NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

THE SEC, THE ACCOUNTING PROFESSION, AND SELF-REGULATION

Speech by

John R. Evans
Commissioner

Distinguished Speaker Series
Department of Accounting
University of Kentucky
Lexington, Kentucky
February 28, 1979

I appreciate this opportunity to participate in your Department of Accounting Distinguished Speaker Series which is intended to help you keep abreast of the major and rapid changes occurring in the accounting profession. The challenges facing accountants may well be greater than ever before and the way these challenges are met will, in great part, determine the future of the profession. As background for my remarks on the SEC and the Accounting Profession, I would like to describe briefly the nature and basic responsibilities of the Commission.

The Securities and Exchange Commission is an independent, quasi-judicial, regulatory agency in the executive branch of the government established by the Congress in 1934 to administer the federal securities laws. These laws were enacted to protect investors against misrepresentation, manipulation, and other fraudulent acts and practices in the sale and purchase of stocks, bonds and other securities by requiring full disclosure of information so that investors may evaluate the securities being offered for sale.

Within the broad framework of enforcement, adjudicative, and rule making authority granted to us by statute, the Commission has a great deal of flexibility and is fundamentally independent of the White House and political pressures from Congress. We do report, however, to House and Senate oversight committees and our budget must have approval

---

of both the oversight committees, which set an authorization limit, and the appropriation committees, which determine how much we can spend for our activities. If we misuse our power, of course, it can be restricted or withdrawn by the Congress. The federal courts also operate as a further check on the Commission because certain Commission orders and decisions are appealable to the courts by an aggrieved party.

Over the last few years, the actions of federal government regulatory agencies like the SEC have been the subject of considerable scrutiny and criticism. It is suggested that regulation is inflationary, that it discourages competition and innovation, and places unnecessary costs and burdens on business activities. A number of recent studies indicate that a majority of Americans feel that the costs of government regulation outweigh the benefits. In a nation like ours, where freedom of action by individuals and institutions is regarded so highly, it is not surprising that those who bear the burden of regulation are often critical of its effects. In many instances, such criticisms may be justified; yet, the basic function of government is to maintain an environment in which life, liberty and the pursuit of happiness can be secured and in which citizens can expect personal safety and fair treatment in their personal and business activities. These ends are sought through the enactment of laws which provide for minimum acceptable standards of behavior and these laws are administered and enforced by government agencies.

Government regulators are often portrayed by their critics as nameless, faceless bureaucrats seeking to expand their authority, jurisdiction, and influence without being accountable to the public. In my experience over the last 16 years as a Senate staff member and a member of the SEC, I have found that most members and employees of regulatory agencies are dedicated, capable, and hard-working, and serve the public at some personal and financial sacrifice. Moreover, as private citizens, consumers, and taxpayers, they also share the benefits and burdens of regulation just as other members of the public do.

I am personally pleased to see an increasing emphasis on minimizing government regulatory interference with private sector activities because in my judgment, competitive market forces often provide better, less burdensome and more efficient regulation than can be fashioned by government regulators. Nevertheless, broad brush attacks on regulation are not particularly helpful. What is needed is an open recognition that some regulation is necessary and careful analysis of the costs and benefits in making determinations as to where deregulation would be in the public interest and where additional regulation may be appropriate.

Long before deregulation became a fashionable cause, I believe the SEC provided an example of government regulation at its best by administering the securities laws in a unique way which emphasizes self-regulation by private sector organizations. We have also sought for years to remove regulatory constraints where possible, while undertaking new initiatives where required in order to fulfill the Commission's mandate to protect investors. We have been somewhat successful in removing constraints and in fostering greater competition in our securities markets, in simplifying reporting requirements for broker-dealers and in reducing the burdens of seeking capital through securities markets. However, because most of you are accountants or are preparing to enter the accounting profession, I will focus on the Commission's relationship with the accounting profession and some of our major accounting decisions to illustrate how we attempt to hold government intervention to a practicable minimum while providing relatively effective protections to investors.

By federal statute, accounting professionals are given a major, indispensible role to perform in the proper functioning of the securities laws and the SEC is given the responsibility to assure fulfillment of that role. The Securities Act of 1933 and the Securities Exchange Act of 1934 require certain financial disclosures by public companies to be "certified by an independent public or certified accountant" and presented "in such detail and such form as the Commission shall prescribe." The Commission has authority, among other things, to establish accounting requirements, to deal with evolving accounting issues, and to ensure that those who audit financial statements of public companies are independent. During its early years the Commission considered undertaking the establishment of a uniform system of accounting standards, but determined in 1938 that the primary responsibility for accounting principles should remain in the private sector with those who practice the accounting profession.

Since that time, except in those infrequent instances where we have by rule provided otherwise, we have accepted financial statements prepared in accordance with accounting principles for which there is substantial authoritative support (i.e., generally accepted accounting principles) for filing with the Commission, and have presumed financial statements prepared in accordance with principles for which there was no substantial authoritative support to be misleading. In 1973, the Commission recognized the Financial Accounting Standards Board as the standard-setting body for the profession. As stated in Accounting Series Release No. 150, the Commission presumes that the standards issued by the FASB have substantial authoritative support and those which have been considered by the FASB and rejected are presumed to have no such substantial authoritative support. My vote in 1973, and my continued strong support of this arrangement, stems from a belief that the private sector generally has the resources and the understanding to fulfill the standard-setting role more efficiently than does the government.

The Commission's willingness to rely primarily on private sector accounting standard-setting does not relieve the Commission of its responsibilities under the federal securities laws to assure that financial reporting adequately serves the needs of the investing public. Therefore, the relationship we have with the FASB is a delicate one which requires a continual dialogue and a degree of forbearance on the part of the Commission. Official Commission comments on Board proposals before final approval by the Board could have an undue influence on the final decisions and such comments or routine disagreement by the Commission with Board-approved standards could undermine and destroy the private standard-setting mechanism. However, our staff follows the Board's activities very closely and often gives its views on Board proposals, and members of the Commission meet with the Board from time to time, as we did earlier this month in Stamford, Connecticut to discuss the Board's activities and exchange views.

Looking back over the actions of the FASB since its formation six years ago, there have been only two or three times when the Commission differed with the Board. In view of the expertise of Board members and their staff, their dedication to the public interest, and the process by which the Board adopts accounting statements, I expect the Commission's support of the FASB and its decisions to continue. It should be noted, however, that on those rather infrequent occasions when the judgments of the Commission and the Board differ significantly as to what a particular accounting standard should be, our statutory responsibilities require the Commission to be prepared to specify accounting principles different from ones which are being considered or have been adopted by the FASB.

Recently, the Commission took such a step on the issue of oil and gas accounting. The Energy Policy and Conservation Act of 1975 requires the Commission to assure the development of a reliable energy data base relative to the production of crude oil and natural gas and explicitly permitted us to rely on the FASB should we deem it appropriate. The Commission deferred its consideration of the issue until the FASB had made its decision. The FASB determined that the appropriate accounting treatment was the successful efforts method which is characterized by capitalizing only the costs directly related to productive properties. The other primary accounting method, the full cost method, under which all costs incurred in finding and developing oil and gas reserves within broad cost centers are capitalized, was rejected by the Board. After hearings in Washington and Houston during which more than 50 witnesses, including representatives of the FASB, oil and gas producers, financial analysts, economists, investment bankers, commercial bankers, broker-dealers, and academic and public accountants appeared, the Commission concluded that neither of the two traditional methods provides sufficient useful information on financial position and operating results of oil and gas producers and that steps should be taken to develop a method of accounting that recognizes proved oil and gas reserves in financial statements. Our staff is now attempting, with the help of a recently appointed Advisory Committee, to develop reserve recognition accounting ("RRA").

Although most of the Commission's decision-making in this area occurred last summer, we considered a related matter just last week. The Commission's rules prohibit changes in accounting methods unless it can be demonstrated that the change is to a preferable method. The question before us was whether a company may change from successful efforts to full cost or vice versa pending development of RRA. To simplify somewhat, we determined that although a switch from any currently used method to either the standardized form of the full cost method or the standardized form of successful efforts method, which the Commission specified for use pending development of RRA, would be preferable to some other form of either of these two methods, once that election was made it would be unlikely that a registrant could sustain the burden of proving that a switch from one of the two specified methods to the other was preferable in view of the Commission's conclusion that both methods were unsatisfactory.

Another accounting matter in which the Commission and the FASB differed relates to inflation accounting. Members of the Commission have been concerned for some time that increased rates of inflation make financial statements prepared on the basis of historical cost less meaningful.

Although the FASB issued an exposure draft in 1974 which would have required financial statements to include supplemental data in which historical costs were adjusted for changes in the general price level, the Commission believed that an impetus was needed to stimulate more meaningful disclosure about current economic costs and values to investors. After considerable study and comment, in 1976 we adopted our replacement cost rule which requires certain larger companies to disclose the estimated current replacement cost of inventories and productive capacity at the end of each fiscal year for which a balance sheet is required and the approximate amount of costs of sales and depreciation based on replacement cost for the two most recent fiscal years. Our rule has provided the primary operative experiment with financial reporting which is not purely historically cost based.

As part of its conceptual framework project, the FASB has now issued another proposal to reflect the effects of changing prices on financial statements. I believe our efforts have been very useful as a necessary first step toward financial statements which more adequately reflect the impact of inflation. But, if the FASB proposal results in adoption of an appropriate accounting standard, I believe it would be advisable and would expect the Commission to either withdraw or amend our rule.

State and municipal government financial statements present another accounting standard-setting issue which is of current interest to the Commission. Although state and municipal governments which issue securities are subject to the anti-fraud provisions of the federal securities laws, they are not subject to the registration and reporting provisions. Thus, state and municipal issuers are not required to comply with specific established disclosure standards. Moreover, there is no requirement that financial statements prepared for investors be audited, or that audits be conducted by independent accountants.

The Commission recently issued a final report closing its investigation In the Matter of Transactions in the Securities of the City of New York. That investigation was prompted by the 1974 New York City fiscal crisis. The Commission determined not to pursue any enforcement actions as a result of that investigation, but we call for a legislative solution to some of the problems which our investigation disclosed. The Commission concluded that the most critical deficiency is in existing municipal accounting and financial reporting practices and our report recommends that legislation designed to standardize the methods used in the preparation of municipal accounts and the form and content of municipal financial statements be accorded the highest legislative priority.

Senator Harrison Williams is expected to introduce federal legislation in the near future to require that state and municipal governments follow standardized accounting practices in their financial statements and that such statements be independently audited. The press has reported that the authority to establish accounting standards might be assigned to a private body and the enforcement authority to an existing government entity, but it is unlikely that federal legislation would require compliance with standards or rules and regulations promulgated by a private entity without government agency oversight. In my opinion, the best form of legislation to provide for private standard-setting would follow the pattern of the existing securities laws and authorize the Commission to adopt standards while recognizing in the legislation or the legislative history the Commission's right to rely on standards promulgated by a private sector accounting standard-setting body. With SEC oversight, the recent agreement of the FASB and the National Council of Governmental Accounting to cooperate in the establishment of principles for state and municipal financial reporting could form the basis of a satisfactory solution to a major municipal securities disclosure problem with a minimum of federal government involvement.

In addition to oversight of accounting standard-setting, the Commission has oversight authority with respect to some activities of the public accounting profession itself.

Because financial statements certified by independent accountants are central to the corporate disclosure system, the Commission must assure that the attest function is meaningfully performed and that accountant independence is not compromised.

This oversight responsibility has taken on increased significance because members of Congress who oversee the Commission have suggested that neither the Commission nor the profession has been fulfilling its responsibilities adequately and that additional legislation may be necessary to resolve perceived problems. In response to these criticisms, the Commission has undertaken to report to Congress annually on the discharge of its oversight responsibilities with respect to the independence of accountants and the profession's development of a viable system of self-regulation.

The Commission has indicated that it would favor more government involvement only if self-regulatory efforts prove unsuccessful and has been firm in its support of the accounting profession's efforts to develop a meaningful self-regulatory program. Through the American Institute of Certified Public Accountants, the profession has undertaken to develop such a program by establishing an SEC Practice Section, the articulated objectives of which include:

(1) Improving the quality of Practice by CPA firms before the Commission through the establishment of practice requirements for member firms

(2) Establishing and maintaining an effective system of self-regulation of member firms through mandatory peer reviews, required maintenance of appropriate quality controls, and the imposition of sanctions for failure to meet membership requirements

(3) Enhancing the effectiveness of the Section's regulatory system through the monitoring and evaluation activities of an independent oversight board composed of public members.

The Commission is monitoring this effort very closely, and consistent with its oversight responsibilities, has identified certain issues which need to be addressed if the process is to be credible. These include access by the Commission staff to peer review work papers, incorporation within the peer review program of audit engagements even though litigation is involved or threatened, and the need to include offices outside the U.S. in the peer review.

With respect to independence, the Commission has actively encouraged corporations to establish audit committees, composed of directors unaffiliated with management, to whom auditors can report. Pursuant to our suggestion, the New York Stock Exchange has adopted a rule requiring listed companies to have audit committees. Almost 70 percent of all companies whose securities are traded on the National Association of Securities Dealers Automated Quotation System also have audit committees. In addition, the Commission has required that reporting companies disclose whether or not they have audit committees, what the duties of such committees are, and the relationship, if any, of the members of such committees to management. As the Commission stated last July in its first report to Congress:

> The formation by public companies of audit committees composed of independent directors is one of the keys to strengthening auditor independence. In companies where the auditors report to an independent audit committee, a potentially important buffer is provided to insulate accountants from inordinate management pressures and to strengthen the auditor in his relationship with management--and hence his independence.

The Commission is also addressing the question of whether the performance by accounting firms of services for their clients in addition to the audit function potentially compromises the accounting firm's independence with respect to the audit. In 1977, the Senate Subcommittee on Reports, Accounting and Management recommended that independent auditors should not perform nonaccounting management advisory services such as executive recruitment and marketing analyses because such services are incompatible with the audit responsibility. The Commission has deferred consideration of whether it should prohibit management advisory services in order to provide the AICPA's Public Oversight Board with an opportunity to consider the issue and make recommendations. We have, however, adopted requirements that publicly held companies disclose such services, the percentage relationship which the non-audit fees bear to the audit fees and whether the provision of these additional services has been approved by the board of directors or the audit committee. Thus, pending issuance of the report of the Public Oversight Board, which is expected next month, and any further Commission consideration in light of this report, investors will be provided with information which will permit them to form their own judgment as to possible conflicts of interest which independent accountants may have.

It may be evident from my remarks thus far that despite a strong Commission preference for self-regulation and maximum private sector responsibility, the Commission uses its authority to address accounting problems directly when necessary. As Judge Friendly stated many years ago:

> In 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 crow-bar.

When, in the context of the corporate disclosure system, accountants engage in conduct which operates as a fraud or deceit or when accountants make untrue statements of material facts, they violate the securities laws and the Commission responds with direct enforcement actions. Our primary enforcement tool is the civil injunctive action pursuant to which we may ask a federal court to enjoin an accounting firm or practitioner from violating or aiding and abetting violations of the securities laws.

The Commission may also bring administrative proceedings with notice and an opportunity for hearing before an administrative law judge pursuant to Rule 2(e) of the

Commission's Rules of Practice. This rule provides that the Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it to those found not to possess the requisite qualifications to represent others, to be lacking in character or integrity or to have engaged in unethical or improper professional conduct or to have willfully violated or willfully aided and abetted violations of the federal securities laws or the Commission's rules and regulations.

Rule 2(e) is intended to assure that those who represent others before the Commission operate in accordance with appropriate ethical and professional standards and that the Commission may rely on such professionals to maintain the integrity of the Commission's administrative processes. As the Commission has stated:

> The Commission and its staff do not and cannot investigate representations made to it, but must be able to rely on their completeness if this process is to work. The objectives of the securities laws can only be achieved when those professionals who practice before the Commission, both lawyers and accountants, act in a manner consistent with their responsibilities. Professionals involved in the disclosure process are in a very real sense representatives of the investing public served by the Commission, and, as a result, their dealings with the Commission and its staff must be permeated with candor and full disclosure. It cannot resemble an adversary relationship more appropriate to litigants in court, because the Commission is not an adverse party in this context.

In addition, the Commission may issue a report of investigation pursuant to Section 21(a) of the Securities Exchange Act which authorizes the Commission to conduct investigations of violations of the securities laws and, assuming due process safeguards are complied with, to "publish information" concerning such violations. Although we have used this publication authority sparingly, it does provide a mechanism by which the Commission can, in the context of a specific factual situation, present its views on issues or conduct significant to those who are regulated by the Commission, those who practice before the Commission, reporting companies, or the public at large. This can have the salutary effect of improving industry or professional standards in those cases where the Commission does not believe an injunctive action or an administrative proceeding is necessary or appropriate.

The Commission and its staff also act directly in interpretive and rule making contexts. With regard to the former, our staff assists publicly held companies and their accountants to resolve difficult accounting questions through meetings, staff accounting bulletins, and interpretative releases and letters. For example, the staff is presently considering recommending that the Commission issue an interpretive release urging companies to exert greater efforts to assure that their financial news releases, particularly those containing earnings figures, are more informative and useful to investors.

A current example of Commission rule making relates to the Foreign Corrupt Practices Act which was signed into law on December 19, 1977. This statute is intended, in part, to address the problem of undisclosed questionable or illegal corporate payments, both domestic and foreign, which the Commission believes represent "a serious breach in the system of corporate disclosure" and threaten "public confidence in the integrity of the system of capital formation, which rests on a foundation of full and fair disclosure of corporate business and financial transactions." The Act amends the Securities Exchange Act to require publicly held companies to keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and to maintain a system of internal controls sufficient to provide reasonable assurance that, among other things, transactions are executed in accordance with management's authorization, accountability for assets is maintained, and financial statements conform with generally accepted accounting principles. According to the Senate Report on the bill, these accounting provisions are intended to strengthen the audit process and improve the accuracy of corporate books and records.

Pursuant in part to its rule making authority with respect to this new provision of the Act, earlier this month the Commission adopted two new rules. The first prohibits any person from falsifying or causing to be falsified any book, record or account which reflects the transactions and disposition of the assets of an issuer. The second rule prohibits officers and directors of an issuer from making false, misleading or incomplete statements to any accountant in connection with an audit or examination of the issuer's financial statements or the preparation of required reports. I believe these two rules will discourage the kinds of false and misleading disclosures which gave rise to the Foreign Corrupt Practices Act, thereby helping to assure that reported financial information is reasonably accurate and complete.

In order to assist in the implementation of the statutory provision that companies devise and maintain a system of internal controls, our staff is also considering whether to recommend that the Commission propose for public comment a requirement that management report on internal accounting controls in certain filings with the Commission and in the annual report to shareholders. My initial reaction is that such a report could assist investors in evaluating management's stewardship of corporate assets and the reliability of reported financial information.

The Commission's relationship with the accounting profession is a good example of our unique approach to regulation. By emphasizing self-regulation and maximum private sector responsibility, participation and initiative, the Commission has been able to enhance the effectiveness of our relatively small staff and budget resources to fulfill our statutory obligation to protect investors with minimal governmental regulatory burdens. Perhaps this is one of the reasons why the SEC is considered by many to be the best regulatory agency in Washington.