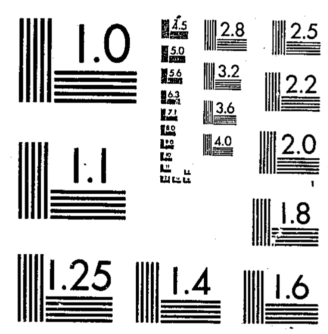

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National Institute of Justice
United States Department of Justice
Washington, D. C. 20531

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ACCOUNTING AND AUDITING PRACTICES AND PROCEDURES

HEARINGS

BEFORE THE

SUBCOMMITTEE ON
REPORTS, ACCOUNTING AND MANAGEMENT

OF THE

COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

NINETY-FIFTH CONGRESS

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The Institute Responds...

An AICPA response to a study prepared by the staff of the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs

April 1977

AICPA American Institute of Certified Public Accountants

65583

A response by the *American Institute of Certified Public Accountants to the study by the staff of the Subcommittee on Reports, Accounting and Management, U.S. Senate Committee on Governmental Affairs, entitled "The Accounting Establishment"*

April 1977

AICPA
American Institute of Certified Public Accountants

Foreword

In December 1976, a study entitled *The Accounting Establishment* was released by the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs. The study was prepared by the staff of the Subcommittee. "The major purpose of this study," according to Subcommittee Chairman Lee Metcalf, "is to provide Congress and the public with an understanding of the various private organizations and Federal agencies involved in establishing and administering accounting practices which have substantial impact on Federal policies and programs, as well as private economic decisions."

On March 1, 1977, Senator Sam Nunn, of Georgia, a member of the Subcommittee, informed AICPA Board Chairman Michael N. Chetkovich that hearings on the accounting profession were scheduled for this spring and asked Mr. Chetkovich for comments on the report as a whole, "with particular emphasis on its recommendations."

This request resulted in the following memorandum of comment on the staff study and in the accompanying transmittal letter in which the memorandum is briefly summarized.

Wallace E. Olson

WALLACE E. OLSON, *President*
American Institute of CPAs

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AICPA **American Institute of Certified Public Accountants**
1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

March 28, 1977

The Honorable Sam Nunn
United States Senate
110 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Nunn:

Re: The Staff Study of the Subcommittee on Reports, Accounting and Management, U.S. Senate Committee on Governmental Affairs entitled "The Accounting Establishment"

Thank you for the opportunity to present this preliminary response on behalf of the American Institute of Certified Public Accountants (the "Institute") to the Staff Study of the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs (the "staff study") entitled "The Accounting Establishment." Attached is a more detailed response to the issues raised by the staff study. We expect to elaborate in later submissions and in testimony at the hearings we understand are planned by the Subcommittee.

The Institute is a voluntary association consisting of approximately 130,000 certified public accountants and is the largest organization of accountants in the world. It has been the principal force for the last 75 years in developing, strengthening and refining financial accounting and auditing standards.

The purpose of this letter and the accompanying memorandum is to discuss the role of the accounting profession with respect to the credibility of financial statements prepared by management and provided to investors, creditors and the public; to outline the history of the continuing efforts of the profession to strengthen this role; and to describe the efforts and resources presently dedicated to the continuing solution of the evolving problems in the financial reporting process.

We believe that this analysis will demonstrate that the accounting profession has acted responsibly in the past and has the will and capability to deal with problems relating to financial reporting in the future and that the transfer of the standard-setting responsibility to governmental hands

While this response has been approved by the Board of Directors of the Institute, it does not purport to reflect the views of all 130,000 members.

would impede, rather than further, the resolution of such problems. Also, we believe that the record of the profession refutes the principal charges leveled at the Institute, the accounting profession, the Financial Accounting Standards Board and the Securities and Exchange Commission in the staff study and shows that such charges are not supported by the study.

Events of recent years have focused attention on the importance of audited financial statements in our economy. It has been recognized as never before that these statements are of critical importance to investors, creditors and the public; as a consequence, the performance of those associated with them is a matter of legitimate public concern. This period has seen huge and dramatic corporate failures and cunning and well-publicized frauds perpetrated on investors (and auditors) by unscrupulous promoters. These events have given rise to vast amounts of litigation against everyone involved in the corporate process—officers, directors, attorneys, accountants—and charges of improper accounting and auditing.

It is not surprising that public accountants have been the targets of such attention since they are important to the process of financial disclosure. Much of the criticism has its origins in the misconception that financial statements are prepared by auditors. The preparation of financial statements is the responsibility of management; the auditor's responsibility is to examine them for conformity with generally accepted accounting principles. Also, there is a lack of understanding of the limits imposed by cost and other considerations and of the extent of assurance auditors can reasonably give with respect to financial statements.

The Institute does not assert that auditors have been completely without blame in some of the cases that are mentioned in the staff study or that the concerns expressed in the staff study are totally groundless; there are problems in financial reporting that must be resolved. However, a fair consideration of those cases and those concerns requires also a fair consideration of the substantial efforts which the profession has made and is continuing to make to avoid repetitions of past problems, as well as to anticipate new problems. It should be recognized that as a result of these efforts the quality of financial reporting in the United States is better than anywhere else in the world.

The more important of these efforts are described in the attached memorandum of which the following is a brief summary:

1. *Financial Accounting Standards.* At the present time financial accounting standards (sometimes referred to as accounting principles) are being developed by the Financial Accounting Standards Board (FASB). Headquartered in Stamford, Connecticut, it was established some four years ago in response to recommendations of a committee chaired by Francis M. Wheat, Esq., formerly a commissioner of the Securities and

Exchange Commission. That committee, which included only a minority of practicing CPAs, concluded unequivocally that accounting standard setting should take place in the private sector. The FASB engages in extensive research and thus far has issued 20 exposure drafts of proposed standards and has published some 14 accounting standards, 18 interpretations and 13 discussion memoranda and has held 14 public hearings. It has an extensive agenda. Some 12 items are under study. This production has not only been voluminous, but it has also effected significant changes in accounting. The Board's approach has been thoughtful, careful, and diligent, and there is every reason to believe that given reasonable time it will resolve the presently recognized major issues pertaining to financial accounting standards and those that emerge in the future. To help assure the continuing effectiveness of the Board, the trustees of the Financial Accounting Foundation, the entity which secures the financing for the Board and generally oversees its activities, are making an in-depth review of the structure and operations of the Board, which is to be completed very shortly.

The staff study alleges that the SEC has improperly delegated its authority over accounting matters to the profession. It is true that the SEC has allowed the profession to take the initiative in establishing financial accounting standards. However, the record shows that the SEC has not hesitated to step in and take action on its own whenever it has felt that this procedure was not yielding satisfactory results. In addition, the SEC makes very effective use of the ample opportunities for expressing its views to the standard-setting bodies. The arrangement complained of in the staff study has existed for almost 40 years without any public dissent from any SEC chairman, commissioner or chief accountant and with the full knowledge of all sectors including the Congress. Furthermore, there is no showing that a direct exercise of authority by the Commission during this time would have yielded higher or better standards.

2. *Auditing Standards.* Audits provide reasonable assurance that matters are as represented in financial statements. Auditing standards are the rules that regulate the manner in which financial statements are examined by independent auditors and the manner in which auditors express their opinions on such statements. Auditing standards are formulated by the Auditing Standards Executive Committee, a senior committee of the Institute. These standards are being developed and refined on a continuing basis, thus providing prompt response to constantly changing needs. The present activity is vigorous and fruitful. Also it is fair to observe that many of the deficiencies alleged against auditors do not stem from shortcomings in auditing standards.

Many forces are operating to strengthen auditing standards and procedures and to decrease the possibility of misleading audited financial statements.

a. An independent commission on auditors' responsibilities appointed by the Institute in October 1974 is headed by a former chairman of the SEC (three of the seven members are practicing accountants; the others are a lawyer, a businessman, a financial analyst, and an educator). The commission expects to publish a preliminary report by April 1 of this year; this report is expected to call for various measures to be undertaken to strengthen the audit function;

b. Accounting firms, as a consequence of the increasing complexity of business transactions and sensitivity to rising public expectations, have strengthened their internal quality controls, supervision, training and audit procedures; and

c. Most large firms have arranged to have their practices and procedures reviewed by another firm or a panel appointed by the Institute to evaluate the adequacy of their quality control procedures.

3. *Independence.* Auditors are subject to stringent rules promulgated by the Institute, state boards of accountancy, state societies of certified public accountants, the SEC and other federal agencies regulating the relationship between the auditors and their clients. These rules are designed to assure independence from clients. With very few exceptions the cases cited as instances of audit failure do not involve the slightest evidence that lack of independence was a factor.

The staff study asserts that the independence of auditors is impaired by their performance of certain services, such as management advisory services, tax advice, and the like. There is no evidence that the performance of these services has compromised any auditor; on the contrary, the performance of such services generally assists the auditor by affording him an opportunity to learn more about the client, its internal controls, the quality of its personnel and its operations, knowledge that is helpful to the performance of the audit function.

Contrary to the suggestion of the staff study, the testifying by accountants on their own behalf before congressional committees and other public bodies does not evidence impaired independence. To deny auditors the opportunity to assist in the development of policy would be to deny them a basic right and would deprive policy makers of valuable assistance and advice. Moreover, clients' opinions vary; thus, while an auditor's testimony may please some clients, it often may displease others.

Auditor independence has been strengthened by the SEC requirement that changes of auditors be publicly reported and disagreements about accounting principles between the departing auditor and the client be disclosed. Reports filed with the SEC indicate that in five years, 165 changes of auditors involving disagreements over accounting principles

have occurred. In addition, there have been innumerable instances where clients have agreed to modify their financial statements at the insistence of the auditors without a change in auditors taking place.

Accounting firms have developed sophisticated systems to assure compliance with standards of independence and these standards are rigidly enforced. Furthermore, the growth in the number of audit committees made up of outside directors (after July 1, 1978, every company with securities listed on the New York Stock Exchange must have such a committee) provides a means for auditors to resolve auditing problems with non-management directors.

4. *Domination.* The staff study asserts that the AICPA and the accounting profession are dominated by the "Big Eight" accounting firms. The facts and figures contradict this charge. Members of the "Big Eight" firms are one-third or less of the Institute Council, its ultimate policy-making body, and of the Board of Directors. Also, they do not dominate the senior technical committees; for instance, members affiliated with "Big Eight" firms on one of the most important Institute committees (the Auditing Standards Executive Committee, which is singled out for discussion in the staff report) are less than a majority (8 out of 21). Any proposal to carry in this Committee must receive a two-thirds vote. Of course, the fact is that the "Big Eight" firms are not a monolith; on most substantive professional issues, there are strong differences of opinion among them.

These large firms audit a high proportion of publicly held companies. They naturally have a keen interest in committees of the Institute working on the problems of auditing such companies, and their partners have much to offer to the work of those committees. Furthermore, because of their size, they often are better able to commit personnel and resources to the voluntary work of the Institute. Finally, there is no showing whatsoever that the presence in relatively large numbers of partners of the "Big Eight" firms on Institute committees has operated to the detriment of the public interest or the profession.

5. *Liability.* The staff study proposes legislative reversal of the 1976 Supreme Court decision in *Hochfelder* v. *Ernst & Ernst,* which held that to sustain an action for damages under the SEC's Rule 10b-5 a misconduct greater than simple negligence must be alleged and shown. The staff study discussion of this matter overlooks the fact that auditors continue to be liable for negligence in connection with registration statements under the Securities Act of 1933; that, according to some courts of appeal, they continue to be liable for recklessness and similar misconduct in connection with damages arising out of market transactions; that substantial liabilities may still accrue against them as evidenced by

the Equity Funding settlement ($39 million contributed by the auditors or their insurers); and that some courts of appeal have held that negligence is sufficient to sustain an action by the SEC.

6. *Concentration.* The staff study asserts that there is undue concentration in the accounting profession because a large percentage of the audits of listed companies are done by the "Big Eight" firms. Audits of publicly held companies frequently require services in tens, and in some cases, hundreds, of locations. Thus the emergence of large accounting firms is substantially attributable to the nature of demands for auditing services which have developed as American corporations have grown larger and expanded the scope of their operations.

7. *Disciplinary Matters.* The staff study has criticized the Institute's efforts to appropriately discipline its members for misdeeds.

It is true that relatively few disciplinary matters stemming from highly publicized cases have been concluded. A large number are pending since the Institute has considered it unwise and potentially unfair to carry through disciplinary proceedings against allegedly errant CPAs while civil litigation and SEC proceedings were pending. The standards for determining whether a member of the Institute should be subjected to disciplinary measures are higher than those which characterize civil litigation or an SEC proceeding. Consequently a determination by the Institute to discipline a member could seriously prejudice that member in related proceedings. In all cases where it appears that a member is charged with some misdeed—and this includes virtually all instances in which members are charged in court or before the SEC with misconduct—a proceeding is commenced against him and it is processed to conclusion as soon as the other proceedings have terminated.

In appraising the adequacy of regulation of the profession it must be recognized that the Institute is by no means the only discipline to which accountants are subject; state licensing authorities, state CPA societies, the SEC and other governmental agencies, and private litigation provide other disciplinary restraints which in their totality are very formidable.

Conclusion. An examination of the staff study discloses a significant gap between the purported evidence and the recommendations. Furthermore there is a total lack of evidence that adoption of the recommendations in the staff study would remedy any of the alleged faults.

Most important, the staff study fails to recognize the tremendous efforts that are being made by the accounting profession to eliminate as far as humanly possible the causes of misleading financial statements. The Financial Accounting Standards Board, in existence less than four years,

is moving vigorously to resolve problems that have plagued issuers and accountants for generations. The Auditing Standards Executive Committee is persistently seeking to strengthen standards and to clarify the responsibilities of auditors; it is expected that the recommendations of the Commission on Auditors' Responsibilities, appointed by the Institute and headed by former SEC Chairman Manuel F. Cohen, will go far to assist this effort. As a consequence of the sensitivity of the profession to public needs, concerns, and expectations, greater vigilance on the part of the SEC, and extensive litigation, accounting firms at great cost have strengthened their systems of quality control and their means of avoiding errors.

We respectfully suggest that imposing a vast new scheme of federal regulation on the accounting profession is unnecessary. We submit that the evidence is clear that the profession has the competence, the incentive, and the desire to effect any changes necessary to provide enhanced reliability of financial reports.

Respectfully submitted,

Michael N. Chetkovich

Michael N. Chetkovich
Chairman of the Board

cc: Members of the U.S. Senate Committee on Governmental Affairs

END