accented as the commission staff attempts to keep issues from going to the commissioners.[31] The guiding principle of the consensus network is to achieve harmony and agreement, and accordingly, the leaders

of institutions belonging to consensus networks are to be expected to be consensus leaders -- that is, personalities who foster compromise and agreement at the cost of reform and setting new directions.[32] Within the regulatory commissioners networks, consensus personality commissions are assured by the Presidential practice of informally first attempting to clear a proposed commissioner with the regulatees to secure their advance agreement, before submitting the name to the senate.

The resulting sameness of attitude between commissioners and regulatees may result in the commissioners becoming out of touch with external environment, even when under great pressure from it, thus delaying or omitting necessary responses, as for example, the SEC's failure to retrieve its financial standards development function from the Accounting Principles Board when the latter's failure over the business combination accounting issue became common knowledge in the latter half of the 1960s.

To summarize this section, the following points can be made about the general performance of the regulatory commissions. Criticism and disillusionment with the regulatory commission form of government has become commonplace, as has the observation that the end result of their operations is to favor the interests of their regulatees as the commissions develop common interests with them. Regardless of the observations which can be made of the aggressiveness and willingness of the commissions to engage in vigorous adversary relations with their regulatees at the outset of the commission's existence, the general critical observation is to note that meaningful conflict seems rare between regulator and regulatees. However, conflict is unreasonable to expect, given the compelling drive for the commission to become part of the network into which it is thrust. Instead of engaging in conflict, the regulatory commission consensus network which focuses upon it, shares the attitudes of the other prominent members, develops common policy perspectives and seeks to produce stable, equilibrium conditions within its network. Several factors account for the regulatory impulse toward producing stable, non-disruptive network relations; conflict cannot be maintained perpetually because of the psychological difficulties implicit in such a state; close relations with regulatees foster common perspectives and understandings; commissioner selection process and interchange of personnel between commission and regulatees guarantee sympathetic relations; administrative processes through written mediums make disputes less volatile and produce a sense of unreality; within the regulatory consensus network, bureaucratic "consensus" personalities thrive in public and private sector organizations alike, and conflict avoidance becomes the operational mode.

Question: does the Securities and Exchange Commission fall into the regulatory mould described above?

III. The Securities and Exchange Commission and its Administration of Corporate Financial Standards Rulemaking

The Securities and Exchange Commission has long had the reputation of being among the best, if not the best, of the federal regulatory commissions. This section examines the performance of the SEC in relation to the administration of its responsibilities for the development of corporate financial reporting standards, and, its attitude toward supervising the accounting profession. The question to be answered is clear: has the SEC behaved differently from the way in which the regulatory commissions in general have performed. If SEC performance has been typical of regulatory commission behavior in general, and I must indicate at this point that I believe it has, then the Subcommittee's Staff Study recommendation for transfer of financial standards setting authority to another government area becomes supportable.

The Staff Study recommends restoration to the federal government of the authority and responsibility for corporate financial reporting rulemaking as designated to it under the laws of 1933 and 1934. This recommendation unfortunately has been mischaracterized as a federal "take over" of authority from the private sector, which simply distorts the true state of affairs. Analyzed in terms of the manner in which the SEC relinquished, probably improperly, certainly inadvisably, its authorities over corporate financial reporting rulemaking at an astonishingly early period in its history, the crucial staff recommendation is more properly interpreted as a return to the basic intention of the Securities Acts. In the following pages I will document the details of this transfer of authority, and will identify some of its negative consequences for public policy.

Table 1

Patterns of Control over Corporate Financial Reporting Rulemaking Authority

Corporate financial reporting rulemaking authority has vested in various institutional areas over the past 90 years. Traced from 1887, an admittedly arbitrary date based on the formation of the first U.S. national accounting society, control has followed this pattern:

A. Private Sector Control: Pre June, 1933

1. 1887 to June, 1933:	Financial-industrial system control, dominated by the corporate sector.

B. Public Sector Control: June 1933 to December, 1936

2. June, 1933-Oct. 1934: (17 months)	Federal Trade Commission administration of the Securities Act of 1933 through the newly formed Registration Division headed by James M. Landis.
3. October 1934-December 1936 (27 months)	Securities and Exchange Commission administration of corporate financial reporting rules.

C. Private Sector Control January, 1937 to the present

4. 1937-1959	Primarily accountant controlled through the Committee on Accounting Procedure (CAP), a committee of the American Institute of Accountants, later renamed the American Institute of Certified Public Accountants (AICPA).
5. 1959-1972	Primarily accountant controlled plus some corporate representation, through the Accounting Principles Board, governed through the AICPA.
6. 1973 to Present	Sharing of control by the AICPA and the Corporate sector, through the three tiered organization composed of the AICPA controlled Financial Accounting Foundation (FAF), its dependent Financial Accounting Standards Board (FASB), and its subsidiary advisory groups designated as the Financial Accounting Standards Advisory Council (FASAC).

With respect to its responsibilities to develop rules for corporate financial reporting, has the SEC avoided conflict, acted as the staff of its network institutions, and sought to achieve consensus positions, or did it move with vigor to accomplish its charge?

As indicated in Table 1, above, the SEC relinquished its control over the development of corporate financial rulemaking standards within only twenty-seven months of its initial operations in October, 1934. By December, 1936, the SEC had declared its intention to permit the accountants of the American Institute of Accountants (AIA) (later the American Institute of Certified Public Accountants (AICPA) to develop corporate financial reporting rules, and also, to permit the AIA to handle cases of ethics violations by its members.

Several other questionable episodes in the saga of the SEC are equally notable: namely, failure to develop any other fundamental approaches to financial standards than disclosure for investors, failure to take action during the worst excesses of the business combinations abuses of the conglomerate merger movement, and failure to take over from the Accounting Principles Board after its operational paralysis in the early 1970s. I will mention each of these incidents briefly to illustrate the consistency with which the SEC avoided setting financial standards during almost all of its history. The complete information is entertainingly detailed in my book.

The SEC's Transfer of Financial Standards Rule Making Authority to The American Institute of Accountants

Sections 19A and 19B of the 1933 Securities Act gave the Federal

Trade Commission ample authorities and subpoena powers to set financial standards for corporations. These were reaffirmed in the 1934 Act under Sections 13(a) and (b).[33] The authorities were dramatic compared to the hands-off attitude of the 1920s, and attest to public disillusionment about financial sector misdoings in the period leading to the 1929 crash,[34] as well as to periodic manic speculations in the capital markets. The approximately one year period between the two Acts saw the build-up of the most concentrated financial sector assault ever witnessed on the federal government, focused on the '33 Act's Section 11 which had replaced the obligation of signers of prospectuses and financial statements from the common law's reasonable-man standard to that of fiduciaries, giving plaintiffs the right of recission.[35] The '34 Act returned Section 11 liability to the common law standard, gave the financial sector its own regulatory commission, but confirmed the federal government's authority over corporate financial reporting.

The SEC's relinquishment of that authority to the accountants of the AIA proceeded in two steps -- (1) a decision to pursue a vague idea of disclosure, the desirable dimensions of which are still under consideration by the SEC, rather than to affirmatively decide on the objectives and methods of financial reports, and (2) a decision to have the AIA develop "accounting principles".

- <u>The SEC's disclosure decision</u>

The decision to pursue disclosure as the fundamental objective of

the SEC's operations was not inevitable; the SEC could have chosen to design a system of accounting based on some comprehensive ideas of what accounting information was needed and how it ought to be presented. Yet the chance to develop such a system was avoided in early 1935 in the Northern States Power Company decision when by a 3-2 vote the commission permitted an accounting treatment of which they all disapproved, on the grounds that it had been disclosed in a footnote. This placed the SEC in a permanently disadvantaged position since it established the footnote disclosure precedent and relieved the SEC of the necessity of developing affirmative financial reporting requirements.[36]

- <u>Transferring Financial Rulemaking Authority</u>

The SEC from its inception underwent a continuing barrage from the private sector: accountants' uncooperativeness caused Chief Commissioner Landis in 1936 to publicly accuse the profession of "loyalties to management ... stronger than their responsibilities to the investors". In the ensuing exchange of protests and explanations, for some reason, probably a combination of exhaustion, frustration, and the prospect of leaving for the Deanship of the Harvard Law School, Landis authorized SEC Chief Accountant Carman Blough to agree that the SEC would refer to the AIA all accounting questions before the SEC with which the SEC took issue where accountants had signed the statements, as well as all ethics violations cases. The first set of accounting questions went from the SEC to the AIA in January, 1937, thereby dramatically reducing AIA anxiety levels. At the AIA's annual meeting in fall, 1937, Blough announced as official policy that the SEC would not create comprehensive accounting principles, and would look to the accountants to do so. The SEC's ASR No. 4 in 1938 put the policy in writing. It all made accounting leader R. H. Montgomery very happy, and at the 50th AIA anniversary in 1937 spurred him to include in his presidential address the comment, "We have survived the Securities and Exchange Commission, which has done a good job."[37]

The SEC's Failure to Retrieve its Rulemaking Authority

There are two striking features to the SEC's failure to attempt to retrieve its rulemaking authority: the way it tolerated successive ad hoc attempts by selected private sector institutions to develop accounting principles, and, its failure to take decisive action to resolve the Accounting Principle Board's stalemate on accounting for business combinations during the worst excesses of the conglomerate merger movement in the latter 1960s.

- The ad hoc development of accounting principles: The CAP and the APB

The AIA's Committee on Accounting Procedure (CAP) was reconstituted to develop accounting principles in 1938 with one full time research assistant, one part time research director (anti-academic Harvard Professor T. H. Sanders) and a committee of 22, spread around the nation, of whom 2/3 had to approve a rule before it was released, even though the rule was to have the only AIA's moral authority, that is, members were not to have to follow the rule.[38] The CAP, to use Carman Blough's description, adopted the "put out the brush fires" approach,

which lasted for twenty years until criticism from within the accounting profession and the financial sector -- not from the SEC -- caused its abandonment in 1959 for the Accounting Principles Board (APB). To be sure, the CAP had some accomplishments -- it put out 51 Accounting Research Bulletins (ARBs) with No. 43 a restatement of the first 42, and some standardization was accomplished, but alternative accounting conventions characteristically were approved, and enough ambiguous language was included to permit exceptions. ARB No. 48 was a case in point. It specified pooling of the interests as an acceptable alternative for purchase accounting when businesses were to be combined (purchase accounting could be abused also and initially, pooling was thought by some to correct the situation). But the requirements for a pooling to be acceptable were loose and contained debilitating qualifiers and loopholes, making it hopeless as a standard, and it became the medium for some wild business combination accounting in the '60s, no doubt facilitating the conglomerate merger movement. In any event, the CAP failed, partly because of criticism from within the accounting profession, partly from outsiders, especially from the Controller's Institute (later called the Financial Executives Institute (FEI)), which felt it was having insufficient input into the ARBs. Throughout its operations, the CAP was characterized by its predominant orientation toward the accounting firms' clients, its antagonistic ideological attitude toward federal government regulation, its lack of recognition of the impact of accounting on the society at large, hostility toward

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the academic accountants, a continuing anti-intellectualism, and a dedicated opposition to uniform accounting.[39]

The successor organization, the Accounting Principles Board, (APB), was a magnification of the ills of the CAP.

Once again, the committee was too large and the staff too small. The Accounting Principles Board had eighteen members compared to the 22 members of the CAP it replaced. All APB members had to belong to the AICPA. Industry members who also belonged to the AICPA could be on the Board. Of the 12 practicing public accountants' positions on the APB board, six had to be from the "Big Eight" accounting firms. Three university professors, two financial executives, and a director of research made up the remainder, and up to 8 analysts could be employed. APB recommendations, like the CAP before it, were not to be binding on the Institute's members. Two early attempts at developing a comprehensive approach to accounting principles demonstrated the APB's inability to operate on anything but an ad hoc basis. Professor Maurice Moonitz of the University of California at Berkeley had been appointed the first permanent research director of the APB in July, 1960. The first APB research study was written by him and published the following year, devoted to a theoretical exposition of accounting including the environment of accounting, accounting itself and the postulates upon which a system of accounting should be built. The APB was taken aback by the document, because of its departure from the approach they had been trained and experienced to expect. In 1962, a third APB research

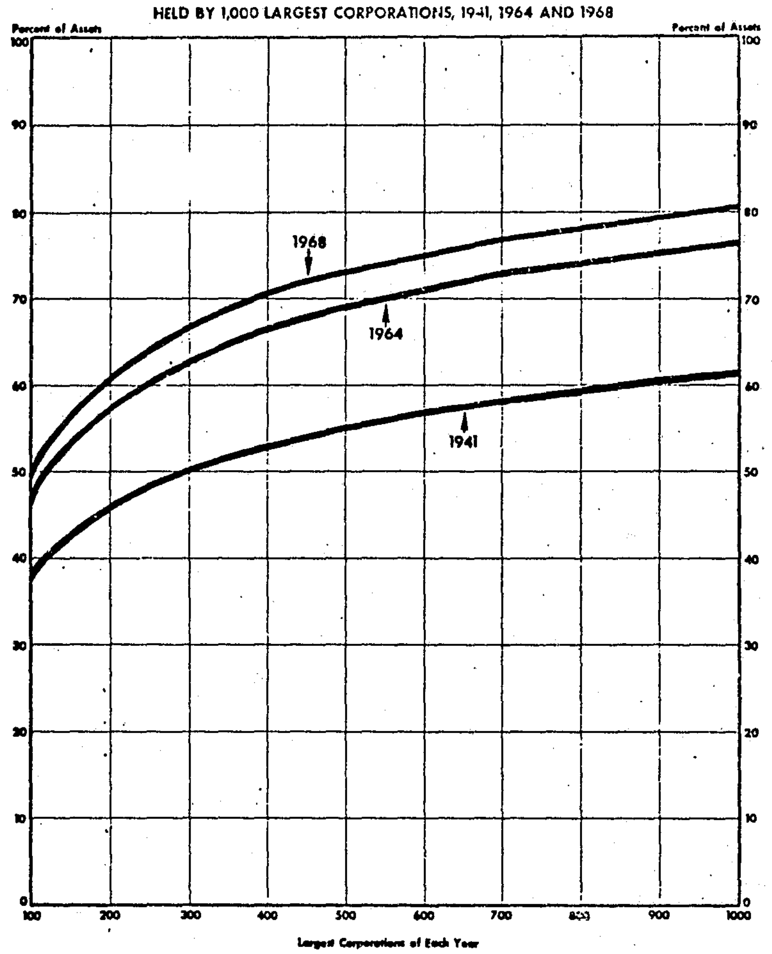
study co-authored by Moonitz and Professor Robert T. Sprouse, also at Berkeley, formulated principles compatible with the postulates of the first study. Some of the recommended principles were sharp departures from existing practice -- for example, reflecting merchandise and plant at current values and showing cash settlement receivables and payables at present (discounted) values. Nine comments were filed on the study and 8 of them were unsympathetic. Furthermore the Institute disclaimed the study as not representing official AICPA policy, a warning placed on the front cover and copyright page to that effect. Obviously, theoretically based research studies involving major reforms were not going to be accepted by the AICPA. So much for theory. The following year Professor Moonitz was replaced by Paul Grady, a retired Price Waterhouse partner, whose research study #7 was a consolidation of practice in the usual tradition of the AICPA; the familiar form of item by item research continued under Grady's successor, Reed Storey. The episode proved that the APB, like the CAP before it, was utterly incapable of approaching accounting and financial standards problems on anything but an ad hoc basis.[40]

• <u>The SEC, the Conglomerate Merger Movement and the Failure to Retrieve Rule Making Authority</u>

Near the end of the conglomerate merger movement of the 1960s, industrial concentration among manufacturing corporations, as shown in Table 2, increased to where the largest 100 corporations in the United States in 1968 controlled almost 50% of total assets, compared to 38%

Table 2

Figure 3-2
CUMULATIVE SHARE OF CORPORATE MANUFACTURING ASSETS
HELD BY 1,000 LARGEST CORPORATIONS, 1941, 1964 AND 1968



Source: Bureau of Economics, Federal Trade Commission.

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Table A-1.–Aggregate concentration, alternative levels, 1941, 1964, and 1968
(Percent of corporate manufacturing assets)

Largest	1941	1964	1968
100	38.4	46.8	49.4
200	46.2	57.2	61.1
300	50.2	62.9	67.3
400	53.0	66.6	71.1
500	55.3	69.3	73.8
600	57.0	71.4	75.9
700	58.4	73.1	77.5
800	59.6	74.5	78.8
900	60.7	75.6	79.9
1,000	61.6	76.6	80.8

in 1941 and 47% in 1964, and the largest 1000 corporations controlled about 81% of all corporate manufacturing assets, compared to 62% in 1941 and 77% in 1964.[41] During the concentration wave large firms became increasingly active as acquirers of other businesses; where the acquiring firms were industry giants, industry concentration was also likely to increase. Concentration of assets occurred **mainly in** the top 51 to 150 firms, with acquisitions concentrated most heavily in newer industries. Asset concentration definitively increased during the conglomerate merger movement, market concentration somewhat increased. Poor earnings performances were also common for most merger active firms, which failed to deliver their promise of growth through synergism and expert management. The economic efficiency of the conglomerate merger movement was absent, and the price in concentration was high.[42]

The conglomerate merger movement peaked in 1968-69, dropped off in 1970, and substantially was over in 1971. Thus the concentration statistics would have been more dramatic had they been updated for the year 1971. The conglomerate merger movement was not slowed by the anti-trust laws because it was felt that Section 7 of the Clayton Act had no force to prevent mergers solely because of asset size. Thus antitrust agencies took little or no action against pure asset mergers during the movement's progress.

The role that accounting conventions played during the merger movement is still debated, in spite of the fact that at the time the feeling of those involved in the stock market was that the merger active firms pursued combinations and used the pooling of interest technique with an eye towards instantaneous growth in earnings in order to create stock price increases. Because the pooling device usually reduced the outstanding shares of the combined firm while maintaining the earnings of both, earnings per share of the combined firm automatically increased above those of either of the two firms before combination. How many people were fooled, and under what circumstances, still remains a matter of argument and analysis, but it is clear that the pooling technique had the advantage of not providing the embarrassingly large goodwill account associated with the purchase accounting technique which reflected the amounts paid for a corporation in excess of its asset value. In essence, the pooling technique may have prompted mergers if for no reason other than permitting the acquirer to disguise the amount of money actually paid for the acquired company. After the merger movement was over, many of the previously most active merger oriented firms had to divest acquisitions to meet indebtedness. Pooling was not the only accounting device that was used during the conglomerate merger movement to produce illusory gains and earnings, but it was the controversy that raged about the use of pooling that resulted in the abandonment of the Accounting Principles Board.[43]

Two interesting factors stand out in the controversy over the pooling of interests method of accounting for business combinations: first was the inability of the APB to produce a standard which limited the use of the device, a step urged by Accounting Research Studies No. 5

and 10, promulgated by the AICPA in 1963 and 1968, respectively. The abuse of the pooling device had become known in the early 1960s, but in spite of mounting criticism, the Accounting Principles Board, torn from within and subjected to great external pressures, was incapable of acting on the issue, certainly the most important one of its existence.[44]

Even more striking was the inability of the Securities and Exchange Commission to prod itself from its spectator's role and to take charge. The SEC remained true to its role as a staff activity, content with issuing its ritualized threat to the effect that if the accounting profession didn't do something the SEC might have to. It was a signal the financial standards consensus network understood, which meant that the SEC had affirmed the distribution of authority. SEC Chairman Manuel F. Cohen's position in 1964 was typical when he said, "from its inception, the Commission has preferred cooperation with the profession to governmental action and has actively encouraged accountants to take the initiative in regulating their practices and in setting standards of conduct." The codification of the SEC's rules had, "been accomplished in the spirit of cooperation and voluntary action" with between the Commission and leading professional accountants. "To the extent that the profession has been willing to move ahead we have been content to remain logically in the background, filling the vacuum when necessary and stimulating study and development of accounting and auditing principles on a continuing basis".[45]

Later on, SEC Chairman Homer Budge, in an appearance before the Congressional Committee warned, once again, that if the profession didn't solve the pooling or purchase accounting problem soon the Commission itself might have to do so.[46]

The conglomerate merger movement and the failure of the APB and the SEC to do anything about its accounting abuses indicated clearly enough the limitation of the financial standards setting network in the early 70s. The fact that a new group, the FAF-FASB-FASAC, was formed with the SEC's blessing to take over where the APB had failed, demonstrated that control over the determination of accounting principles remained in the same hands, by and large, in the existing consensus network, setting up the presumption that financial standards development ("accounting principles" were out of vogue) would continue on the same basis. In the absence of any major structural changes actually differentiating the FASB from its predecessors, the CAP and the APB, my contention was that FASB performance would follow past network patterns, particularly because SEC behavior could be relied upon to continue its past performance.

A large part of the Securities and Exchange Commission's performance with respect to the development of accounting and financial standards has been ceremonial and there is no reason to believe that an alteration in this condition will occur. The SEC disclosure philosophy has not changed, neither has its determination to let selected private sector groups set financial standards, nor has the procedure

for its commissioner selections altered. Commissioners will continue to be acceptable to the network and be consensus personalities, and will continue to attempt to reconcile conflicting network interests. There is nothing to suggest that the SEC will ever take a vigorous, affirmative lead in the development of comprehensive, uniform financial standards, but is it possible that the FASB might do so, or at least, are they likely to improve significantly the present system for determining financial standards?

<u>The Prospects for the Financial Accounting Standards Board</u>

The differences of the FASB with its predecessor organizations the APB and the CAP are minor, particularly when the FASB is recognized as the creature of the same parties in interest previously backing the earlier groups. In fact, the AICPA-client relationship is even more pronounced this time, since some of the 3 seats of the seven man FAF are allocated to the corporate financial sector, three FASB seats are for other than the accounting practitioners, and of the original 27 member FASAC, 6 come from public accounting firms, 5 from corporations, 8 from the financial sector, 3 from academe, 2 from law firms, 2 from government, and 1 former SEC chief accountant.

The FASB still avoids developing a comprehensive accounting approach as well as uniform accounting principles, preferring the ad hocism long established. The FASB is still accused of largely avoiding the more controversial issues, although one rule, FASB rule #8 on translating foreign currency has earned them the anger of the corporate sector, and as the Subcommittee Staff Study points out, accounting alternatives still continue to be included in some of the FASB pronouncements. Although the SEC took a more vigorous approach during the administration of former chief accountant John C. Burton, the activism was essentially Burton's, rather than the Commissioners, and is not likely to have a lasting effect on the FASB. In summary, the substitution of the FASB for the APB has not altered the fundamental structure of the financial standards consensus network and it is therefore impossible, I believe, to expect that the future FASB performance will be substantially different than performance of it and its predecessors have been in the past.

IV. Conclusions and Recommendations

I have tried to demonstrate several points which need now to be summarized.

- That SEC participation in the development of corporate financial reporting standards primarily has been ceremonial and care-taker, rather than leading and innovative.
- That the SEC's financial standards rulemaking development operations are comprehensible as staff functions performed for its consensus network associates, and that there is no basis for believing that the SEC will alter its future behavior.
- That failure to retrieve its authority after the demise of the APB and its subsequent endorsement of the FASB should eliminate any illusions about the SEC ever taking a leadership role in developing comprehensive and uniform corporate financial standards rules.
- That there is little reason to expect that the FASB will follow any pattern of behavior other than the ones followed by its predecessor organizations, the CAP and APB.
- That the FASB will continue to develop corporate financial standards on an ad hoc basis, and without any focus on creating uniformity.

The output of the existing system will be comparable to its performance when the APB was in operation. Which reduces the issue to its essentials--does one like the output of the present system, or are the perceived deficiencies sufficient to demand a different product?

Because if what is desired is something other than what the present consensus network is doing, the only way to get it, in my opinion, is to make some major structural changes to the system. Tinkering won't do; neither will promised changes in attitude, however sincere, because the structural limitations of the existing network guarantee its repeat performance of established patterns. Two interrelated questions therefore remain:

(1) What other system output would be preferable?

(2) What structual changes to the system are most likely to produce those changes?

<u>What Other System Output Would Be Preferable? What Structural Changes Would Be Likely To Produce Those Changes?</u>

The Subcommittee Staff Study indicates several areas where different outputs of the financial standards rulemaking and implementation system would be preferable to the existing productions. These include:

- Real independence of accounting firms from the business interests of their clients.
- More competition for the "Big Eight" accounting firms from smaller rivals.
- Uniform accounting standards eliminating alternative methods of accounting.
- More reliable auditing performance.

Structural changes to the existing system are recommended by the Staff Study to accomplish the changes indicated above, and I will close this statement by discussing the proposed structual alterations associated with each of the four objective changes.

1. <u>Real Independence of accounting firms from the business interests of their clients.</u>

One would expect that the AICPA and FASB would insist that they are independent of clients, but logic and the evidence presented in the Staff Study contradict that real independence can or does exist in the present system. Combining accounting and management advisory services by an accounting firm and selling both to a given client places the accounting firm in a position where there is a possible temptation to bend the accounting and auditing services to validate or fulfill the promises or advice of the management advisors, in effect emeshing the firm with the client's business interests. Under such circumstances, even honorable men are apt to rationalize. The defense that the accounting and management groups organizationally are separate can be challenged because, as is common knowledge, every institution has its informal organization, and communication occurs on golf courses, at dinners, parties, etc. Perhaps a comparison with the distinction between price conspiracy and parallel pricing in antitrust law is appropriate; awareness and unsaid understandings can be as effective as specific agreements. It is best that people not be tempted.

The involvement of the AICPA with the users of corporate financial rules is another case in point, which I believe has been established in this statement, the Staff Study, and in other research. Accountant J.S. Seidman almost twenty years ago made a prophetic remark in this connection. He said

> Today, (1959) CPAs alone are pretty much the high priests of accounting principles. In twenty years, will the users of accounting also be part of the hierarchy?[47]

There is no question but that the answer today to Seidman's query is "yes". The combination of accounting and financial sector individuals on the FAF-FASB-FASAC is completely apparent. One might argue only that the rulemaking organization is designed to make independent anyone assuming a position in it, but that claim is hardly believable on several grounds. The Staff Study indicates that the revolving door syndrome between FASB and accounting firms has already started; this can be expected to continue, of course, since it is characteristic of regulatory commission consensus networks. But more important is the fact that it would take rather unbalanced personalities to assume completely new identies when they moved from, say, Price Waterhouse to the FASB. Personalities as modified by past contacts and experience shape people, and establish recurring behavior patterns, and personality perspectives can be expected to remain intact although jobs change within the same network.

Finally, the Staff Study offers evidence on representation of clients by accounting firms to influence public policy, rather than accounting practices, on such matters as corporate taxation, plus engaging in congressional lobbying on behalf of themselves and corporate clients. Although it can be argued that those activities are the legitimate exercise of citizens engaged in legitimate and laudable business, that misses the point, since the matter at issue is independence from, hence impartiality toward, the application of accounting and auditing standards for clients. It is, of course, a question of degree whether one believes that the boundary of independence between accountants and clients has been eliminated. The Staff Study so believes, and I find myself in agreement.

- <u>Structural Recommendations to Achieve Independence of Accountants from clients</u>

Major recommendation of the Staff Study in this respect include preventing accounting firms from offering management advisory services, which I endorse. Another structural device would be to remove financial standards rulemaking authority and place it with the federal government, thus eliminating accountant-user joint development of financial standards, which I previously urged, and continue to do so.

2. <u>More competition for the "Big Eight" accounting firms from their smaller rivals.</u>

The Staff Study recommendation aims at a reduction in the influence of the "Big Eight" firms, and could also foster accountant independence. The possible structual devices to effect this are mandatory changes of accountants after some years or choices offered to shareholders for their selection. While preventing long term associations between accounting firm and client could tend to prevent too close a relationship between them, freedom of contract, and the advantages of compatible business arrangements are also important. The alternatives available to produce more competition in the public accounting area deserve careful consideration and further study by the Subcommittee.

3. <u>Uniform accounting standards eliminating alternative methods of accounting.</u>

The proposal for development of uniform accounting and the elimination of accounting alternatives is of crucial importance and interest. At stake are several difficult and debatable technical problems, namely, whether uniform accounting systems are useful and desirable, and whether accounting alternatives mislead investors.

. Is uniform accounting useful and desirable?

The institutions formulating accounting principles and financial standards since 1934 have resisted developing uniform accounting for several reasons. One accounting method frequently seemed as logical as another, so permiting all to be used as long as the method was disclosed appeared reasonable. Another stated reason was that the needs of different firms varied, and what represented fair presentation for one company might not do the same for another. A third reason, unstated, is that there was no governing set of postulates that ever had been adopted which would have provided a guide for preferring one rule over another. And, of course, permitting alternative treatments also allowed the accountant to tailor, to an extent, the financial reports according to the wishes of the client.

Uniform accounting has several merits, however, and ought to be seriously considered. One argument, which I will discuss below, is that it provides better information for the investor. In a broader sense, the uses of corporate financial information for macro-economic policy making purposes has never been appreciated by the financial standards rulemaking network, including the SEC. For example, in the area of antitrust administration, one of the fundamental problems of industry concentration and performance analysis is the difficulty of associating industry structure with firm performance because of the non-comparability of profit data related to the use of varying accounting conventions. Almost none of the economic studies trying to relate structure to performance have attempted to standardize for accounting data fluctuations except in the most rudimentary sense, and the results of these studies have therefore been conjectural, making

antitrust policy more difficult, because of data problems. Another economic problem is trying to forecast inventory stocks nationally, an important part of determining GNP and economic activity levels, and this dilemma relates to methods of inventory valuation. Finally, the issue of tying individual firm to national accounts has not been considered for the United States although it has been implemented in other industrialized western democracies.[48]

Several reasons for the neglect of macro uses of accounting data are apparent. It is clear that the present developers of financial standards do not regard it as their concern, nor would they have the expertise or perspectives needed for the task. Neither has the SEC considered the broader aspects of accounting useage part of their mission, preferring to take the narrow view of their responsibilities, thus concentrating on the non-controversial disclosure route. Part of the explanation for this is some concern that the authorities of the SEC do not extend so far, but more important, I think, are the backgrounds of the Commissioners themselves. Of the 55 persons who have been appointed commissioners of the SEC since its inception, including Dean Harold H. Williams, there were:

Lawyers	40
Bankers	4
Brokers	3
Engineers	3
Economists	3
Agriculturalists	1
Accountants	1
	55

of which one economist and one engineer had accounting backgrounds as well. The relation between the educational and professional backgrounds of the commissioners and the policy of the SEC favoring disclosure and avoiding consideration of the public policy uses of accounting data is understandable in terms of what the commissioners had been trained to think was important and suggests that economists and other social scientists ought to hold at least two seats on the SEC to achieve a professional and public policy perspective of greater breadth.

. Do accounting alternatives mislead investors?

The traditional approach to the stock market has been that accounting manipulations can fool some investors, sometimes a sizable proporation, and can affect stock market prices. When manipulations are fraudulent or hidden from the public, there would appear to be no question but that stock prices can be affected. But what of alternative accounting practices when disclosed; for example, changes in inventory evaluation or depreciation policy which might affect reported profits but which represent no change in the firm's real position. Do these produce variations in stock prices? One school of thought argues that such accounting manipulations are immediately discounted by the market and do not affect stock prices, and some of the accumulated evidence is persuasive, especially in terms of long run effects. The evidence is far less certain, I believe, when it comes to the short run, and some material, as well as intuition, leads to the belief that accounting alternatives can affect stock prices immediately after information release. Now if it is true that stock prices can be affected by alternative accounting manipulations in the short run, it means that investors are being misled, and that uniform accounting ought to be adopted. On the other hand, if accounting alternatives are immediately

discounted by the market and do not affect stock prices, there is, from that point of view, as much reason for eliminating alternatives, which would make the reported corporate financial numbers interpretable without adjustments. I conclude that it is to the interest of investors to develop a uniform accounting system.

. Structural Recommendations to Achieve a Uniform Accounting System.

The Subcommittee Staff Study recommends federal government establishment of financial standards eliminating accounting alternatives through either a Cost Accounting Standards Board (CASB)-like group, or through the Government Accounting Office (GAO), thus removing both the SEC and the FASB from control of financial standards development. The recommendation's objective is one with which I agree, and have previously urged, although my preference had been for the development of an accounting code by a scholarly group with the resulting code to be passed into law by the Congress, enforced by the SEC, and heard in a separate, special court.[49] Nevertheless, either of the recommended courses of action offered by the Staff Study could work, provided that the direction to the initiating group was sufficiently specific.

4. More Reliable Auditing Performance

The Staff Study cites instances of auditing failures, and has associated these failures with some structural problems in the auditor-client relationship, as well as the failure of the SEC to exercise sufficient control. Structural reforms called for by the Staff Study are legislation permitting damaged individuals to sue auditors for negligence and thus ameliorate the effects of the

Hochfelder decision, and federal government standards and supervision for auditors. Auditing is a sampling process, of course, and one can assume that deliberate and clever attempts to deceive auditors will be successful from time to time, regardless of legislation. What was of concern to the Subcommittee Staff Study, however, was the apparent ease with which so many cases of illegal corporate payments had escaped auditors' attention. Certainly the suggestions of the Staff Study for steps to raise the standards of auditing are reasonable and can be implemented without major difficulty, and these ought to have the support of both accounting firms and corporations who alike are concerned with their professional performance and individual reputations.

FOOTNOTES

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33. Section 19A of the 1933 Act delineated the special powers of the Federal Trade Commission, which was given authority to make whatever rules were necessary governing registration statements and prospectuses and "defining accounting, technical, and trade terms," plus the authority "--to prescribe the form or forms in which required information shall be set forth, the items or details to be shown in the balance sheet and earnings statement, and the methods to be followed in the preparation of accounts, in the appraisal or evaluation of assets and liabilities, in the determination of depreciation and depletion," etc. Section 19(b) gave the FTC sufficient subpeona powers for the production of corporate books and papers deemed relevant to FTC inquiries. The 1934 Act empowered the new Securities and Exchange Commission under Section 13(a) (1) to require documents from corporations registered under the provisions of the Act, and sub-section (b) of Section 13 said the Commission could specify the form of the necessary reports balance sheet and earning statements data report preparation methods, appraisal or valuation of assets and liabilities, depreciation and depletion, differentiation of recurring and nonrecurring income, etc.

34. One of the most striking abuses centered in investment trusts, essentially manufactured securities representing interests in other securities, to satisfy the speculative demand for stocks. Holding company abuses were another major tragedy leading to legislation in the 1930s. The Pecora hearings demonstrated serious abuses of investors, implicating some of the most respected Wall Street houses. Many stock purchasers had been cheated by questionable stock market practices; many financial reports inadequately showed sources of income.

35. A material misstatement or omission from the prospectus gave the purchaser the right to rescind the contract and to recover the difference between what he had paid and the stock market prices, whether or not the purchaser relied on the prospectus. The reaction to the provision was violent, and brought on the unprecedented, and unrepeated, "Wall Street Strike" of 1933-34. See Chatov, 1975, op. cit., pp. 74-94.

36. Chatov, Robert, op. cit., pp. 107-111.

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38. The SEC subsequently gave the CAP rules the force they needed by considering them as substantial authoritative support for accounting conventions used in submitting required reports.

39. Chatov, Robert, op. cit., pp. 133-169.

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