IS GOVERNMENTAL REGULATION OF ACCOUNTANCY NECESSARY?

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ABSTRACT

This report contains an examination of the Senate document, "The Accounting Establishment", which calls for extensive governmental regulation of the accounting profession. It examines ten major points presented in the Senate document in an attempt to support or refute the document's recommendations. It attempts to present views from both sides of this controversial issue and to base its conclusions on emperical evidence, where such evidence exists. The report concludes with a list of alternative recommendations which the writer feels are workable and in the public interest.

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IS GOVERNMENTAL REGULATION OF ACCOUNTANCY NESESSARY?

I. Introduction[1]

As early as 1914, the Federal Trade Commission expressed its desire to establish a uniform accounting system on an industry basis. Yet, until the stockmarket crash of 1929, accounting was considered by most to be an arcane subject better left to accountants themselves. During the aftermath of the market crash, Congress seriously considered legislation to require that all audits of publicly-held companies be performed by accountants employed by the Federal Government. But Congress scrapped that proposal and instead passed the Securities Laws of 1933 and '34 which resulted in the creation of the Securities and Exchange Commission. Congress directed the S.E.C. to protect the public from false and misleading financial information by requiring publicly-owned corporations to disclose financial information in statements certified by independent auditors. Thus, the Securities Laws established an important role for the independent accountant while simultaneously providing for the initial steps towards governmental regulation of accountancy.

In 1938, the S.E.C. issued Accounting Series Release (A.S.R.) No. 4 which permitted the accounting profession to play an active role in establishing and improving accounting standards. A.S.R. No. 4 announced that accounting standards established in the private sector would be deemed as being protective of the public interest

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[1]The format and style of this report parallels that of the *Journal of Accountancy*.

as long as such standards had "substantial authoritative support." The effect of A.S.R. No 4 has been that the accounting profession has been largely self regulated with the S.E.C. providing an oversight function. Since the release of A.S.R. No. 4 in 1938, there have been three authoritative standard setting bodies within the private sector which have sought to strengthen the accounting profession by promulgating accounting principles which meet the criteria of "substantial authoritative support". The Continuing Committee on Accounting Procedure was instituted in 1938, which was replaced in 1959 by the Accounting Principles Board, which in turn saw its demise in 1972 being replaced by the current Financial Accounting Standards Board. Although the demise of the two predecessor organizations of the Financial Accounting Standards Board (F.A.S.B.) has been attributed to their ineffectiveness in dealing with the accounting challenges of their times, and there are some critics who contend that the F.A.S.B. may not be any more effective in solving current accounting problems, the private sector has thus far been able to retain its practice of establishing accounting and auditing standards without excessive governmental intervention. However, in March, 1977 the Subcommittee on Reports, Accounting, and Management of the United States Senate released a massive report calling for extensive governmental regulation of the accounting profession. This staff study entitled "The Accounting Establishment" found the private sector inept and ill suited to undertake the responsibilities of establishing accounting and auditing standards in the public interest. The report is better known as the "Metcalf Report" after the late Chairman of the Subcommittee,

Senator Lee Metcalf. The report states that it was "precipitated by continual revelations of previously unreported wrongdoing by major corporations, as well as a series of corporate failures and financial difficulties which have come to light in recent years. In many cases, the problems which occurred were caused or aggravated by the use of accounting practices that failed to reflect accurately the substance of corporate business activities."[2]

The numerous recommendations of the "Metcalf Report", should they be adopted, would entail sweeping changes in the present accounting structure. The private sector would no longer set accounting and auditing standards and the Certified Public Accountant would become a quasi federal inspection agent. Such sweeping changes should be seriously considered before adoption and thus, I consider the examination of these recommendations and their supporting data an important topic for research. The objective of this paper is an examination of the major points contained in the "Metcalf Report" in an attempt to either support or refute the recommendations based on these points. In the event that I cannot confirm the appropriateness of the Senate recommendations based on the supporting data, I will attempt to present alternate recommendations which I believe to be workable and in the public interest.

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[2]The Subcommittee on Reports, Accounting, and Management, The Accounting Establishment, III.

II. Literature Review

Since the release in March, 1977 of the "Metcalf Report", numerous articles have been written both pro and con about this staff study. Most of these articles have been written by practicing Certified Public Accountants (C.P.A.), mostly from large accounting firms in defense of the present accounting structure. Other articles have been supplied by those who have not particularly benefitted from the present structure and are justifiedly displeased with it. However, in my literature search I have not encountered one article which was written by someone without a vested interest in the outcome of this controversy. This is only to be expected because disinterested and completely unbiased individuals would not bother to comment. I have attempted in this research to look at each issue from both sides and base my conclusions on empirical evidence where such evidence exists. However, the issues presented in the "Metcalf Report" are substantially political in nature, and thus reasonable men will differ in their conclusions. At least I can attempt to correct for the biases inherent in the various arguments pro and con concerning governmental regulation of accountancy and base my conclusions and recommendations on information rather than emotion.

III. Corporate Abuses

The "Metcalf Report" states that it was initiated in response to unexpected corporate failures that were "caused or aggravated by the use of accounting practices that failed to reflect accurately the substance of corporate business activities."[3] The staff study also points out that these corporate failures have led to requests for substantial assistance to such companies from taxpayers. The study cites the Penn Central collapse, Equity Funding fraud, and improper and illegal activities by Gulf Oil Corporation and Northrop Corporation as illustrations of corporate abuses with which it is concerned. In each case, the study questions, "Where was the independent auditor?" The study suggests that serious questions must be raised concerning the independence and competence of auditors due to the accounting and auditing problems which have led to these corporate abuses.

In order to determine if these recent corporate wrongdoings were indeed aggravated by accounting practices which failed to reflect the substance of business activities, I examined the Equity Funding fraud and Penn Central collapse. Upon an examination of the report of Robert M. Loeffler, the trustee in bankruptcy of the Equity Funding Corporation, I found no evidence to suggest that accounting principles and practices supported this fraud.[4] Instead I found negligence in performing standard auditing procedures at the root of the perpetuance of this fraud. To illustrate my findings, I must point out that the Equity Funding

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[3] *Ibid.*, III.

[4] *Ibid.*, 723.

fraud was nearly ten years old when it first came to public attention in April, 1973. The fraud was unsophisticated in both design and execution. Its various elements were created piecemeal, as need dictated, and little attempt was made to integrate the various elements of the fraud. Mr Loeffler reports:

> " The fraud was not the brainchild of computer-age financial wizards. It was to a great extent simply a pencil fraud, perpetrated by means of bogus manual accounting entries, with virtually no support for those entries in many cases. That the fraud persisted undetected for so long is attributable to the audacity and luck of its perpetrators and, just as importantly, to the glaring failure of the Company's auditors to perform properly the obligation which they had undertaken."[5]

The Equity Funding fraud was executed by inflating the company's reported earnings by recording non-existent commission income. Over the years, this practice produced bogus income which totaled over $85 million. In addition to inflating income, the conspirators borrowed funds to ease the cash needs of the company due to its continuing operating losses. However, the borrowed amounts were never recorded as liabilities on the company's books. Sometimes this was accomplished by not recording the sources of funds at all, while other times complicated but completely fictitious transactions were invented which wound their way through numerous foreign and domestic subsidiaries. Although collusive management fraud, as is the case here, is often hard to detect, I must announce my reservations about the competence of auditors who fail to discover such haphazard and slapstick attempts at fraud. Even

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[5]<u>Ibid</u>., 706.

a special committee of the American Institute of Certified Public Accountants (A.I.C.P.A.) which investigated the fraud concluded "Equity Funding's internal accounting controls were so weak (that) an auditor would have expanded routine audit tests, thus increasing chances of detecting the fraud."[6] A thorough analysis of the Equity Funding case reveals that the fraud was perpetuated by the failure of the auditors to follow "generally accepted auditing standards", and not because of any deficiency in accounting principles.

The Penn Central collapse was aggravated by the auditors' negligence in permitting the recording of transactions based on form alone when the substance of these transactions was materially different. In February, 1968, the Pennsylvania and New York Central Railroads merged and became the Penn Central Transportation Company. During 1969, Penn Central Co., a holding company was formed and acquired all of the stock of Penn Central Transportation Co. For 1969, the auditors issued a report on the results of Penn Central on a consolidated basis and Penn Central Transportation Co. on a separate entity basis. In June, 1970, the Penn Central Transportation Co. filed a petition for reorganization under the bankruptcy laws. The S.E.C.'s A.S.R. Number 173 reveals that a subsequent Commission investigation found that the management of Penn Central had engaged in a program of concealing the deterioration of the company which occurred in the post-merger period and which led to the filing of the petition in reorganization. While the financial statements that the auditors certified

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[6] Ibid., 726.

did show a declining trend in 1969, they substantially understated the magnitude of the real decline in the economic condition of Penn Central and did not reflect the cash drains which led to the collapse of the railroad when Penn Central Transportation Co. could no longer borrow funds. Specific illustrations of transactions which did not reflect the economic substance of business conditions follow:

Penn Central entered into a transaction in 1968 which involved a nonmonetary exchange within its investment portfolio that resulted in the company recording a gain in the amount of $21 million. There was no separate disclosure in the financial statements or in the accompanying notes to inform the readers of the nature of this transaction. The transaction represented the exchange of Penn Central's 25% interest in Madison Square Garden Center and its 55% interest in the Penn Plaza Office Building for a 25% interest in Madison Square Garden Corporation. Before the transaction, Madison Square Garden Corporation owned 25% of Madison Square Garden Center, 20% of the Penn Plaza Office Building, the real estate on which the former Madison Square Garden had stood, and other minor assets. Penn Central, which received no cash, recorded the gain of $21 million by valuing the Garden Corporation stock received at the average market price per share as reflected on the New York Stock Exchange during the year, and then subtracting the carrying value of the assets given up. The auditors contended that the transaction qualified as an exchange of distinctly different kinds of assets and, in accordance with accounting theory then in existence, was an exchange of assets to which a gain or loss must have been recognized.

However, the S.E.C. upon examination of this transaction revealed that it "represented the substitution of an investment in one form for essentially the same investment in another form."[7] Thus, there was no change in economic interests in Madison Square Garden Center, the principal asset involved, and no income recognition was justified.

Another example of the application of incorrect accounting principles in the Penn Central case involved its 97% owned subsidiary, Lehigh Valley Railroad Company. Lehigh Valley remained a 97% owned subsidiary of Penn Central Transportation Co. at the time of the merger of the Pennsylvania and New York Central Railroads. In 1968, the Lehigh Valley losses amounted to $6 million, and in 1969 the losses were $5.1 million before an extraordinary charge of $1.2 million. The footnotes to the 1968 and 1969 financial statements separately disclosed these losses. The Lehigh Valley results, however, were not consolidated with Penn Central's results during these periods. Management's reason for not consolidating the operations of Lehigh Valley was their contention that Penn Central's ownership was temporary since the Interstate Commerce Commission had required that Lehigh Valley be offered for affiliation with another railroad as a condition precedent to the I.C.C.'s approval of the merger. However, the S.E.C.'s investigation discovered that management was well aware that none of the other railroads had any interest whatsoever in acquiring Lehigh Valley. Furthermore, a management representative had flatly stated that Lehigh Valley was not worth anything. The S.E.C. maintained that in both 1968 and 1969 the auditors should have insisted that management furnish evidence that offers had been made to other railroads concerning

[7] Accounting Series Release No. 173, p. 3516.

the anticipated divestiture of Lehigh Valley. Furthermore, the auditors should have satisfied themselves by further inquiries as to whether management had evidence of interest from other railroads or from other potential acquirers. In the absence of information indicating reasonably possible divestiture, Penn Central's ownership of Lehigh Valley could not be considered temporary and therefore, the operating losses of Lehigh Valley should have been reflected through consolidation.[8]

In both of these above illustrations concerning the Penn Central collapse, it appears that the accounting principles upon which the financial statements were based did not accurately reflect the substance of economic reality. The "Metcalf Report" contends that uniformity of accounting principles would alleviate this problem, however, I do not think so. The problems at Penn Central reflect management's successful efforts to record income from transactions which were specifically structured to give an appearance of being bona fide, but which did not reflect a business or economic change that would justify the recording of income or deferral of losses. Accounting principles, whether uniform or not can be misused by deliberate attempts of management to create sham transactions, which may result in poor judgements by auditors. I believe the above examples point to inadequate discharge of responsibility on the part of independent auditors and not inadequacy in prescribed accounting principles. The F.A.S.B. Statement of Position on the "Metcalf Report" responds to the assertion that accepted accounting principles may contribute to corporate abuses by explaining

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[8] *Ibid.*, 3518.

that "The accounting issue arose from applying an accepted principle in circumstances where there were insufficient, inaccurate, or misrepresented facts required to satisfy accepted criteria for the use of the principle, rather than the acceptability of the accounting principle itself."[9] The F.A.S.B. continues by pointing out that a number of the most recent and disturbing examples of significant financial difficulties and corporate failures have involved banks, notwithstanding close Federal regulation under the banking laws and required audits by bank examiners. As the General Accounting Office's recent report on banking problems indicates, financial trouble and corporate failures play no favorites between regulated and unregulated industries when proper management standards and internal controls are stretched or ignored.[10]

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[9]Financial Accounting Foundation, Financial Accounting Standards Board, Statement of Position on Study Entitled, "The Accounting Establishment", 34.

[10]*Ibid.*, 35.

IV. Alternative Accounting Principles

In the letter of transmittal to the Chairman of the Senate Government Operations Committee, the "Metcalf Report" states that "Corporations presently have substantial discretion in choosing among alternative accounting standards to report similar business transactions. As a result, the amounts of earnings or losses reported to the public can vary drastically depending on which accounting alternatives are chosen."[11] To support this statement the staff study reproduces a table of acceptable alternative accounting practices which was originally prepared by a study group of the A.I.C.P.A. The table lists 12 separate business transactions with a total number of 42 acceptable ways to report these transactions (See Table 1). However, the F.A.S.B."Statement of Position" reveals that the table presented by the Subcommittee staff and the resultant conclusions derived therefrom cannot be relied upon, because the table was developed in 1965 and has not been updated to reflect 13 years of progress, including steps by the F.A.S.B. and its predecessor, the A.P.B., to reduce and in some cases eliminate the alternatives. Furthermore, the "Metcalf Report" makes no effort to distinguish among those alternatives which are reasonably necessary to reflect different circumstances or wholly different transactions, even though the 1965 research study did make this important distinction when it originally published the information. An updated analysis of the table, as developed by the F.A.S.B., illustrates that of the 42 alternatives, 30 are not alternatives or represent only minor impact on the

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[11]The Subcommittee on Reports, Accounting, and Management, III.

financial statements and are therefore considered immaterial (See Table 2).

I make no attempt to suggest that present accounting principles are anywhere close to being uniform; many acceptable alternatives do exist. However, a very difficult problem in trying to narrow or eliminate the number of acceptable accounting alternatives is the determination of which transactions and their surrounding circumstances are sufficiently similar that an accounting method will reasonably provide meaningful information, and which ones are sufficiently different thereby precluding the use of one method. The F.A.S.B. contends that it has required a single accounting treatment when it has determined that circumstances are substantially the same for all those affected and that the treatment will result in the most meaningful and useful financial presentation.

Another statement by the "Metcalf Report" that must be put in proper perspective is that preparers and auditors of financial statements have a free choice, or the right to change accounting principles once applied, to present matters in the most favorable light. Primarily, there is no merit to assuming that accounting changes are bad per se. Secondly, as A.P.B. Opinion No. 20 points out, "There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. This presumption may be overcome only if the enterprise justifies the use of an alternative acceptable accounting principle on the basis that it is preferable or if an official pronouncement of an authoritative standard-setting body requires or expresses preference for another principle or rejects

the principle then being applied."[12] Opinion No. 20 further requires that the change in accounting principle and its cumulative effect on income be fully disclosed in the financial statements, together with an explanation of why the newly adopted principle is preferable. To embody all of these accounting concepts, the auditor's report at the end of the financial statements contains a statement to the effect that accounting principles have been applied on a consistent basis with those of the preceding period. These procedures help assure the users of financial statements that the results of operations of the current period are comparable with those of previous periods and precludes the wide swings in earnings due to the picking and choosing among alternatives that the "Metcalf Report" refers to. Although these measures to some degree safeguard the interests of investors, auditors can and do make errors in judgement concerning the preferability of accounting principles. It must be remembered that the financial statements are the representations of management, and that management sometimes attempts to justify a change in accounting principle by presenting misleading information to the auditor. However, it is fully within the sphere of responsibility of the auditor to be aware of this possibility and to determine by whatever means necessary that the change in accounting principle is indeed preferable. One of the "Big Eight" accounting firms, Arthur Andersen & Co. sought a motion to enjoin the application of the S.E.C. rule that requires the independent auditor to advise in writing whether, in his opinion, the change in accounting principle was preferable in the circumstances. Arthur Andersen's position was that independent auditors

[12]Financial Accounting Foundation, Financial Accounting Standards Board, 30.

should not be forced to determine which accounting principles are clearly preferable, thereby assuming the responsibilities of the authoritative standard-setting bodies. Andersen maintained that a prescription of this nature would result in every accounting firm becoming a mini rule-making body. The court denied the motion to enjoin, basing its decision on the premise that if auditors would not shoulder the responsibility of determining the preferability of accounting principles, then the public would be left unprotected from the whims of management.

One of the most pervasive assumptions upon which the "Metcalf Report" is based is that uniformity in accounting principles is the ultimate goal in establishing effective accounting information. The report presents no evidence that uniform accounting is desirable, but instead treats its desirability as self-evident. Many authors have discussed the pros and cons of uniform accounting. I see no point in rehashing that argument again. R.L. Hagerman, Associate Professor of Accounting at the State University of New York states:

> "It is important to look at the empiracal evidence on the desirability of uniform accounting standards. For example, agencies of the Federal Government imposed uniform accounting principles on all state-chartered banks in 1964, but allowed the national banks to continue choosing among alternative accounting policies. If the desirability of uniform accounting were self-evident, we would expect the information content of the state bank's financial reports to increase relative to those of the national banks. I tested this hypothesis and found no evidence to support the desirability of uniform accounting."[13]

Even the Cost Accounting Standards Board (C.A.S.B.), the

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[13] Robert L. Hagerman, "The Metcalf Report: Selling Some Assumptions," Management Accounting, (Jan.,1978), 15.

Congressionally established standard-setting board, which was instituted to promote uniformity in accounting for costs incurred by defense contractors, has concluded that uniformity in cost accounting is not always desirable, if indeed possible. In its Statement of Operating Policies, Procedures, and Objectives (Mar., 1973) the C.A.S.B. recognized "the impossibility of defining or attaining absolute uniformity, largely because of the problems related to defining like circumstances."[14] The C.A.S.B. contends that it does not seek to establish uniformity in accounting principles or charts of accounts for all the complex and diverse businesses engaged in defense contract work. The point to be emphasized here is that if the C.A.S.B., within its narrow area of concern for the costing of Government contracts, does not believe that uniformity in accounting principles is workable due to the diversity of business transactions, the authoritative standard-setting bodies in the private sector which establish accounting standards for all but regulated industries, necessarily encounter even more diversity in business transactions. Thus, uniformity in accounting principles for all industries may not provide the most meaningful information.

Realistically, I believe that uniformity in accounting principles could be attained only if business transactions were uniform. Furthermore, true precision in financial statements could be attained only if estimates did not have to be made in preparing the financial statements and if uncertainties inherent in the nature of business were removed. As Arthur J. Dixon explains, "There is no absolute truth in accounting principles. The best that can be

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[14]Cost Accounting Standards Board, "Statement of Operating Policies, Procedures, and Objectives," (Mar., 1973), 2.

accomplished in establishing accounting principles is to seek the most truthful answer."[15]

The "Metcalf Report" soundly criticizes the present use of alternative accounting principles stating that, "Use of a variety of questionable accounting methods has been instrumental in giving many investments an appearance of value which was not actually present, and has led to the manipulation of security prices."[16] It is quite probable that investors have suffered losses in the stocks of many companies because they were misled by the use of alternative accounting principles. Adequate disclosure has been supported by many as an alternative policy to uniform accounting. However, in order for adequate disclosure to be a viable alternative to uniformity in accounting, disclosures must be proved to indeed protect investors and prevent these losses. The Efficient Market Hypothesis has been employed by several researchers to test the investor's ability to make accurate investment decisions when confronted with alternative accounting principles. This hypothesis states that the market for securities is efficient if security prices reflect fully and promptly all available information disclosures. Frances A. Mlynarcyk studied the question of whether or not investors are able to understand and adjust for alternative accounting principles. He related the stock prices of selected utility companies to their earnings based on either the deferral or flowthrough methods of accounting for taxes and concluded that "It appears that if alternative accounting measures

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[15] Arthur J. Dixon, "Commentary on the Metcalf Committee Report," The CPA Journal, (June, 1977), 12.

[16] The Subcommittee on Reports, Accounting, and Management, 149.

having major impact on reported profits are few in number and if the alternatives are communicated in the reporting process, investors are able to adjust for the measuring variations."[17]

Another study by T. Ross Archibald investigated the effect of changes from accelerated depreciation to straight line on the security prices of the firms making the switch. If investors can be misled by alternative accounting methods, then the change in depreciation methods should have increased the security prices because reported income was increased. Archibald discovered, however, that security prices did not increase, thus giving weight to the conclusion that investors are able to adjust for different accounting methods if they are properly disclosed.[18] The Efficient Market Hypothesis, however, is based on the premise that the stock market is "set" by the actions of sophisticated investors and financial analysts. The "Metcalf Report," on the other hand, insists that the objective of financial reporting should be to provide uniform information for all investors, both naive and sophisticated. However, if the stock market is indeed set by the actions of informed investors, and there is reasonable evidence to believe that it is, the naive investor does not gain any competitive advantage or edge on the market by trying to analyze the financial statements in an attempt to discover items which may indicate potential changes in securtiy prices, for these items have already been adjusted for and are fully reflected in security prices.

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[17] Hagerman, 15.

[18] *Ibid.*, 15.

Thus, perhaps the "Metcalf Report's" assumptions concerning the actual users of financial information is misguided and that this information should be directed towards informed investors and financial analysts.

V. <u>The S.E.C.: An Abdication of Responsibility</u>?

The "Metcalf Report" is particularly critical of the "extraordinary manner in which the S.E.C. has insisted upon delegating its public authority and responsibilities an accounting matters to private groups with obvious self-interests."[19] This criticism stems from the issuance of A.S.R. No. 4 in 1938 which announced that the S.E.C. would rely on accounting standards established in the private sector as long as such standards had "substantial authoritative support." The report also points out that after the demise of two previous private sector standard-setting bodies due to their failure to satisfactorily resolve pressing accounting issues, the S.E.C. again endorsed the private sector by issuing A.S.R. No. 150 in 1973. This release was a policy statement specifically endorsing the newly created F.A.S.B. as the only private body whose standards would be recognized by the S.E.C. as satisfying the Federal Securities Laws. The report maintains that the S.E.C. has delegated the establishment of accounting standards which are binding on all publicly-owned corporations to the special interest groups which control the F.A.S.B. and has reserved a mere oversight role for itself.

I must agree with the "Metcalf Report's" assertion that the S.E.C.'s authorization of the establishment of accounting standards in the private sector if such standards are based on "substantial authoritative support" is very vague. To this date accountants have successfully sidestepped the issue of what constitutes substantial authoritative support by pointing to Generally

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[19]The Subcommittee on Reports, Accounting, and Management, V.

Accepted Accounting Principles. But this is circular logic and has therefore led to problems which were sure to result from any system which measures the quality of its standards by the degree of their general acceptance. However, I do not concur with the staff study's conclusion that the S.E.C. has improperly delegated its authority and responsibilities on accounting matters to the private sector. The S.E.C. was not primarily intended to be a legislative body, but rather an enforcement body. From the 1930's the S.E.C. has looked to the accounting profession for the development of standards and confined itself to oversight, administration, and enforcement. In the words of John C. Biegler, managing partner of Price Waterhouse, "This is not an abdication of authority. It is the most responsible and effective way to exercise authority."[20]

In further response to the "Metcalf Report's" assertion that the S.E.C., through issuance of A.S.R. No. 150, has given up its rights to reject, modify, or supercede F.A.S.B. pronouncements through its own rule-making procedures, I will rely on the Federal District Court's interpretation of A.S.R. No. 150:

> "A.S.R. No. 150 emerges, then, as a method by which the S.E.C. will evaluate Accounting principles. It does not ordain the result of the evaluation. It does not prescribe per se approval to or rejection of any accounting principle. It merely acknowledges a fact, the existence of an authoritative body of principles, and says that it will credit those principles."[21]

Although A.S.R.s No. 4 and No. 150 have been interpreted by

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[20]John C. Biegler, "Who Shall Set Accounting Standards?", Address on Feb. 22, 1977, Vital Speeches of the Day, 43 (Mar. 15,1977), 347.

[21]The U.S. District Court, Northern District of Illinois, Eastern Division, Arthur Andersen & Co. vs. the S.E.C., No. 76 c 2832.

many to support whatever views they were interested in espousing, the best indication of the true effects of these two policy statements is obtained by looking at the incidence of S.E.C. rejection or override of accounting principles established in the private sector. The S.E.C. rejected A.P.B. Opinion No. 2 and issued A.S.R. No. 96, thus permitting financial statements filed with it to reflect either the flow through method or the deferral method of the Investment Tax Credit. In A.S.R. No.147, the S.E.C. characterized lessee disclosure required by A.P.B. Opinion No. 31 as inadequate and imposed additional disclosures of its own. In A.S.R. No. 148, the S.E.C. adopted accounting rules for certain liabilities, thus triggering F.A.S.B. Statement No. 6, "Classification of Short-Term Obligations Expected to be Refinanced." In 1975 the S.E.C. urged theF.A.S.B. to take prompt action on changing the presentation of gains from early extinguishment of debt, indicating that it would do so if the F.A.S.B. did not. The result was F.A.S.B. Statement No. 4. In A.S.R. No. 190, the S.E.C. required the disclosure of replacement cost data for companies meeting certain qualifications, notwithstanding the recent F.A.S.B. Exposure Draft suggesting price level adjusted information. Other areas where the S.E.C. has taken steps to modify or override private sector standards include accounting for business combinations as pooling of interests, catastrophe reserves, disclosure of inventory profits, capitalization of interest, disclosure of unusual risks and uncertainties, etc.[22] The point of these numerous examples is that the S.E.C. has not remained idle, thus permitting the private sector to do whatever

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[22] Financial Accounting Foundation, Financial Accounting Standards Board, 37.

it pleased. The S.E.C. has used its discretion to intervene in the private sector's establishment of accounting principles whenever it deemed necessary. Arthur J. Dixon, in his "Commentary on the Metcalf Committee Report" ventures that the "S.E.C. has the best of both worlds -- the public pressure and expense is endured by the F.A.S.B. and the private clout remains with the Commission."[23]

The "Metcalf Report" also criticized the S.E.C. for its tendency to treat large accounting firms more leniently than individual C.P.A.s and small firms in disciplinary actions. The study asserts that individual C.P.A.s and small firms are routinely suspended from practice before the S.E.C. and publicly identified while "Big Eight" firms receive relatively mild sanctions and the individuals involved are not publicly identified. The S.E.C. has responded to these charges by explaining that practice of accounting before the Commission is substantially carried on in the form of large accounting firms which have obligations to design adequate quality control and review procedures. The involvement of large accounting firms in disciplinary proceedings creates special problems in the determination of appropriate remedies. Harvey L. Pitt, General Counsel of the S.E.C. explained that the problems which have come to the attention of the Commission during private investigations involving "Big Eight" accounting firms have involved a small proportion of the personnel of these firms. He believes that the shortcomings which led to the institution of a proceeding were rooted in poor supervision, lack of adequate quality controls, or insufficient

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[23]Dixon, 13.

enforcement of those controls that existed. In some instances, personnel whose training did not parallel the complexity of the tasks undertaken were required by the firms to assume responsibility beyond their competence. Pitt states, "In such circumstances, where the problems sought to be remedied appeared to result more from organizational defects than wrongdoing on the part of particular individuals, the Commission has deemed it appropriate to name accounting firms as respondents in proceedings ··· and not individuals."[24] The suits that the S.E.C. has instituted against the "Big Eight" accounting firms have not been friendly affairs and the S.E.C. has thus clearly demonstrated its willingness to initiate actions against large accounting firms.

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[24]The Subcommittee on Reports, Accounting, and Management, 1475.

VI. Lack of Independence?

The "Metcalf Report" expresses its alarm at the lack of independence and lack of dedication to public protection shown by the large accounting firms. The report states,"Information received by this subcommittee generally confirms that the first loyalty of these firms is to the managements of corporate clients who retain them and authorize payment of their fees."[25] The charge of lack of independence of the large firms is indeed a serious one considering the nature of their role in protecting the public from misleading financial information. However, the "Metcalf Report" makes this charge without any evidence to substantiate it. Instead it points to recent corporate abuses as sufficient supporting data for its claims. Walter E. Hanson, senior partner of Peat, Marwick, & Mitchell emphasizes that there is no reason to believe that large accounting firms are any more suceptible to the possibility of lack of independence than small accounting firms because none of the fees from their clients amount to more than 1% of the large firms' revenue.[26] Even where C.P.A. firms have been held culpaple as a result of corporate wrongdoings, it has been, in almost every case, because of negligence on the auditor's part and not involvement in management's perpetuance of the wrongdoing. Yet, it is the accounting firm that often suffers most of the pain and publicity.

The "Metcalf Report" contends that the C.P.A.'s increasing involvement in his client's affairs has led to his lack of independence. However, it is probable that an auditor's insecurity

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[25] The Subcommittee on Reports, Accounting, and Management, 68.

[26] "C.P.A.s Suggest the Watchdogs They Want", Business Week, (May 23, 1977), 95.

with or ignorance of his client's affairs should be of greater concern to the Subcommittee. The auditor suffering from either of these infirmities is much more likely to be subject to management domination than the one who feels secure with his position and who is knowledgeable about the affairs of his client. The "Metcalf Report" unfortunately does not distinguish between independence and indifference. Independence is a state of mind and therefore cannot be legislated. I feel that the present ethical standards and rules prescribed by the S.E.C. and the accounting profession insure the highest degree of auditor independence obtainable. These measures are certainly not infallible, but they do preclude a wide range of direct or indirect personal and financial interests in or involvement with the client and its management.

The Subcommittee suggests that mandatory rotation of auditors is the panacea to overcome too much familiarity and too little independence between auditors and their clients. However, the Cohen Commission's recent report on auditor's responsibilities found that many of the worst cases of audit failures occurred the first year or two after a change in auditors. The Cohen Commission concluded that mandatory rotation of auditors might result in even more corporate abuses. Instead, the report recommended rotation of audit personnel within the C.P.A. firm.[27]

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[27]"A Sharper Definition of the Auditor's Job," Business Week, (March 28, 1977), 56.

VII. Excessive Market Concentration in the Accounting Profession

The "Metcalf Report" criticizes the fact that the supply of auditing and accounting services to corporations listed on either the New York Stock Exchange or the American Stock Exchange is heavily concentrated among the "Big Eight" firms. The Subcommittee reveals that 92% of the New York Stock Exchange and 76% of the American Stock Exchange is audited by the "Big Eight" accounting firms. The "Metcalf Report" explains that excessive market concentration has traditionally caused problems concerning the price and availability of goods and services and calls for an investigation of the "Big Eight" to reveal possible anti-competitive effects. A survey of the editors of the Practical Accountant lends some support to the Subcommittee's concerns because it revealed that of accountants who do not work for "Big Eight" firms (but who constitute slightly more than 50% of the total practicing membership of the A.I.C.P.A.), 48% were disturbed by excessive market concentration of the supply of auditing services to large corporations. Some of the accountants surveyed expressed their anger concerning the practice of some large accounting firms of creating a list of non-clients and conducting active campaigns to woo them.[28] Although the long-standing ban on advertising by C.P.A.s has recently been lifted, solicitation is still considered unethical, and the practices of some large accounting firms fall within this latter category. In most cases, the large firms prey on one another and not their smaller counterparts, yet this is

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[28] "What Accountants Think About the Metcalf Report," The Practical Accountant, (Nov./Dec., 1977), 65.

still unprofessional and the practice should be stopped. The Subcommittee, feeling that competition among accounting firms for selection as independent auditors for major corporations should be increased, proposed that more than one accounting firm be presented on the ballot at the annual meeting of shareholders. Realistically, this proposal would probably result in increasing the already fierce competition among the "Big Eight" and thus, serve to squeeze the non "Big Eight" firms out of the publicly-held audits they now conduct, which is definitely not the intent of the Subcommittee.

An unfortunate oversight of the "Metcalf Report" is that it fails to recognize that the practice of accounting consists of two significantly different types of practice. At one end of the scale, the "Big Eight" audit a substantial portion of the publicly-owned corporations which are required to report formal financial information to the S.E.C., credit grantors, and stockholders. At the other end, the small public accounting firms serve proprietorships and small businesses which are usually closely held and in which there is little interest outside the ownership group. This bipolar arrangement rarely results in a large firm replacing a small firm, however, there are situations towards the middle of the scale in which larger and smaller firms compete. Yet, this competition does not insure that large firms will dominate and necessarily replace smaller firms. Arthur Young & Co. reports that of its former clients that changed auditors during the past six years, more than half are now audited by accounting firms other than "Big Eight" firms. [29]

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[29] "Professional Responsibilities in a Time of Change," _The Arthur Young Journal_, (Spring/Summer, 1977), 21.

In response to the "Metcalf Report's" charge of excessive market concentration, Price Waterhouse & Co. conducted a study of 450 manufacturing industries and found that in 36 of them, the eight firm concentration ratio varied between 90% and 100%.[30] Peat Marwick and Mitchell conducted a similar study that surveyed 18 broader industry groupings and concluded that "at least half of the major industries are more concentrated than the auditing profession."[31] John C. Biegler of Price Waterhouse makes the point that there is a "Big Eight" instead of a "Big Eighty" because there are only a few hundred very large corporations in the United States. I concur with his belief that any independent accounting firm that undertook an audit of even a handful of these multinational corporations would find it necessary to develop a worldwide accounting organization with the staff and facilities comparable to the "Big Eight". Some proponents of the "Metcalf Report's" recommendations suggest that a consortium of small firms would be just as effective in auditing large multinational corporations as a "Big Eight" firm, and would thereby eliminate excessive market concentration. I believe this to be an absurd proposal which would result in organizational problems and lead to numerous audit failures.

To dispell the concerns of the Subcommittee concerning lack of fee competition in the highly-concentrated accounting profession, Price Waterhouse refers to a recent study that examined companies' reasons for switching auditors. The report revealed that many of

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[30] "C.P.A.s Suggest the Watchdogs They Want", 95.

[31] Ibid., 95.

the corporations changed auditors reporting that they believed that they could get the same service for less money.[32] Furthermore, in contrast to the Subcommittee's worries about lack of competition in the accounting profession, the Cohen Commission states that, "Competition among auditors already threatens the competence with which audits are performed."[33] The Commission blames the management of C.P.A. firms for engaging in heated drives to sign up more clients, thus generating excessive price competition and simultaneously reducing the quality of audit work. I believe the previous examples demonstrate the inaccuracies of the "Metcalf Report's" charge of lack of competition in the accounting profession.

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[32] Ibid., 95.

[33] Ibid., 95.

VIII. Amendments to the Federal Securities Laws

The "Metcalf Report" reveals that the U.S. Supreme Court adversely affected the opportunity for individuals to recover damages from negligent accountants in Ernst & Ernst vs. Olga Hochfelder, et al., 96 Sup. Ct. In this case, the Court held that "scienter" -- the intent to deceive, manipulate, or defraud -- is a necessary requirement of any private action for civil damages under the fraud provisions (section 10b, rule 10b-5 of the 1934 Act) of the Federal Securities Laws. The Supreme Court supported its conclusion by stating, "When a statute speaks so specifically in terms of manipulation and deception, and of implementing devices and contrivances -- the commonly understood terminology of intentional wrongdoing -- and when its history reflects no more expansive intent, we are quite unwilling to extend the scope of the statute to negligent conduct."[34] The Subcommittee, which feels that the standards governing the auditing of publicly-held corporations should be strengthened, not weakened, calls for Congressional amendments to the Federal Securities Laws to strengthen the rights of aggrieved individuals to sue negligent auditors.

However, before we blindly push for amendments, let us examine the existing provisions under the Securities Laws which enable aggrieved individuals to obtain satisfaction for damages suffered. Section 11 of the 1933 Act provides that an auditor of financial statements included in a registration statement for an offering

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[34]The Subcommittee on Reports, Accounting, and Management, 1485.

of securities can be liable if there is a misstatement or omission of a material fact in the audited financial statements. An investor who purchased the securities covered by the registration statement need not even prove that he read the financial statements to recover damages from the auditor. To avoid liability, the auditor must prove that he acted with due diligence (without negligence). Section 18 of the 1934 Act has a similar provision which imposes liability for any document filed with the S.E.C., including audited financial statements. Under this section, the plaintiff must prove reliance on the financial information. The standard of liability is whether the auditor acted in good faith and did not have knowledge that the statement was false and misleading. I believe these two sections of the Federal Security Laws, in addition to various Common Law liabilities serve as adequate remedies for auditor negligence.

The Subcommittee recommends that the Hochfelder decision be overturned and that accountants be subjected to unlimited liability for negligence under the "fraud" provisions of the 1934 Act. The Subcommittee further recommends that this liability be determined without any limitation based on: (a)apportionment between the auditor and others who were negligent, (b)recognition that the negligence resulted in only part of the damage, or (c) statutory ceilings on the amount of damages the accountant must pay. The past decade has seen a dramatic increase in the number of lawsuits against auditors. In some cases, the auditor is the only defendant with substantial insurance coverage and the courts sympathetic with aggrieved investors, have assessed damages

completely out of proportion to the auditor's limited role in the alleged wrongdoing. Arthur Young & Co.'s response to the "Metcalf Report" entitled Professional Responsibilities in a Time of Change, illustrates the potential impact of unlimited liability to accounting firms in its example of a class action suit by shareholders or security traders. The example demonstrates that if the stock of a company with 12.5 million shares drops $10, and this can be traced back in some fashion to the negligence of the auditors, they are faced with a potential liability of $125 million. If we use the "Metcalf Report's" estimate that the profits of the "Big Eight" total $500 million per year, such a single judgement against one of those firms would amount to two years profit for that firm. Arthur Young & Co. states, "Such a judgement would probably destroy the firm and ruin its partners. The potential for such exposure already exists in the event that a jury is persuaded that there has been fraud on the part of any of our own firm's 5000 professional people. To add a similar exposure for negligence might make partnership in a firm with large clients quite unattractive."[35] Arthur Young & Co. also points out that since professionals are human, they are bound to make mistakes. If each partner of a C.P.A. firm made only one professional mistake in his career as a partner, a large firm with 600 partners, with an average tenure of 25 years as a partner, would average 24 partner mistakes a year. The potentially vast exposure to an unlimited class of aggrieved individuals for an unlimited amount would probably bankrupt the accounting profession.

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[35] Professional Responsibilities in a Time of Change, 30.

Even if the Subcommittee proposal for imposing unlimited liability for negligence upon accountants could be demonstrated to be a successful deterent to negligence, the costs and consequences of such measures would outweigh the benefits. For example, the prospect of unlimited liability would probably: (1) force many practitioners out of the profession because of their inability to purchase insurance at an acceptable cost, (2)inhibit C.P.A.s from undertaking new types of services of a subjective nature, such as forecasts for fear that exposure to liability would be too great, and (3) increase the cost (ultimately to the public) of professional accounting services due to the increased cost of protection procedures and devices. In addition to a cost versus benefits approach, the "Metcalf Report's" recommendation that the Hochfelder decision be overturned by Congressional amendment is legally unsound because it commingles two distinct concepts: fraud and negligence. At present the Federal Securities Laws provide ample remedies for negligence, and I see no reason to transform a clearly intended fraud provision into one of negligence.

IX. Management Advisory Services

At present, many large accounting firms obtain substantial amounts of revenue by providing management advisory services for their clients. Among the "Big Eight", the relative importance of management advisory services to revenues ranges from 5% of total revenue for Haskins & Sells to 16% of revenue for Arthur Andersen. The types of management advisory services performed include executive recruitment, marketing analysis, plant layout, product analysis, actuarial services, and financial management services. The "Metcalf Report" soundly criticizes the "Big Eight" for providing management advisory services by stating that, "Such involvement creates a professional and financial interest by the independent auditor in a client's affairs which is inconsistent with the auditor's responsibility to remain independent in fact and in appearance."[36] The Subcommittee further argues that in some cases the independent auditor not only becomes involved in the business affairs of its client, but may be placed in the position of auditing his own work. The Subcommittee is not the only group alarmed by the performance of management advisory services by large accounting firms. A survey by the editors of the Practical Accountant revealed that of those accountants which did not work for a "Big Eight" firm, 48% responded yes to the question, "Do you agree with the conclusion of the Metcalf Report that the 'Big Eight' firms have seriously impaired their independence by creating a financial interest in their clients through the rendition of management advisory services, actuarial services, and the recruiting of key

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[36] The Subcommittee on Reports, Accounting, and Management, 8.

executives for positions within their clients' organizations?"[37] In addition to this group of alarmed respondents, members of management consulting firms are obviously upset by the rapid expansion of management advisory services offered by large accounting firms. Independent consultants complain that C.P.A.s unfairly use the special role created for them by the Federal Securities Laws as a natural tie-in for the performance of management advisory services. The consultants emphasize that C.P.A.s can charge lower fees and complete the job faster because they are already familiar with the client's operations due to their audit work. The independents further charge that accounting firms have "off season" rates for their consulting work to encourage clients to employ their services during the summer months.

The "Metcalf Report" has a very narrow view of what constitutes acceptable auditing and accounting practices performed by C.P.A.s. Everything falling outside of this narrow range is defined as an unacceptable management advisory service. For example, the report states, "Auditing and accounting services involve designing a reliable system of record-keeping for businesses," and that "these are basic services which have been performed traditionally by the accounting profession. The need for expertise in providing such services to businesses is the primary reason for the development of the accounting profession and licensing of C.P.A.s."[38] However, on another page, the "Metcalf Report" defines "designing and implementing electronic processing and

[37] "What Accountants Think About the Metcalf Report", 65.

[38] The Subcommittee on Reports, Accounting, and Management, 33.

other services which help managements of client companies make financial decisions" as an unacceptable management advisory service which serves to impair auditor independence.[39] The "Metcalf Report" seems to ignore the fact that the record-keeping systems of virtually all publicly-held corporations employ electronic processing equipment. Thus, the Subcommittee has apparently reached two contradictory conclusions:

(1) Designing a reliable system of record keeping is an acceptable advisory service

but

(2) Designing a system of record keeping that employs electronic data processing and assisting a client in installing the system are unacceptable advisory services.

Another deficiency of the "Metcalf Report" concerning its position on management advisory services is that it fails to consider the circumstances in which management advisory services may be essential to the successful performance of audit work. For example, in the case of insurance company audits, the S.E.C. and the A.I.C.P.A require that an auditor either take responsibility for the actuarial assumptions in the financial statements or modify his opinion. To eliminate this handicap, Touche Ross & Co. undertook a joint venture with a firm of actuaries. This arrangement helps assure continuity of audit work and is more economically efficient for both Touche Ross and its corporate clients.[40]

The "Metcalf Report" does not cite one case in which providing management advisory services contributed to a failure of audit performance, either because the auditor's independence was impaired or for any other reason. Furthermore, the Cohen Commission's

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[39] Ibid., 35.

[40] "More C.P.A.s Chime in on Self Regulation", Business Week, (June 6, 1977), 85.

findings, drawn from a questionaire to a cross section of 1450 C.P.A.s and a staff analysis of 20 legal cases involving alleged audit failures, uncovered no evidence that management advisory services performed by C.P.A. firms compromised the auditor's independence. However, the Cohen Commission worries that potential conflicts are very real and thus proposes some limitations on management advisory services, especially in the area of executive recruitment. The Cohen report cautions C.P.A.s not to expand consulting into new services without careful consideration of the "reality or appearance of independence."[41]

The economic advantages of C.P.A.s performing management advisory services for their clients are indisputable. Prohibiting management advisory services by C.P.A.s would deny the businessman an important source of specialized professional advice based on his auditor's existing and substantial knowledge of his operations. However, the issue germane to this paper is the social desirability of the performance of management advisory services by C.P.A.s. In all cases the C.P.A. must remember that he is dealing with not only the reality of his relationship with his client, but also the public's perception of his relationship with this client. Certain management advisory services, such as executive recruitment, lend themselves to potential conflicts of interest. For example, a C.P.A. who places an executive in a top financial post in a client company may have a direct interest in helping that person succeed, and may be tempted to compromise when the rules of the profession offer any latitude. For this reason, I view executive recruitment by

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[41] "Should C.P.A.s be Management Consultants", Business Week, (April 18, 1977), 72.

C.P.A. firms as an inappropriate form of management advisory services and suggest that it be prohibited. Furthermore, I fully endorse the Cohen Commission recommendations that companies disclose in their proxy statements a description of all work other than auditing services performed by their auditors. This assures the public that any possible conflicts of interest due to the performance of special services by the auditor will be readily discoverable.

X. Deficiencies in Auditing Standards

The "Metcalf Report" is as equally critical of present auditing standards as it is of accounting principles. The report belittles auditing standards for permitting an independent auditor to use a great amount of discretion in determining how much testing of corporate records should be done. The report states, "A continuing series of unexpected major business failures combined with revelations of illegal secret funds in large corporations has raised serious questions about the adequacy of current auditing procedures."[42] The C.P.A.s answer this charge by emphasizing that they are auditors and not detectives. Accountants generally believe that in conducting audit examinations, it is necessary to maintain an attitude of healthy skepticism, but believe that they should not be held responsible for fraud if they apply reasonable procedures and standards.

In evaluating the Subcommittee's criticism of present auditing standards, it is important to understand exactly what the auditing process entails. Auditing the data that back up financial statements is necessarily a sampling process. The cost of screening every transaction would be prohibitive and not worth the marginal benefits obtained therefrom. Thus, when an auditor issues a clean opinion on the financial statements of a client, it does not mean that the client is financially sound. It merely indicates that the accountant has tested the client's records and controls and was satisfied that the financial statements fairly reflect those records. In performing an audit examination, the auditor's greatest concern is that a material error will occur in the accounting process and that his examination will not detect it. This concept

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[42]The Subcommittee on Reports, Accounting, and Management, 91.

is known as the ultimate risk in the auditing process and is quantified by multiplying: (1) the risk that the client's system of internal control will allow a material error to occur, by (2) the beta risk (the chance of not detecting a materially mistated account balance), and by (3) the risk that other auditing procedures will fail to detect a material error. For illustrative purposes, if the auditor finds the effectiveness of the client's system of internal control to be 80%, believes the effectiveness of supplemental audit procedures to be only 20% and is willing to tolerate a beta risk of 5%, the ultimate risk is less than 1% that a material error will occur that the auditor will not detect:

Ultimate Risk = .05(1 - .8)(1 - .2) = .008

The point of this example is that although auditing involves a sampling process, the results can be highly effective if the proper procedures are employed. However, this statistical theory is only valid when the client's system of internal control is correctly appraised and when supplemental audit procedures are correctly performed. For example, whenever collusive management fraud exists, the auditor's evaluation of the client's system of internal control as a basis for reliance thereon is completely worthless. Additionally, improper or inadequate audit procedures due to time limitations or other factors destroys the effectiveness of the audit. To illustrate this latter problem, the Cohen Commission found that in its survey of 1450 C.P.A.s, more than half indicated that, at one time or another, they had failed to take a required audit step due to budgeted time limitations and had informed no one of the omission.[43] Such omissions drastically reduce the

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[43] "A Sharper Definition of the Auditor's Job", 56.

total effectiveness of the audit.

My research has presented no evidence that leads me to believe that present auditing standards are ineffective in determining that the client's financial statements present fairly the results of his business operations. The auditing failures concerning major business collapses that the "Metcalf Report" refers to have usually resulted from substandard performance rather than from poor standards. However, a major shortcoming of present auditing standards is that they do not meet--and perhaps cannot be designed to meet--the expectations of the public. The public would like assurance that financial data is accurate and that any fraud or other illegal acts have been discovered. Present auditing standards cannot do this. The two possible solutions to this dilemma are to reeducate the public or seek improvements in auditing standards. The Cohen Commission seeks a healthy compromise between these two alternatives. It suggests that the auditing process will need to become a continuing, year-round operation and that auditors will have to do more than simply bless the company financial statements once a year. As for the detection of fraud, the Commission argues that users of financial statements have always thought that one of the chief purposes of an audit was to uncover any significant management fraud. C.P.A.s should acknowledge that responsibility, the Commission concludes, rather than continually arguing that this task is next to impossible because fraud is so difficult to detect. To accomplish this task, the Commission calls for increased attention to internal controls and the subsequent preparation of a formal opinion on the adequacy

of the company's internal control system. In an attempt to reeducate the public, the Cohen Commission calls for a new two-part opinion section in the auditor's report. The first part would contain a statement from corporate management itself, explaining that the financial figures are the company's basic responsibility and that it has selected the appropriate accounting principles. The auditor would then state whether or not he believes tha accounting principles selected by management are appropriate under the circumstances.[44]

It appears that many of these Cohen recommendations will be adopted by the accounting profession. I believe these recommendations are basically sound and will help to reduce the discrepancies between public expectations concerning the results of an audit and the profession's ability to meet these expectations.

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[44] *Ibid*., 55.

XI. "Big Eight" Dominance of the Accounting Profession

A very major point of the "Metcalf Report" is that the A.I.C.P.A., the "Big Eight" accounting firms, and the Financial Accounting Foundation's other sponsoring organizations dominate the F.A.S.B.'s standard-setting process in order to serve the special interests of the "Big Eight's" large corporate clients. The Subcommittee states that, "The 'Big Eight' firms effectively control the power structure (of the A.I.C.P.A.), and use the A.I.C.P.A. to advance their collective interests."[45] The Subcommittee points out that the A.I.C.P.A. Board of Directors, who have exclusive authority to elect and remove members of the Financial Accounting Foundation (F.A.F.) Board of Trustees, is composed 33% of representatives of "Big Eight" firms. The F.A.F. Trustees, who have exclusive authority to appoint and remove members of the F.A.S.B., are also composed 33% of C.P.A.s previously affiliated with "Big Eight" firms. And finally, the F.A.S.B., which actually establishes accounting standards is composed 43% of C.P.A.s formerly affiliated with "Big Eight" firms. The organizational structure of the standard-setting process in the private sector and the relationships of the various sponsoring bodies is illustrated in Table 3.

The six sponsoring bodies of the F.A.F. are:

(1) The A.I.C.P.A. composed of a cross section of practicing accountants, of which 15% represent "Big Eight" firms.

(2) The Financial Executives Institute composed of corporate executives.

(3) The National Association of Accountants composed of corporate financial officers.

(4) The American Accounting Association composed of academecians.

(5) The Financial Analysts Federation composed of security analysts.

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[45] The Subcommittee on Reports, Accounting, and Management, 9.

(6) The Securities Industry Association composed of investment bankers.[46]

All of these sponsoring bodies contribute time, personnel, money, and other resources to the F.A.F. The bulk of the F.A.F.'s financial support can be traced to the "Big Eight" which each contribute $200,000 annually and the Financial Executives Institute which indirectly, through the corporations it represents, contributes substantial amounts. In 1975, corporate contributions traceable to members of the Financial Executives Institute amounted to over $1.5 million.[47] The F.A.F. is a non-profit organization which passes all of these financial contributions on to the F.A.S.B. to be used in meeting its expenses of operations.

Table 3 demonstrates that a large proportion of C.P.A.s from "Big Eight" firms are represented in this standard-setting process. The percentage figures are especially significant considering the fact that only 12% of the nation's C.P.A.s are affiliated with "Big Eight" firms. The above discussion of the sources of financial support for the F.A.F. also demonstrates that substantial amounts of money being used to establish accounting principles are contributed by large corporations. Thus, it is compelling to assume, as the "Metcalf Report" does, that "Big Eight" firms, large corporations, and other self-seeking sponsoring organizations of the F.A.F. unduly influence the standard-setting process in the private sector.

The "Metcalf Report's" conclusions about the effective domination of the "Big Eight" firms over the standard-setting process

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[46] The securities Industry Association was added as the sixth sponsor of the F.A.F. in October, 1976. It was not included in my research because I could not find any information concerning its influence on the standard-setting process.

[47] The Subcommittee on Reports, Accounting, and Management, 15.

has many supporters. The Practical Accountant's recent survey of 1000 accountants not affiliated with "Big Eight" firms produced the following results:

> To the question, "Do you agree with the conclusions of the Metcalf Report that the 'Big Eight' firms dominate the A.I.C.P.A. and the practice of accounting through the F.A.F. and the F.A.S.B.?", 75% responded yes and only 22% disagreed. To the question, "If your answer to the question above is yes, do you feel that the overall impact of this 'domination' on the profession as a whole is detrimental?", 46% answered yes; 28% answered no, and 26% had no opinion.[48]

Another indication that the large accounting firms may exercise excessive influence over the A.I.C.P.A., and thus the ultimate standard-setting process, is a statement by a former member of the A.I. C.P.A. Committee on Displacement of C.P.A. Firms. The former member, who is a partner in a small accounting firm, stated that his committee was not permitted to expand its activities into meaningful areas which might benefit non-national A.I.C.P.A. members, and that it was abolished after completing some minor tasks which were acceptable to the leadership of the A.I.C.P.A.[49]

To counter these charges, the technical staff of the F.A.S.B. prepared an analysis of the comments received from those alleged by the Subcommittee to dominate the F.A.S.B. in response to the Exposure Drafts for F.A.S.B. Statements Nos. 2, 5, 7, 8, 9, 12, 13, and 14. These F.A.S.B. Statements constitute 8 of the Board's most significant Statements since its creation in 1972. The technical staff selected the accounting proposals, and the major issues within each proposal, before commencing the analysis and without regard to possible outcome. The staff categorized the respondents on these

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[48] "What Accountants Think About the Metcalf Report", 65.

[49] The Subcommittee on Reports, Accounting, and Management, 1733.

issues as follows:

(1) The F.A.F.'s six sponsoring organizations

(2) The 15 largest accounting firms

(3) All academecians

(4) Fortune's 1975 listing of the 500 largest industrial corporations.

These responses are contained in the F.A.S.B.'s public record and have been made available for the Subcommittee's further inspection.

Taking the 19 issues on which it was possible to say that a given response on the Exposure Draft was equivalent to a given attitude on the F.A.S.B.'s final position in the Statement, the analysis revealed that:

(1) The least supportive of F.A.S.B. decesions were business enterprises. Views expressed by a majority of business enterprises were rejected by the Board on 12 of the 19 issues.

(2) Those sponsoring organizations representing the views of corporate financial and accounting executives also had little apparent influence on the F.A.S.B., for the Financial Executives Institute disagreed with the Board on 6 of the 10 issues that it addressed and the National Association of Accountants disagreed on all 5 on which it took a position.

(3) The Financial Analysts Federation, which in contrast to the "Metcalf Report's" statement that, "The Financial Analysts Federation appears to have the least influence as a sponsor of the F.A.S.B. ...."[50], supported the Board on all 15 issues on which

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[50]The Subcommittee on Reports, Accounting, and Management, 164.

it took a position.

(4) The A.I.C.P.A. supported the F.A.S.B. on 8 issues and disagreed on 4.

(5) The major accounting firms were in accord on 9 issues and in disagreement on 6.

Further analysis of this study revealed that the sponsoring organizations frequently disagreed among themselves; major accounting firms disagreed with each other, their clients and the A.I.C.P.A.; and the F.A.S.B.'s most consistent support in terms of positions taken seems to come from the users of financial statements.[51] This study demonstrates how incorrect it is to speculate, as the "Metcalf Report" does, that sponsoring organizations of the F.A.F., large accounting firms, and large corporations act in concert when commenting to the F.A.S.B. on accounting proposals.

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[51] Financial Accounting Foundation, Financial Accounting Standards Board, 13.

XII. Can Government Do a Better Job?

The underlying presumption of the "Metcalf Report" and its various recommendations for governmental establishment of auditing and accounting standards is that the Federal Government can do a better job. The "Metcalf Report" states, "Available evidence, however, indicates that government agencies are capable of setting standards competently and more efficiently than private organizations."[52] The Subcommittee bases this claim on the experience of the C.A.S.B. which was established by Congress in 1970 to set cost accounting principles for defense contractors under Federal contracts. The C.A.S.B.'s staff and annual budget is approximately half the size of that of the F.A.S.B. which has led the Subcommittee to proclaim,"The fact that the C.A.S.B. is successfully setting accounting standards with approximately half of the resources used by the F.A.S.B. suggests that Federal agencies are capable of performing that task more efficiently than private organizations."[53]

I feel it is useless to debate the theoretical issue of whether or not the Federal Government can efficiently establish accounting principles. I believe a more useful endeavor involves an examination of past governmental experience in this area. A previous section of this report mentioned the governmental establishment of accounting principles for state banks since 1964. Although the accounting principles are uniform, they have not resulted in improved user decision making, which is the ultimate goal of accounting information. Another example of governmental establishment of accounting principles has been the Interstate Commerce Commission's

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[52]The Subcommittee on Reports, Accounting, and Management, 19.
[53]Ibid., 187.

regulation of the railroad industry for 76 years. The results have been mediocre, and definitely do not point to a mandate for governmental establishment of accounting principles. History has also shown that the Federal Government has bowed under industry pressure concerning the application of accounting principles. The Investment Tax Credit is a case in point, in which Congress in 1971 overturned an A.P.B. opinion requiring that the Investment Tax Credit be spread over the economic useful life of the asset that gave rise to the credit. Industry naturally desired immediate recognition of the credit and pressured Congress to adopt an amendment under which no specific method of accounting for the Investment Tax Credit could be required. The result is a lack of uniformity in the ways by which a company may account for the credit. History, in the form of the Internal Revenue Code, has also demonstrated that governmental regulations lack consistency and clarity. Additionally, if the Federal Government took over accounting standard setting, it would inevitably think of numerous objectives other than economic decision making to be achieved by the application of various accounting principles. This would result in a diffusion of focus of the financial statements, and in trying to achieve too many objectives, few would be achieved.

A major deficiency of the "Metcalf Report" is its comparing the present standard-setting functions of the Federal Government (including the C.A.S.B.), with the standard-setting function of the F.A.S.B. The scope of the Federal Government's efforts in setting accounting standards is limited when compared to the scope of the F.A.S.B.'s work. The F.A.S.B. is charged with improving

standards of financial accounting and reporting for all operations of all companies, in all industries and environments. The Federal Government's efforts, on the other hand, have been restricted to specific kinds of transactions or industries. The F.A.S.B.'s task of establishing and improving accounting standards is infinitely more pervasive and complex, its constituency larger and more diverse, and the subject matter not limited to a specific function of government.

Another oversight of the "Metcalf Report's" recommendations for governmental establishment of accounting principles is that there are two significantly different spheres of reporting within the United States economy. The "Metcalf Report" proposes governmental establishment of accounting principles in order to further regulate the large publicly-held corporations. However, accounting principles must also be determined for the many thousands of non-publicly-held businesses that receive audited or unaudited opinions by C.P.A.s. Some of the principles, at least in respect to disclosure, that are appropriate for publicly-held companies may not be necessary for closely-held companies. Thus, a rule-making body in the private sector would probably be necessary in any event in order to insure that informative financial data is presented by these small companies.

The F.A.S.B. in its Statement of Position concerning the "Metcalf Report" describes the present system of setting accounting standards as one that promotes the coming together of varying points of view in order to assist the F.A.S.B. in determining what is most in the public interest. It believes that were the government to take over, the standard-setting process would become more

adversary in nature, thus constructive criticism and willingness to cooperate would diminish, and with it accounting standards most responsive to the needs of investors and the general public. The F.A.S.B. states, "We are concerned that government accounting standard-setting would become legalistic and mechanical in both formulation and application, with problems frequently resolved in the courts."[54]

My research has given me no indication that governmental establishment of accounting and auditing standards would be superior to the present system. I believe that before we label the present system as inadequate and unsalvageable, we should present an alternate plan which clearly demonstrates its superiority. The "Metcalf Report" does not do this, however, it does point out some deficiencies in the present system that need to be corrected. The private sector has recently undertaken many steps to eliminate these real or perceived deficiencies referred to in the report. If the report's accusations in some way lead to improvements in the accounting structure, then perhaps the study will result in definite future benefits to the accounting profession and the public.

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[54]The Financial Accounting Foundation, Financial Accounting Standards Board, 3.

XIII. Conclusions and Recommendations

My analysis of the "Metcalf Report" has revealed that it was inadequately researched and that many of its conclusions were erroneous. The recommendations based on this inadequate data can therefore be no better than the data itself. However, the "Metcalf Report" represents an outside perspective of the accounting profession,and for this reason it is useful in indicating the public's perception of the profession. Public confidence in the accounting profession is basic to its survival. Therefore, all real or perceived deficiencies inherent in the present accounting structure, as illustrated in the "Metcalf Report" require immediate attention by the profession. I believe the following recommendations will help to eliminate many of these deficiencies and thus strengthen public confidence in the profession:

(1) The establishment of audit committees. An auditor should refuse to accept an engagement unless the client maintains an audit committee composed of the board of directors and other outside interests. The audit committee would hire, terminate, and set the auditor's fees. Independence is better preserved if directors, rather than management select and employ the auditors.

(2) Prohibition of executive recruitment as an acceptable management advisory service. This type of service lends itself to conflicts of interest and decreases public confidence in the profession.

(3) Disclosure in client proxy statements of all accounting and advisory services performed by the independent auditor. This disclosure will enable the public to identify potential conflicts of interest inherent in the advisory services performed.

(4) Establishment of federal penalties for management who intentionally mislead auditors by falsifying books and records. At present, state laws are mere wrist slappings. Since the financial statements are the basic responsibility of management, the liability for misleading statements should thus be proportioned between the auditor and management. At present, the auditor appears to be the only "deep pocket", and gets sued, rightfully or wrongfully, for everything.

(5) The narrowing and elimination of alternative accounting principles. For example, do we really need so many depreciation and inventory methods? Present accounting theory permits the auditor to depart from "Generally Accepted Accounting Principles" if he feels that by employing these principles, the financial statements will be misstated. So therefore, why not eliminate many unnecessary and rarely used methods? If the auditors, in rare cases believe the eliminated method to be clearly preferable, let him justify his conclusion and use the method of his choice.

(6) Stronger S.E.C. participation in mandatory peer review. Voluntary peer review is the accounting profession's response to the "Metcalf Report". I believe it is a noble effort by the profession to improve the quality of its audit work. However, to the public, it appears to be just another ploy to avoid governmental regulation. I believe public confidence in the program would be increased if the S.E.C. maintained strict oversight of the program and required that it be mandatory for all firms practicing before it.

All of the above recommendations envision self regulation of the accounting profession. My research has not indicated

that governmental regulation of the profession would be superior to the present system; in fact, I would expect much the opposite. The Subcommittee evidently abandoned many of its previous conclusions concerning the desirability of governmental regulation of the accounting profession, because in November, 1977 it issued a revised report. This report, entitled "Improving the Accountability of Publicly-Owned Corporations and Their Auditors" calls for "self initiated action by the private sector in cooperation with the S.E.C." The report warned, however, that "The public has reasonable needs and expectations which must be satisfied, and the amount of time for achieving reforms is not unlimited."[55] Representative John Moss, who heads the Subcommittee on Oversight and Investigation in the House of Representatives, evidently believes that the accounting profession has unreasonably delayed in implementing these reforms, for in March, 1978, he introduced legislation calling for extensive governmental regulation of the profession. The House is yet to vote on this bill, and thus, the present status of the issue of governmental regulation of accountancy remains unclear.

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[55] The Subcommittee on Reports, Accounting, and Management, _Improving the Accountability of Publicly-Owned Corporations and Their Auditors_, 22.

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APPENDIX

The "Metcalf Report's" 42 Acceptable Accounting Alternatives

TRANSACTION	NUMBER OF ALTERNATIVES
1. When revenue generally recognized	3
2. When revenue recognized for long-term contractors	2
3. Accounting for unfunded pension cost	2
4. Accounting for funded pension cost	3
5. Charging of real and personal property taxes to income	8
6. Treatment of tax versus financial accounting divergencies	3
7. Methods of depreciation	4
8. Inventory methods.	5
9. Accounting for discounts	2
10. Fixed asset acquisition	4
11. Fixed asset construction	3
12. Development costs in extractive industries, et cetera	3

TABLE 1

THE STUDY'S "42 ALTERNATIVES" IN 1977

Business Transaction	1	2	3	4	5	6	7	8	9	10	11	12
Different Circumstances or Wholly Different Transactions (14)	3	2		2		2				3	1	1
Eliminated (4)			1	1		1				1		
Sole Practice (1)			1									
Not Accounting Method (1)								1				
Immaterial (10)					8				2			
Rare and Disappearing (2)							1	1				
Alternatives (10)							3	3			2	2
Total (42)	3	2	2	3	8	3	4	5	2	4	3	3

Table 2

ORGANIZATIONAL STRUCTURE OF THE ACCOUNTING ESTABLISHMENT

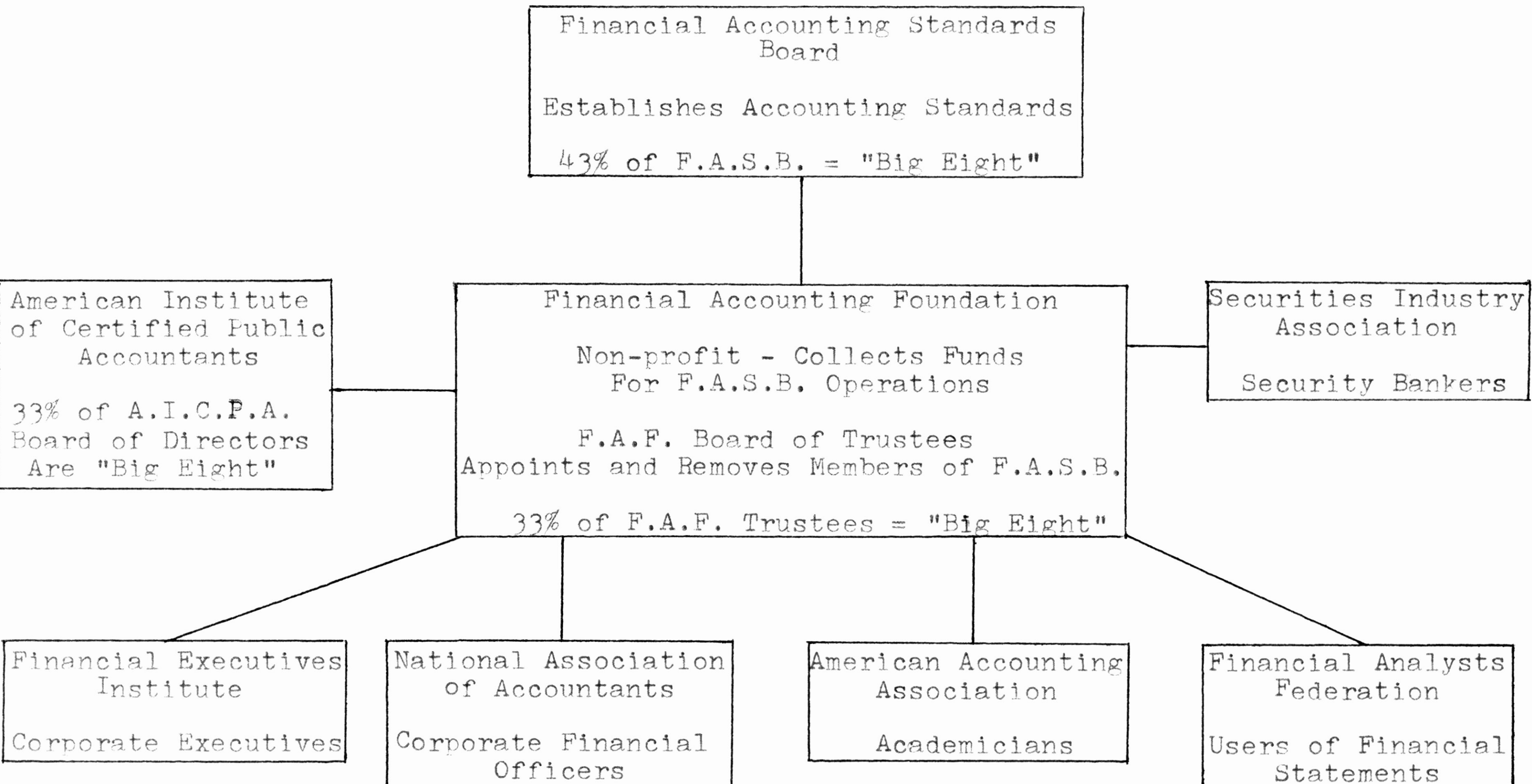

Table 3