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AUDITORS' RESPONSIBILITIES AND THE PUBLIC INTEREST

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On an early spring day in Washington some time ago, a southern Senator and a leader of the accounting profession briefly debated the issue of whether the federal government or private auditors should have primary responsibility for reviewing the financial statements of public issuers of securities. Their dialogue went like this:

> Senator. Suppose that we decide on the final passage of this bill here to employ five or six hundred auditors from your organization, that would be all right, then, would it not?
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> Accountant. I do not think that the government could employ five or six hundred independent accountants.
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> Senator. Why could they not?
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> Accountant. I do not think the type of men that are in the public practice of accountancy would leave their practice to go in the government employ.
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> Senator. Well, if it were sufficiently remunerative they would?
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> Accountant. Yes; if the government made their time worthwhile. * * * [Y]ou will have to build some more buildings in Washington to house them if you are going to do that.

Senator. Then we had better not pass this bill at all. */

The year in which this dialogue took place was 1933, between Senator Robert Reynolds, of North Carolina, and Colonel A. H. Carter, President of the New York State Society of Certified Public Accountants. The legislation in question was the Securities Act of 1933. This rather casually reached decision to rely upon independent, non-governmental auditors to serve as the watchdogs of financial information under the newly-created federal securities laws was one of the critical components of the rebuilding of public trust and confidence in our Nation's capital formation processes following the 1929 market collapse. The strength and vitality of the business sector during the past 46 years, and the important role which accountants have played in our economic system, has, I think, demonstrated Congress' wisdom in looking to the private accounting profession rather than creating a corps of federal auditors.

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*/ Hearings Before the Committee on Banking and Currency on S. 875, U. S. Senate, 73rd Cong., 1st Sess. 59 (1933).

Recently, however, in February, 1979, the U. S. Court of Appeals for the Ninth Circuit made this observation concerning the auditor's role:

> "[The Securities and Exchange Commission's] frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier with the accountant it would have caught the scent of wrong-doing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on existing securities laws." */

The court's use of the word "conscription" conjures up images of involuntary service in a difficult, dangerous campaign pressed by an insensitive sovereign. Clearly, in an era in which we are engaged in a serious re-examination of the depth of the government's involvement in private business, the notion that accountants are not the conscripts of the federal bureauracy is a satisfying one. I will not debate today either the correctness of the court's decision

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*/ Securities and Exchange Commission v. Arthur Young & Co., 590 F.2d 785, 788 (9th Cir. 1979) (emphasis in original).

or its wisdom in analogizing the Commission's view to "conscription." I do, however, believe that there is a real danger that this metaphor could be misinterpreted by the profession in a way which could do it serious damage by encouraging accountants to react in a fashion which is not consistent with public and congressional perceptions of their duties.

For that reason, I would like to share with you some thoughts about the evolving role of the independent accountant in strengthening public confidence in the integrity of financial reporting. The colloquy between Senator Reynolds and Colonel Carter is, I think, relevant to that theme. For one thing, the enactment of the federal securities laws and the demand these statutes created for a sophisticated and reliable private auditing profession are, in large measure, the genesis of the size, prestige, and economic rewards which the profession enjoys today. To put it bluntly, your franchise is based on the securities laws enacted in 1933 and 1934. Moreover, while the nature and definition of the auditor's responsibilities have changed substantially during the past four decades, the growth and development of the auditor's role can best be understood if the implications of Senator Reynold's suggestion that auditors be federal employees are kept in mind. In

certifying financial statements under the federal securities laws, the private auditor performs a kind of quasi-public function. And with that role go special responsibilities -- responsibilities which might not exist if the auditor-client relationship were purely one of private concern. To debate whether those responsibilities amount to "conscription" into the scheme of the federal securities laws would be a fruitless semantic exercise. To examine whether auditors are meeting the expectations of the users of their opinions is, on the other hand, a task in which the profession must be constantly engaged.

Legal Requirements v. Public Expectations

I want first to turn to some factors which must be evaluated in the course of such an examination. The rationale for the auditor's work -- indeed, the justification for the existence of the profession -- arises from the need for reliable financial information in order for our economy to function smoothly. Obviously, if users of financial data, who often may have little or no contact with the business in question, could not trust in its financial statements, capital formation and lending could not be carried on as they are today.

In exploring the auditor's responsibilities for the level of trust in the business community's financial reporting, the perspective of the 1930's is useful. Today, although economic and social conditions are radically different than they were in 1933, public confidence in our economic institutions, including the corporate community, has again eroded. In 1968, for example, Yankelovich, Skelly, and White found that seventy percent of the respondents in a national survey agreed that business tries to strike a fair balance between profits and the public interest. Only two years later, in 1970, that figure had dropped to one-third. It reached a low point of fifteen percent in 1976 -- an 80 percent loss of support over eight years. And, it has not recovered significantly in the years since 1976, with readings of fifteen percent again for 1977, seventeen percent in 1978, and nineteen percent in the most recent survey. If these survey results, and others like them, are an accurate reflection of confidence in our private economic system, then it is not difficult to understand why the political process frequently seems insensitive to measures which would improve the health of the private sector. And, correspondingly, if that tendency is to be changed, it will have to be through measures which increase public confidence in the integrity of business institutions.

In large measure, of course, the causes of public mistrust of our basic economic institutions are external to the business community and the accounting profession. It appears that major societal crises, such as the events of the late 60's and mid-70's, lowered confidence levels in all institutions -- including government. The Vietnam involvement, the inexorable consequences of a chronically rising rate of inflation, and the constellation of events known as Watergate, have all played a significant part in the erosion of confidence in traditional institutions. These society-wide crises do, however, have impacts on the accounting profession. For example, a prolonged period of 8 percent plus inflation has caused the meaningfulness of financial reporting based strictly on historical costs to come into question. Similarly, revelations, incident to the Watergate investigation, of corporate political and other dubious payments, both at home and abroad, have caused questions to arise concerning the accountant's role in detecting improper corporate financial transactions and bringing them to light. The result has been the intense Congressional scrutiny which the profession has experienced in the past several years.

I have no simple answers to the question of how the auditor should respond to these new pressures, nor can

you, in the final analysis, expect government to provide those answers. Indeed, in my judgment, one of the factors which serves to obscure the auditor's proper role is confusion between the level of conduct which the law demands and the level of conduct called for by changing economic conditions and by user and public expectations. Increasingly, we tend to conform our conduct to the law and ignore the latter. Yet, I believe that, at the same time that the courts are responding to the increased litigiousness of our society by drawing what may seem to be arbitrary and often inconsistent lines to define the auditor's exposure, the public and its representatives in Congress are raising their expectations of the role of the accounting profession.

The Auditor's Role

A. Enhancing Public Trust

Let me offer my perspective on the role of the auditor. The accountant and the accountant's audit are crucial to the objective of full and accurate disclosure, which is the hallmark of the federal securities laws and an indispensible prerequisite to our system of capital formation. Through his audit and certification, the accountant provides the means for independently checking and confirming the information reported by corporations. The consequences which turn on the proper discharge of that role are reflected in Judge Friendly's observation that

> "[i]n our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar." */

If the accountant cannot be expected to assure disclosure of material information when the accountant is aware of it, then the significance of the audit is greatly lessened and the public's reliance on the audit certificate may well be -- in another of Judge Friendly's phrases -- a "snare and a delusion."

That the accountant who gains knowledge of material undisclosed facts shoulders important disclosure obligations would, at first blush, seem hardly a controversial proposition. However, the Ninth Circuit's language in the Geotek case, which I quoted earlier, may have cast some doubt on it. The court's opinion appears to have interpreted the Commission's position as imposing an indefinite and undefined affirmative duty upon a public accountant to ferret out fraud and "go public" with his findings. The court concluded that it

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*/ United States v. Benjamin, 328 F.2d 854, 863 (2nd Cir.), cert. denied sub nom. Howard v. United States, 377 U.S. 953 (1964).

**/ United States v. Simon, 425 F.2d 796, 806 (2nd Cir. 1969), cert. denied, 397 U.S. 1006 (1970).

would be inappropriate for the federal government to draft accountants into this form of public service.

While I accept the court's decision that the accounting firm did not violate the securities laws, I believe that the court's rationale seriously misconstrued the Commission's view of auditors' responsibilities. Simply stated, the Commission's position is that accountants have an affirmative duty to take action consistent with their professsional obligations as independent auditors when certifying financial statements which they know contain material omissions. Rather than respond to some undefined and indefinite public service obligation, the accountants are required, under the antifraud provisions of the federal securities laws, to do what is called for by generally accepted auditing standards -- with the requirement that all material facts be disclosed and that, where the independent auditor believes that material matters are omitted from the financial statement, "the material should be included in [the independent auditor's] report and he should appropriately qualify his opinion." */

The Supreme Court's decision in Ernst & Ernst v. Hochfelder **/ may also provide a confusing signal. The Court there held, as many of you are aware, that an accountant

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*/ Statement on Auditing Standards No. 1, Section 430.02, The Third Standard of Reporting (1972).

**/ 425 U.S. 185 (1976).

would not be required to respond in monetary damages under Commission Rule 10b-5 to a third person who had relied on the results of his audit, absent a showing of scienter -- intent to defraud. The Court's message there, I believe, was primarily that it would not countenance monetary liability which seemed to be wholly disproportionate to the task the auditor had undertaken. The point is not that the auditor's duty to the users of his audit -- in that case, one of his client's customers -- is any the less. Those who disagree should study the transcript of my recent appearance before a Subcommittee of the Senate Governmental Affairs Committee at which Senator Thomas Eagleton urged the Commission to formulate a legislative response to Hochfelder and demanded to know whether any other profession is not liable for the consequences of its negligence.

Thus, the profession must be cautious in interpreting the conflicting signals concerning its role. The objective should be to ensure that the profession matches its standards of conduct to comport with changing expectations and needs of users of financial information and the pubic -- not merely to the letter of the law. Those expectations tend to change more rapidly than does the law. The signals which the legal system gives off may not correspond to emerging expectations.

But, in the long run, it is the expectations rather than the law which is more likely to prevail in order to restore harmony between the two. The gap will be closed in one of two ways -- the professional group involved will either timely and on its own initiative shape its own standards to conform or risk legislation that will ultimately compel that change -- legislation that will be less well tailored to the problem, probably more burdensome and pervasive, and likely to increase the federal presence in the field. Many of the regulatory statutes now on the books reflect this type of phenomenon. It would be unfortunate were the accounting profession to find itself the next illustration.

B. New Dimensions -- Internal Control

My comments thus far have touched on responsibilities which grow out of the role which Congress created for the accountant in enacting the basic federal securities laws. I want to touch briefly on a new dimension of the accountant's role -- one which Congress set in motion in December, 1977 with the enactment of the accounting requirements of the Foreign Corrupt Practices Act.

As most of you are undoubtedly aware, Section 102 of that Act requires, in part, that public companies maintain a system of internal accounting controls adequate to accomplish certain specific objectives relating to the protection of

corporate assets from unauthorized, improper, or unrecorded use. As the full implications of this mandate begin to be explored, the requirement has apparently become somewhat controversial. However, I find it difficult to understand how the accounting requirements would lead responsible corporations to do much beyond what good corporate practice already calls for. Controlling the business is a basic, familiar managerial goal. Obviously, it would be impossible to conduct an enterprise of any size without keeping records -- accurate records -- and without making provisions to ensure that assets are not misappropriated, and that the venture operates in accordance with management's instructions rather than each employee's individual whims. For that reason, internal accounting controls have long been recognized as constituting an important element in an effective management system, and I would urge that managements approach the Act with that in mind.

From the accountant's standpoint, the new accounting provisions may, however, mark a change in the auditor's role. The passage of the Foreign Corrupt Practices Act demonstrates that public, and thus congressional, concern over the ethics of business and the related question of the integrity of financial information are not likely to abate --

regardless of swings in attitudes toward government regulation generally. Indeed, to the extent that the public expects both less government regulation and greater discipline and assurance in the generation of business financial information, the independent auditor may find himself called upon to serve as the tool to reconcile these conflicting demands. The accounting profession, in harmony with the public's perception of its traditional role, may well be expected to expand its quasi-public functions by assuming the oversight responsibility for corporate internal controls which the Congress wants, but which -- just as in 1933 -- it is unlikely to commit to a corps of federal auditors.

By making deficient internal controls an illegal act, Congress -- regardless of any rulemaking by the Commission -- may have altered the auditor's responsibilities. Existing auditing literature -- Statement on Auditing Standards No. 17 -- outlines the response necessary in the event that the auditor is aware of a client act which appears to be illegal, and thus, as the staff of the Auditing Standards Division of the American Institute of Certified Public Accountants has noted, */ internal control weaknesses may, in certain cases,

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*/ See "Auditing Interpretations -- Internal Accounting Control and the Foreign Corrupt Practices Act," Journal of Accountancy at 130-31 (October, 1978).

require the auditor to take steps which, before the new law, would not have been necessary. For this reason, it is difficult to avoid the conclusion that some further element of "conscription" may have been accomplished implicitly by the enactment of the Foreign Corrupt Practices Act.

Conclusion

I opened my remarks by comparing Congress' consideration, in 1933, of creating federal auditors to the Ninth Circuit's recent observation that the accounting profession has never been conscripted into the enforcement arm of the SEC. I want to conclude with the thought that these two concepts are not fundamentally at odds -- the quasi-public responsibilities which the accounting profession bears are not responsibilities owed to the Commission or to any other element of government. They are a duty to the users of the profession's work, as articulated, for example, in the Financial Accounting Standards Board's conceptual framework project.

For that reason, the profession's goal must be to ensure that the standards to which it holds itself match not merely what the law requires, and not simply what government officials advocate, but also the needs and expectations of the users of financial information. In the last analysis, it is in the service of the investing public and other users of financial information to which the accounting profession has been conscripted.

Thank you.