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THE SEC AND THE ACCOUNTING PROFESSION: ISSUES FOR CONGRESS

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Michael Barrett, Jr. discusses whether private accounting standards have implemented the disclosure mandates of the Securities Acts. He outlines the issues in the SEC's delegation of public authority to the accounting profession as a prelude to the House Subcommittee on Oversight and Investigations' consideration of accounting disclosure standards. Barrett notes that the most important aspect of the SEC's disclosure system is the independence of accountants to accurately report a company's financial health. Amidst evidence of improper relationships between accountants and management, Barrett surveys the problems of the public disclosure system, including the extent to which accountants should provide nonaccounting management advisory services to their clients. In laying out this agenda for the Subcommittee, Barrett urges the SEC to take a leading role in establishing a uniform accounting system to insure fair, accurate, and timely disclosure.

We associate the name of Catherine the Great's Minister, Grigori Aleksandrovich Potemkin, with appearance, not fact: for the Empress's tour of the newly annexed Crimea, he had entire towns created. The appearance to the casual passer-by was one of prospering villages, but behind the façades there was no substance. These "Potemkin villages," it has been suggested, live on today in financial statements. While this may seem an overstatement, there must be a measure of truth to it if, when we compare the financial statements of a collapsed company with its bankruptcy trustee's report, all we find are vanished assets and ephemeral profits.

If we had to single out the most influential document that led to the creation of the Securities and Exchange Commission and the adoption of our present public disclosure rules, my candidate would be the book by Louis D. Brandeis, *Other People's Money* [1]. Drawing on the report of the Pujo Committee, Justice Brandeis recommended a series of changes in the way publicly-held companies and their securities are treated. Writing in 1912, Justice Brandeis observed:

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.... But there

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> should be a further call upon publicity for service. That potent force must, in the impending struggle, be utilized in many ways as a continuous remedial measure.

The recommendations of the Pujo Committee and Justice Brandeis did not become law until after the devastating collapse of the financial markets in 1929. On the other hand, the use of that potent force – publicity – continues today.

When signing the Securities Act of 1933, President Roosevelt announced the old rule of *caveat emptor* would no longer apply to the sale of securites. A new standard was established – *caveat vendor.* An essential key to the success of our federal securities laws since that time has been the creation of authority in the Securities and Exchange Commission to promulgate rules and regulations governing financial disclosures. An important part of the financial disclosure requirement is the publicity advocated by Justice Brandeis.

In the fifty years following the adoption of the principal securities acts of 1933 and 1934, the accounting disclosure requirements have not worked perfectly, but have worked well. Not all, however, would agree with this observation. Recently, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce heard testimony questioning the present effectiveness of SEC rules covering accounting and auditing:

> It is my present view that unless the Commission does, in fact, reverse its present mood and return to the fulfillment of its role as contemplated by the securities laws, I would urge the elimination of that agency. I would then make clear to the investing public that the standard of *caveat emptor* has been resurrected after a half century of fossilization. Such a conclusion would sadden me; nonetheless, it would exorcise the prevailing myth that the Securities and Exchange Commission is acting in the public interest [2].

The author of these words, Professor Abraham J. Briloff, may enjoy a reputation as a maverick, but he has certainly set the Subcommittee, for which I work, on the task of reviewing the amount of substance to the point he has made.

Congress has the constitutional responsibility not merely to add new laws to the plethora of existing ones, but to ensure that the laws are being implemented in the way they were intended. Congressional oversight – looking over the shoulder of government agencies – is how Congress assures itself that things are working. Every legislative committee of the House of Representatives is required by *House Rules* to:

> Review and study, on a continuing basis, the application, administration, execution, and effectiveness of those laws, or parts of laws, the subject matter of which is within the jurisdiction of that committee, and the organization and operation of the federal agencies and entities having responsibilities in or for the administration and execution thereof, in order to determine whether such laws and the programs thereunder are being implemented and carried out in accordance with the intent of the Congress and whether such program should be continued, curtailed, or eliminated [3].

We observe this oversight process from time to time through General Accounting Office Reports, Congressional Budget Office analyses, Committee Staff

Reports and, most importantly, committee and subcommittee hearings. After fifty years, the securities acts have been the subject of oversight many times, and will be again.

In 1970, two days after the Penn-Central Railroad had filed for bankruptcy, one of the Commissioners of the Interstate Commerce Commission (ICC) testified that he was taken by surprise at the bankruptcy. A review by the Committee on Interstate and Foreign Commerce revealed that substantial investor confusion had been created by the financial disclosures made by Penn-Central. The cash hemorrhaging was hidden, the financial statements provided confusing signals and, while corporate insiders had time enough to bail out, over 100,000 small investors held onto what they believed to be a safe investment. The culprit in that case was the accounting rules prescribed by the ICC.

As a consequence, in 1975, amendments were added to the securities acts, including changes to the accounting provisions which gave the Securities and Exchange Commission the overall authority and responsibility to dictate accounting disclosures for securities of publicly traded companies [4]. The SEC was empowered to override the accounting rules of other federal regulatory agencies for investor disclosure and protection. The key architect in pushing that change was Representative John D. Dingell.

Nine years later, Chairman Dingell has asked the Subcommittee on Oversight and Investigations to look into the effectiveness of those changes and the direction of the accounting profession generally. The Subcommittee has set as its course a review of the accounting disclosure standards presently in use, including, but not limited to, those proliferated by government agencies. The investigation has several purposes. First, the Subcommittee wants to see how well accounting practices and disclosures have worked over the past fifty years, both in the Securities Act of 1933 and the Securities Exchange Act of 1934. Second, the Subcommittee is concerned about recent developments such as the increased number of bank failures. As of September 1, 1984, there had been fifty-four bank failures, a number already exceeding the post-Depression record of forty-eight for an entire year. The press has also reported a number of scandals in other types of publicly held companies, some of which are related to accounting disclosures. Finally, the Subcommittee will review what, if any, changes are needed in the laws, their administration, or the regulations promulgated thereunder.

Essential to the success of our financial disclosure system has been the role played by the certified public accountant as the independent auditor of publicly-owned corporations. Without the public's ability to rely upon full, fair, and accurate disclosure of the state of a company's financial health, the system would break down. The accounting profession has been made the single largest enforcer of the securities acts because its members must independently attest to the fairness and accuracy of financial presentations by self-interested corporate managers. The profession is not just a vital extension of the SEC but is an arm without which the Commission could not operate. Congress, the public, and investors rely upon the fact that federal law requires audits to be performed for the benefit of the public – not corporate managers – and that effective and believable audits can only be accomplished by accountants who are clearly independent of corporate managers and their special interests.

Independence is not easily achieved in a system where auditors are hired, paid, and fired by the same corporate managers whose activities are the subject of the audit. Rigorous self-restraint, high ethical standards, real courage, and meaningful enforcement are the only ways for such a system to have any chance of credibility.

The role of an auditor is not easy. He or she must be suspicious, avoid being too "cozy" with the company being audited, and adhere to demanding professional standards. Failure to live up to those standards is recorded as a simple debit/credit entry: lost revenues for the auditor; found revenues for the lawyer. The consequence is the faith lost by the public for whose benefit the entire system was established in the first place.

The Subcommittee on Oversight and Investigations now has, within its files, evidence that raises questions about the independence of some auditors. In one case, the auditors disagreed with management's treatment of certain transactions. A lucrative management consulting arrangement was offered and the auditors changed their mind. The auditors agreed to accept the consulting contract and to accept the company's manner of treating the questioned transaction. In another instance, according to an article in the July 5, 1982, issue of *Business Week* [5], the managing partner of an accounting firm was used by the company being audited to get his junior auditors to "back off." The close relationship apparent between the managing partner and the company officers resulted in the demoralization of the junior auditors. More importantly, it prevented early disclosure of problems which ultimately led to the financial collapse of the company.

The Subcommittee also has evidence that in one instance when the auditors were questioning a series of transactions, an out-of-town trip was arranged and women were supplied to the auditors by the questioned company. The Subcommittee has also received information suggesting various other tie-ins to management accounting services which have been offered or requested. In an actual instance, the Subcommittee has learned that a certain firm was retained by the Defense Department to conduct an audit of a Defense contractor. The auditors prepared a draft report which they delivered to the company. The company then rewrote the report in several crucial areas. The auditors presented their final report with the company's changes to the Defense Department, but did not disclose that they had received any input from the company.

All of these are worst case scenarios and everyone would surely say this could not happen at their firm, but the fact is these things have happened.

These events raise questions in the minds of the Subcommittee members about the independence of the outside auditors.

The primary problem impinging upon the profession's independence is the pyramiding need to grow. The universe of audit clients is circumscribed and already well-developed. Nonaccounting services are the only area left for auditors to increase their billings. Firms are now deriving as much as twenty percent or more of their total billings from management advisory services, as contrasted with accounting services. The vast majority of these management advisory services are performed for clients of the accounting firm. Interestingly enough, some large corporate law firms are now following the auditors' lead and establishing their "independent" management consulting and advisory service organizations.

We are aware of the desire for auditors to advise their clients better. Many will argue that the best way to know whether problems exist is to perform a multitude of services for the client so that such things as inventory problems can be discovered and other internal controls can be better evaluated. Clearly, there are opportunities for companies to conceal material information from their auditors. Nevertheless, the extension of additional services does not seem the best way for the auditors to find dishonest, questionable, careless, or confused corporate book-keeping practices when the desire for more involvement erodes the essentials of independence.

We do not now know the extent of the management advisory services being provided, but we intend to find out. The very minimal step taken by the SEC to require disclosure would have been a significant measure of the scope of a possible problem if it had not been rescinded.

As I mentioned earlier, one of the key concerns in the 1975 amendments to the Securities Exchange Act of 1934 was the authority given to the Securities and Exchange Commission to override accounting standards promulgated by other regulatory agencies of the federal government. The clearest area of abuse at the time the amendments were adopted were those arising from ICC accounting disclosures. Since that time, the Subcommittee on Oversight and Investigations has learned of a series of bank regulatory financial disclosures that are less than adequate. Practices that are not permitted by manufacturing and other companies are permitted by banks which are able to cloak their problems because of their ability to hide behind the regulations promulgated by the sundry bank regulatory authorities. The staff of the Subcommittee has been meeting with several bank regulatory agencies in an effort to identify the differences and to determine what, if anything, should be done.

The Subcommittee will clearly want to consider the deference accorded by the SEC to other government agencies and to question whether the time has come for integration of those regulated companies into the overall SEC disclosure system. The controls exercised by such institutions as the New York Stock Exchange may be helpful, but not every company is listed and traded on that exchange. The role of the SEC must be paramount in the disclosure process.

Our inquiry would not be complete without some consideration of the peer review process. A case has been made that by use of this review, firms can improve their internal standards and help raise the profession's standards. Participating firms claim to have improved themselves considerably through the implementation of peer review. The SEC has used consent decrees to encourage such reviews. On the other hand, there have been failures in the review process. Without pointing to any specific one, it should be enough to say that the Subcommittee will be considering those.

Finally, the Subcommittee, because it has oversight responsibility over the Federal Trade Commission as well as the SEC, will probably consider the question of concentration in the profession through the merger and acquisition process. The recent announcement of the proposed combination of Price Waterhouse and Deloitte, Haskins & Sells has caused some concern for the issue of size and growth [6]. Parenthetically, the Subcommittee is interested to find out how the peer review process worked in this instance. Deloitte, Haskins & Sells was the firm conducting that review: was the peer review process a means of examining the records of another firm to decide whether or not a merger might be appropriate? Should there be a ban on mergers between review participants?

Fifty years after the creation of the Securities and Exchange Commission and eight years after extensive hearings and reports on these subjects by subcommittees in both houses of Congress, it is time to revisit the issues. Is there enough information? Is it fair? Is it intelligent? Is it timely? Has the public authority delegated by Congress and the SEC to the accounting profession been used wisely? These are all issues that the Subcommittee will consider over the next year.

Notes

[1] L. Brandeis, Other People's Money (1912).

[2] *SEC and Citicorp: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce,* 97th Cong., 2d Sess. 164 (1982) (statement of Prof. Abraham J. Briloff, City College of New York).

[3] House Rule X.cl.2(b)(1); § 692(b).

[4] 15 U.S.C. § 78s (1982).

[5] *The Flight Wall Street Missed,* Bus. Wk., July 5, 1982, at 82.

[6] The proposed merger was cancelled by the parties. *See* N.Y. Times, Dec. 19, 1984, at D1, col. 1.

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