Barbara J. Gard
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RECENT GOVERNMENTAL INVESTIGATIONS OF THE
ACCOUNTING ESTABLISHMENT AND THEIR
EFFECTS ON THE PUBLIC ACCOUNTING PROFESSION
In the highly competitive world of business where ethics and morality often fall by the wayside, the public accounting profession has for many years endeavored to conduct its activities with objectivity, independence, and integrity. Indeed, members of the profession are quite conscious of their responsibility in maintaining the trust and respect of those persons and entities with whom they are associated, whether it be directly or indirectly.

During the past few years, however, public accountants have been inundated by a barrage of criticism directed against the very nature of the profession itself. Not only has its integrity been questioned, but many critics have suggested (quite strongly, I might add) that the public interest could much better be served by removing control of the profession from the private sector. Needless to say, accountants view these allegations with great consternation and concern.

It is the object of this paper to examine this controversial issue in greater detail. Attention will be focused upon the major sources of these damaging comments and observations, the accounting profession's reaction to the outcry, and important developments within the profession and external to it which have been initiated to resolve the problem.

**Congressional Subcommittee Reports**

In the past it was generally assumed that the public accounting profession had satisfactorily lived up to society's expectations in terms of fulfilling its established role in the business community. During the early and mid-1970's,
however, prominent members of Congress grew increasingly upset by what they viewed as a lack of commitment on the part of the accounting profession. Unfortunately, it cannot be denied that there have been serious problems in business and accounting practice in recent years.

As evidence of this fact, one need only look back to the 1960's when numerous cases of fraud and bankruptcy were made known to a previously unsuspecting and justifiably irate public. Investors' confidence in public accountants was profoundly shaken by such incidents as those involving Penn Central, Equity Funding, and Stirling Homex.\(^1\) Also of concern to legislators was the profession's apparent inability to discover and expose questionable or illegal corporate payments (that failure, in part, leading to the enactment of the Foreign Corrupt Practices Act in 1977). In addition, there seemed to exist a confusing diversity of accounting practices in the oil and gas industry, resulting in a substantial lack of uniformity and comparability among the various companies.\(^2\)

This combination of factors prompted the United States House of Representatives and the United States Senate to initiate separate investigations of the accounting profession. The results of these investigations were released in September of 1976 and January of 1977, respectively.

The first report, 700 pages in length, was entitled \textit{Federal Regulation and Regulatory Reform}. This particular


\(^2\)Ibid.
study was conducted by the House of Representatives Subcom-
mittee on Oversight and Investigations of the Committee on
Interstate and Foreign Commerce, chaired by Representative
John Moss.3 It had a number of unfavorable comments to make
about the accounting profession; Moss considered introducing
legislation that would create an association of accounting
firms similar in structure to the National Association of
Securities Dealers.4

The criticisms contained in the Moss Report were enlarged
upon and added to in the next report of major impact, entitled
The Accounting Establishment: A Staff Study. The findings of
this study were released to public scrutiny by the Senate Sub-
committee on Reports, Accounting, and Management of the Com-
mittee on Government Operations, or as it is more commonly
known, the Metcalf Committee.5

This lengthy report (1,760 pages) caused quite a furor
among politicians, businessmen, and accountants alike. The
conclusions and recommendations it presented for consideration
certainly did not place the accounting profession in a favor-
able light. In fact, its harsh statements made the Moss
Report seem quite mild in comparison.

The findings of the Metcalf Report are summarized as
follows: Because accounting issues frequently have great

3John J. Willingham and D. R. Carmichael, Auditing Concepts

4Michael N. Chetkovich, "The Accounting Profession Responds
to the Challenge by Government," Vital Speeches of the Day,

impact on economic and social issues, the subcommittee believed it essential that Congress take certain steps to safeguard the public interest. Serious abuses in the past had shown that accountants themselves were incapable of carrying out this responsibility. The report further stated that this failure was due in large part to the complex inter-relationships within the accounting establishment, which it defined as the "Big Eight" public accounting firms, the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, and the Securities and Exchange Commission.

According to Senator Lee Metcalf's findings, the largest accounting firms in the United States tend to overwhelm the smaller firms, and thus they dominate the activities and membership of the AICPA, and through it, the FASB. Metcalf alleges that these same "Big Eight" firms have seriously compromised their professional independence by becoming increasingly involved in the business affairs and activities of their corporate clients. These clients represent a very large percentage (approximately 85 percent in 1976) of the corporations listed on the New York Stock Exchange and the American Stock Exchange. Therefore, the FASB, which has served as the principle rule-making body of the accounting profession since its establishment in 1973, actually functions only to satisfy the self-serving interests of the "Big Eight" firms and their influential clients.

6"The Accounting Establishment: A Staff Study (Summary of)," Journal of Accountancy, March 1977, p. 112.

7Ibid, p.113.
The subcommittee's condemnation also extended to the Securities and Exchange Commission; it viewed this federal organization as having played a large part in the accounting profession's downfall. In enacting the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress empowered the then newly created SEC to require publicly owned corporations to present financial information in a manner that fairly and accurately represents the results of corporate activities.8

The SEC soon decided, however, that it would not exercise its authority to establish accounting standards. Instead, this power was delegated to the private sector, in whose hands it has remained throughout the ensuing years. The Metcalf Committee regarded this action by the SEC as a serious breach of responsibility, for in effect, it violates the intent of Congress as expressed in the aforementioned statutes.

In view of these many deficiencies, the Metcalf Committee felt it necessary to recommend that the federal government assume the responsibility for establishing and enforcing accounting and auditing standards in order that the public interest might be better protected.9 Senator Metcalf further suggested that either the General Accounting Office or a new federal agency similar to the Cost Accounting Standards Board could handle this responsibility quite well. He pointed out that although the SEC would be the logical agency to undertake this assignment, its past record did not indicate that it

8Ibid, p. 117.

9Ibid, p. 119.
could do so in a capable manner.\textsuperscript{10}

\textbf{Reactions of the Accounting Profession}

The results of this study were definitely not well received by the public accounting profession, whose members reacted quite strongly to the sweeping accusations contained in the report. They charged that many of Senator Metcalf's statements were based largely on the opinions of Abraham J. Briloff, an accounting professor at the City University of New York and widely known for his criticisms of the accounting profession.\textsuperscript{11} They asserted that the subcommittee's recommendations relied in large part on one individual's biased judgments.

Members of the accounting profession, representing both large and small CPA firms, presented their arguments in rebuttal of the Metcalf Report's conclusions at public hearings held during the months following the study's publication. Some of the major arguments are as follows:

The Senate subcommittee's report stated that federal agencies could develop accounting standards "more efficiently than private organizations." Accountants replied with the question, "What evidence or empirical data supports this assertion?" It was (and is) their contention that exactly the opposite is true. One need only review the record of past government projects to ascertain that federal organizations lack the flexibility and technical expertise to function in

\textsuperscript{10}"The CPAs Get Another Lashing," \textit{Business Week}, 31 January 1977, p. 76.

\textsuperscript{11}Ibid.
this area. Governmental involvement in the standard-setting process would only serve to complicate what is already a complex and time-consuming activity. In addition, if the government assumed responsibility for this function, it would also have to assume the associated expense—meaning, of course, that taxpayers would find themselves burdened with added costs.

Many advocates of Senator Metcalf's proposal believe that auditing and accounting standards developed by a federal agency would inherently be of higher quality than those developed by the private sector. This implies that past abuses in the accounting profession have been due to inadequacies or deficiencies in the existing standards. It is generally true, however, that most audit failures stem from auditors who have either neglected to apply the established rules or did not apply them correctly. Many of the abuses are the result of clever managerial maneuverings to circumvent auditing procedures.

One of the major allegations contained in the Metcalf Report was that the accounting profession had severely compromised its independence, both in fact and in appearance. In consequence of this loss of objectivity, certified public accountancy can no longer be trusted to act as guardian of the public interest. Public accountants responded to this criticism by stating that politicizing the standard-setting process


13 Ibid.

14 "CPAs Suggest the Watchdogs They Want," Business Week, 23 May 1977, p. 96.
would definitely not improve the situation. In fact, government control of the process would make it even more vulnerable to pressures applied by special interest groups.15

CPAs assert that the accounting profession can remain alert and responsive to society's needs only if it also remains separate and distinct from the government sector. The profession cannot function effectively otherwise. They cite the experience of England's accounting industry as an example of what can happen when this segregation of the private and public sectors no longer exists. Shortly after World War II, the national government and the accounting profession were "integrated." The two now function as a partnership in the world of business. The English find that this situation has produced indistinct areas of authority and responsibility. "The government no longer can perform an oversight role in relation to business because government and business are increasingly the same. Government no longer can exert pressure to solve the problem; it is the problem."16

Final Conclusions of the Metcalf Committee

After hearing the opinions of numerous representatives of the accounting profession and the Securities and Exchange Commission (the latter having entered the conflict in support of the former), the Metcalf Committee was apparently convinced that the above arguments contained some degree of merit. In

15Biegler, p. 348.

any event, the final report issued by the subcommittee modified its original proposals of January, 1977, to a considerable extent. This report recommended that private sector agencies be given another opportunity to prove the accounting profession capable of responsible and effective self-regulation. However, it stated that certain steps are necessary to insure that the individual auditing firm's professionalism and independence are beyond reproach. It suggested that one such step would be to strengthen the role of the audit committee in the attest function.\textsuperscript{17}

Another proposal included in these recommendations favored the establishment of a self-regulatory body similar in purpose to the New York Stock Exchange, and possessing the disciplinary powers necessary to oversee the activities of CPA firms which audit public corporations.

The Securities and Exchange Commission, as well as the public accounting profession, was given an opportunity to redeem itself. In its final report, the Metcalf Committee assigned the SEC the responsibility of monitoring the profession's progress; since that time, chairman Harold M. Williams has made annual reports to Congress concerning the private sector's efforts.\textsuperscript{18}

\textbf{Federal Trade Commission Investigation}

During this same period of time, the public accounting profession was also the object of an investigation conducted by


\textsuperscript{18}"Late Developments," \textit{Journal of Accountancy}, December 1977, p. 3.
the Federal Trade Commission. This investigation focused on three major issues, all of which were primarily concerned with potential antitrust violations.

First of all, the FTC explored the possibility that the state boards of accountancy might be using the Uniform CPA Examination to restrict the number of persons entering the profession, thereby restricting competition. Secondly, the FTC feared that competition was being limited by excessive concentration within the profession in terms of the power and influence wielded by the "Big Eight" firms. And lastly, the ethical restrictions placed on solicitation and advertising were viewed as possible violations of the antitrust laws. The AICPA has already modified the solicitation and advertising rules as a result of pressure applied by the Justice Department.19

Changes and Developments in the Accounting Profession

Although these government studies and/or investigations have had adverse effects on the accounting profession's public image, many accountants believe that the criticism has not been totally unhealthy. Indeed, the resulting conflict and tension might be considered creative, for it has forced the profession to focus on opportunities for improvement.

During the past three years, the private sector has made great strides toward proving itself capable of responsible self-regulation. Foremost among its major reforms was the establishment of a new Division of Firms within the structure of the American Institute of Certified Public Accountants.

The Division's two sections are known as the SEC Practice Section and the Private Companies Practice Section. Membership in either or both is on a voluntary basis. Membership in the former is open to all firms whose clients are registered with the Securities and Exchange Commission, while the Private Companies Practice Section is for those firms auditing privately owned clients.20

As an aside, it is interesting to note that many of the smaller and medium-sized firms protested the creation of this Division. They initiated a lawsuit against the AICPA on the grounds that the new Division did not conform to the Institute's By-Laws.21 In reality, these firms feared that the establishment of two separate sections would increase the power and influence of larger firms while decreasing that of the smaller. Their attempt to nullify the AICPA's action was not successful, and the Division of Firms functions as planned.

This Division of Firms was formed in order to provide a medium through which the professional conduct of public accounting firms and their individual members can be regulated. The two Sections' objectives are similar: Both intend to improve the quality of services provided by CPA firms to their clients by establishing strict requirements for member firms. In pursuit of this goal, each Section has its own procedures for disciplinary action and peer review of auditing


21 "The CPAs are Trying to Outtrace Congress," Business Week, 26 September 1977, p. 59.
practices. In addition, they hope to increase the input of individual firms (particularly the smaller firms) in the establishment of technical standards.22

Much attention has been focused on the SEC Practice Section, primarily because the corporate clients represented by its membership are those that Congress has been most concerned about in terms of potential business and accounting abuses. To qualify for membership in this Section, the CPA firm must meet several requirements. It must: 1) Undergo a peer review (an independent review of that firm's quality controls over its audit practice and procedures) at least once every three years, 2) Provide at least forty hours of mandatory continuing education for all levels of its professional staff each year, 3) Rotate the partner in charge of the audit for each client at least once every five years, 4) Carry certain minimum amounts of liability insurance, and 5) Comply with various other measures designed to safeguard the firm's independence and maintain high standards of practice.23

To assure the public that the SEC Practice Section is meeting its objectives, the AICPA has established the Public Oversight Board, all of whose members are non-accountants.24 Described as the accounting profession's new watchdog, the Public Oversight Board has been assigned the responsibility of monitoring and evaluating the activities of the SEC Practice


23 Chetkovich, p. 596.

24 Ibid.
Section's various programs. In addition, it has at times assumed the role of mediator in conflicts between the Securities and Exchange Commission and the SEC Practice Section.25

As was mentioned earlier, the AICPA has modified its sanctions on advertising and solicitation. Theoretically, this change will provide clients (and potential clients) with greater information about the services offered by CPA firms, thus enabling them to better evaluate the firms in question.

The Metcalf Committee specifically endorsed the increased usage of the audit committee in the auditing process. Under ideal circumstances, the duties of such a committee would include nominating and terminating the independent auditors, reviewing the scope and results of the examination with the auditing firm, recommending changes in accounting policies in light of the examination's results, and examining the corporation's system of internal controls.

As this list indicates, the audit committee functions primarily in an oversight and advisory role. It serves as a valuable channel of communication between management and the external auditors, in that management is likely to be more objective and cooperative when dealing with "outside directors."26

Although both the Securities and Exchange Commission and the AICPA's Commission on Auditors' Responsibilities (the Cohen Commission) have endorsed the usage of audit committees, the Institute stated in February of 1979 that it does not feel their usage should be required. The AICPA explained its position 25"News Features," Journal of Accountancy, March 1979, p. 73. 26Vanetta, p. 356.
by asserting that audit committees are "not necessary either for the maintenance of auditor independence or for performance of an audit in accordance with generally accepted auditing standards." The AICPA does, however, support their usage on a voluntary basis, and recommends that publicly owned corporations establish audit committees composed of outside directors.

Acting upon the recommendations of a special committee appointed to examine the structure of the Auditing Standards Executive Committee, the Institute has reduced the size of the Committee from twenty-one to fifteen members. It believes this modification will result in more effective and timely standards. The Institute rejected an earlier proposal of the Cohen Commission that called for the establishment of a full-time, paid board to take over the standard-setting process. The latter suggestion was not adopted because the AICPA feared a sense of alienation would develop between such a body and the accounting profession.

Determined to demonstrate that the accounting profession is quite capable of correcting deficiencies and solving problems without governmental intervention, the AICPA has appointed a number of special committees such as that described above. These committees have been established for a variety of purposes—to improve the form of the auditor's report, to analyze and make more effective the procedures for detecting management fraud, and to set appropriate standards governing situations


where the client's financial statements are not audited. 29

One such special committee was formed to develop better criteria for evaluating corporate internal control systems. Known as the Minihan Committee, this body concluded that any evaluation of a client's internal accounting controls must be preceded by an evaluation of the control environment. 30 This environment includes factors such as the organizational structure, personnel, EDP, and the manner in which authority is delegated. Following the audit examination, any material weaknesses detected in the internal control system must be reported by the auditor to the client's audit committee or the board of directors.31

The SEC's Involvement

The Securities and Exchange Commission has played an active role in the accounting profession's reform movement. Described by John C. Burton of Columbia University as a "creative irritant," the SEC has (to say the very least) been a very attentive observer of the private sector's progress during the past three years.

In the wake of Watergate, literally hundreds of American corporations were discovered to have made questionable or illegal payments not previously detected during the course of the audit engagement. As a direct result, the Foreign Corrupt Payment Act.

29 Chetkovich, p. 597.


Practices Act was passed by Congress in December of 1977. This legislation puts internal accounting controls under the jurisdiction of the federal government, so to speak. In effect, it increases the accountability of corporate management.32

The public accounting profession has been made keenly aware of its added responsibilities resulting from the passage of the Foreign Corrupt Practices Act. Early in 1979, the SEC proposed a new rule requiring publicly owned companies to give fairly detailed information about their systems of internal accounting control. This two-part program provided:

1) For fiscal years ending between December 16, 1979, and December 15, 1980, corporate management would be required to state whether the existing system provided "reasonable assurance" that the objectives of internal accounting control were being achieved. In addition, management would also be required to disclose any material weaknesses uncorrected at year-end that had been brought to its attention by the independent auditor.

2) For fiscal years ending after December 16, 1980, management would be required to report the same information for the entire fiscal year rather than only at year-end. It was with the implementation of the second step that the CPA firm was scheduled to assume a more active role; the SEC planned to require the external auditor to express two separate opinions. First, the auditor would be required to state whether or not management's representations were reasonable in view of the corporation's own evaluation of the system. Second, the auditor

32Ibid, p. 56.
would be required to examine the system and express his opinion as to whether or not it provided reasonable assurance that internal accounting control objectives were being met.\textsuperscript{33}

The Securities and Exchange Commission has delayed implementing this rule due to receiving so many adverse letters of comment. Many of those who objected stated that the added costs associated with this program would undoubtedly outweigh the resulting benefits. In February of 1980, the SEC stated that if the rule ever were adopted, it would most probably be quite different in its final form from the original proposal.\textsuperscript{34}

Since the Metcalf Committee concluded the public hearings in 1977, the Securities and Exchange Commission has made two annual progress reports to Congress. The latest report, dated June, 1979, indicated that the SEC chairman, Harold M. Williams, was not completely satisfied with the accounting profession's attempts at improved self-regulation. It was his belief, however, that no legislation was yet necessary at that time. He stated, "Progress has been sufficient to merit continued opportunity for the profession to pursue its efforts at self-regulation."\textsuperscript{35}

The SEC remains concerned by the private sector's lack of progress in certain areas. For instance, management advisory services is an issue of continuing controversy between the AICPA and the SEC. The latter organization warned auditors

and their clients in June of 1979 that the performance of some management advisory services represents a potential threat to the auditor's independence. The AICPA, however, cites reports issued by the Cohen Commission and the Public Oversight Board in support of its own assertion that the performance of management advisory services is not inherently damaging to the auditor's objectivity. On the contrary, there are many benefits to be realized by allowing CPA firms to venture into this area. In conducting the audit examination, the auditor has a unique opportunity to become familiar with many facets of a client's affairs. According to the Institute, it is much more efficient and economical for the corporate client to utilize the auditor's knowledge and skill than it would be to retain the services of yet another consultant. It is essential that the CPA firm exercise careful judgment before actually associating with a client on this basis.

The SEC is also dissatisfied with the level of membership in the SEC Practice Section of the AICPA Division of Firms. At the time of the Commission's last report to Congress, less than half of all CPA firms having at least one SEC-registered client had not yet become members of the Section in question. Walter E. Hanson, chairman of the executive committee of the SEC Practice Section, asserted that this is not as serious a deficiency as it first appears. He noted that approximately 99 percent and 93 percent, respectively, of the companies listed on the New York Stock Exchange and the American Stock Exchange

37Ibid.
are audited by members of the SEC Practice Section. The SEC remains unimpressed by this fact, and desires to see further improvement.38

Another item of concern to the Commission is the current advisory status of the Public Oversight Board. The SEC feels that the Board should take a more active role in providing leadership to the accounting profession. If the private sector is to succeed in its self-regulatory efforts, some agency or body within the sector must objectively guide the profession toward its goals; the SEC believes that the Public Oversight Board is the logical body to do so.39

In addition to the abovementioned items, the Securities and Exchange Commission is critical of certain aspects of the SEC Practice Section's peer review process. Not only does the reviewed firm have the ability to exclude certain engagements from review (such as those in litigation), but perhaps what is most exasperating to the SEC staff is its lack of access to the peer review work papers. SEC chairman Harold M. Williams believes these deficiencies detract from the evaluation process' objectivity, both in fact and in appearance.40

**Outlook for the Accounting Profession**

It is obvious from the many events and accomplishments of the past few years that the public accounting profession has a hectic future in store. Relationships already complex in


40Ibid.
nature, such as that between the accounting profession and the Securities and Exchange Commission, are swiftly becoming even more so. Although the private sector has indeed made substantial strides, even more progress is necessary to convince Congress that governmental intervention in the standard-setting process is not warranted. At this point, prospects for the future seem fairly hopeful; needless to say, developments within the next few years should prove to be very interesting.
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