

PUBLIC ACCOUNTABILITY UNDER SECURITIES LAWS

BY SAMUEL A. DERIEUX*

The nature of responsibility of professionals is continually changing. The rate of evolution is sometimes slow, but often accelerates as a result of some spectacular or dramatic event. Such traumatic events are usually the culmination of a series of excesses of one type or another. Excesses may be the result of deliberate fraud, recklessness or naivety. But whatever the cause, the result is almost always some degree of reform to attempt to assure that the event will not recur.

Excesses resulting from the misuse of financial power led to the anti-trust laws. The recurring monetary crises which gave us the Federal Reserve System was caused largely by structural flaws of an uncoordinated banking system. A financially reckless public in the late 1920's and the depression of the early 1930's gave us the Securities Acts which became the charter of the Securities and Exchange Commission.

The federal securities laws, or similar acts, would probably have come about in any event, but unquestionably the severity of the stock market crash and the depression influenced the nature of their provisions and the timing of their passage. Perhaps the first scandal widely publicized involving a possible failure by auditors was the *McKesson & Robbins* case.¹ It came to light that this large company was being run by a convicted swindler and his brothers and that one fifth of the assets shown by the audited balance sheet were fictitious. Following this disclosure, the American Institute of Certified Public Accountants [AICPA] adopted extended auditing procedures which previously had not generally been considered necessary.² In more recent times the great salad oil swindle,³ although not involving audited financial statements, did cause a review of auditing procedures and some revision of those procedures.⁴

We are now involved in what appears to be a new crisis of public confidence. The Watergate Affair and the excesses which it demonstrates will almost certainly result in some type of reform of our election laws. But the crisis of confidence is not limited to political affairs or to any

* Chairman, American Institute of Certified Public Accountants. This article is based upon an Address by Chairman Derieux at the Securities Regulation Institute, San Diego, California, on January 18, 1974.

¹ See SEC Accounting Series Release No. 19 (Dec. 5, 1940).

² COMMITTEE ON AUDITING PROCEDURE, STATEMENTS ON AUDITING PROCEDURE NO. 1 (1939).

³ NORMAN C. MILLER, THE GREAT SALAD OIL SWINDLE (1965).

⁴ AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, COMMITTEE ON AUDITING PROCEDURE, STATEMENTS ON AUDITING PROCEDURE NO. 37 (1966).

other segment of our society. The fact that financial pages of various financial publications and daily papers record names such as *BarChris*, *Continental Vending*, *Four Seasons*, *National Student Marketing*, *Westec*, *Yale-Express* and *Equity Funding* is an indication that financial reporting is vulnerable to attack and that those professionals concerned with financial reporting have an obligation to work toward ever increasing confidence in financial reports.

Early in this century, financial reports of corporations were distributed to a small group which was usually very close to the enterprise and had easy access to whatever information it might need. Prior to 1929, few companies published any figure for operations other than net income for the year, and many corporate managements were outraged when the SEC first required additional income and expense information to be disclosed. In 1929 the AICPA recommended not only that some detail of operations be furnished but also that such statements be in comparative form.⁵ In 1933, a new form of audit report was adopted which called for an opinion that the financial statements be presented "in accordance with accepted principles of accounting consistently maintained by the company during the year under review."⁶ Six years later, this was revised to read "applied on a basis consistent with that of the preceding year."⁷ The emphasis was still on comparing the progress of an enterprise with its own past results rather than with other companies in the same industry or with other potential investments as is the case today.

The prosperity of the post-World War II period initiated a public interest in the stock market that lasted through the 1960's and 1970's although it may seem dormant at present. These new investors do not generally feel a loyalty to any one corporation. They switch investments frequently and have sufficient assets to diversify. Virtually every citizen is in one way or another dependent on the securities market. If he owns no stock himself, his insurance program or his retirement program is almost certainly partially dependent upon securities.

To meet these diverse investment goals there is a need to compare financial statements of a particular company not only with statements of prior years but also with statements of other enterprises and even with other forms of investment opportunity. In order to make valid comparisons, and valid economic decisions, it is necessary that the investor, or

⁵ AMERICAN INSTITUTE OF ACCOUNTANTS, VERIFICATION OF FINANCIAL STATEMENTS (1929).

⁶ *Audits of Corporate Accounts*, Correspondence between the Special Committee on Cooperation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange, 1932-1934 (1934).

⁷ See Note 2 above.

his advisors, have confidence in the reliability of the financial statements. Even though financial statements are the primary responsibility of management, their final form and content are influenced by outside professional advisors. We are considering the roles which attorneys at law and certified public accountants have in serving their clients and in relation to third parties who might rely on financial disclosures made by the clients.

The two basic roles of both professions are those of advocacy and attestation. Advocacy has, of course, been the principal role in which attorneys have served their clients. However, in the role of advocate, an attorney is expected not to compromise his own integrity in representing his client and must remain within the constraints of his profession. CPA's also frequently act as advocates for their clients, particularly in the tax field, and also in other situations involving questions of an accounting nature.

It is not only in the field of securities regulation that attorneys are asked to attest to information while at the same time acting as advocate. Various kinds of tax returns and protests filed with the Internal Revenue Service require a statement to the effect that the facts contained therein are correct to the best of the knowledge and belief of the individual who prepared them. Thus it can be seen that the two professions serve in various capacities which involve the roles of both advocate and attester.

Although the assumption of both roles by one person or one firm raises problems, I do not imply that the two roles would always be in conflict with one another. Nor do I mean to imply that either role is necessarily contrary to the public interest. In fact, there are circumstances under which the public interest is best served by a vigorous advocacy of the client's interest. However, we must always remember that our reliance on advocacy is based on the premise that the other side of the argument is represented by an equally capable advocate. Much of the recent criticism of criminal law is based on a claim that where the defendant is poor, his advocate is generally less able than the advocate of the State; and that where the defendant is rich, the State is less well represented. A professional involved in securities law must therefore consider whether the public investor is being adequately represented. In situations where he is not so represented, an ethical professional must take care not to overreach.

Thus it is not only where advocacy and attestation overlap that the professional has a continuing need to consider his responsibilities. Whenever a professional is associated with financial statements, or is giv-

ing advice to his client concerning such statements, he must consider whether the role involved is advocate or attestor, and if the former, what sort of advocacy will represent those who read such statements. It is for the protection of the general public that constraints are placed on professionals so that their actions and their advice to clients will not impair the public interest.

Others have given attention to the difficulties encountered by the legal and accounting professions in dealing with one another in connection with financial statement disclosures. Perhaps we can better understand these difficulties if we realize that they are not so much conflicts between our two professions as they are conflicts between the roles of advocacy and attestation. Such conflicts may arise within either profession or between the professions. For example, public disclosure of an evaluation of the outcome of litigation may very well have an effect on negotiations for a settlement, and disclosure of some practices of a client company may cause that client to incur liability when none might have been incurred in the absence of such a disclosure. There is also the possibility that disclosure of the nature of a potential tax liability might cause the issue to be raised.

The accounting profession has long recognized that the attesting function requires that the independent accountants be, and appear to be, independent of the client. In reporting on financial statements he must not appear in a dual capacity with respect to those financial statements. Therefore, ownership of stock in the registrant and other relationships that might impair his independence have been prohibited.⁸ More recently, it has been made clear that a dually qualified professional may not serve as independent accountant and as general counsel for a company because of the appearance of an inherent conflict in those roles.⁹

In searching for a resolution of these problems, I can add very little to the discussion except to affirm my belief that one thing which is needed is a better understanding on the part of both attorneys and accountants of the responsibilities imposed on the other profession. The members of each profession must be careful not to undermine the efforts of the other. It is easy to agree with a client who is complaining about inhibiting advice given to him by someone else. However, through an understanding of one another's responsibilities, our professions can be supportive of each other in our attempts to convince clients that they can achieve their legitimate objectives in ways that will not conflict with the public interest.

⁸ AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL ETHICS (1974).

⁹ SEC Accounting Series Release No. 126 (July 5, 1972).

Speaking earlier, Commissioner Sommer¹⁰ stated that to make sound investment decisions users of data must be able to have confidence that the numbers reflect the reality and that the accounting profession must persuade society that it provides significant assurance of reliability in financial representations. This is unquestionably the primary responsibility of the accounting profession.

In every profession there are no doubt some individuals who are not aware of the nature of their responsibilities, and it is unfortunate but true that there are also some who simply don't care. The first group needs education. The second needs discipline.

However successful our efforts at self-education and self-discipline may be, confidence in the reliability of financial statements cannot be achieved unless there is, on the part of the professionals and of the public, an understanding as to the responsibilities assumed by those who attest to the financial statements. There are two parts to this proposition. First, the users of financial statements must recognize what degree of reliability should be expected, and second, the accounting profession must be responsive to the needs of the users. If the expectations of the public are beyond those which can reasonably be provided, we must strive for a better understanding of the impossibility of precise measurement and the fact that the attestor cannot be a guarantor. If performance on the part of the accounting profession is less than that which can reasonably be expected, we must strive for higher levels of performance.

Lack of confidence will of course result from intentional misrepresentation and from reckless disregard of reality. Lack of confidence will also result either from overexpectation or underperformance. Therefore, both good faith and competent performance are necessary ingredients for confidence. Even though all of us involved in the presentation of financial information—management, legal counsel, independent accountants, stock exchanges, and the SEC—see a particular set of circumstances from different perspectives, I believe we are all trying to achieve the same objectives. And all of us will benefit from working in an atmosphere which assures adequate and meaningful financial disclosure.

If management is tempted to indulge in financial puffery or what might be called indecent disclosure, they should be made to realize that every unwarranted short term advantage will be more than offset by a greater long term disadvantage. We have seen some horrible examples of deceptions that have succeeded for a while: an imaginary Canadian subsidiary whose receivables and inventories continued to grow at an ever

¹⁰ A. A. Sommer, Jr., *The Four Musts of Financial Reporting*, unpublished address delivered at AICPA Conference on SEC Development, January 8, 1974, in Washington, D. C.

increasing pace; a salad oil empire that owned more soy bean oil than existed; and a minor life insurance company which appeared to sell more new policies than the seasoned sales forces of long time successful companies in its field. For a while it may have appeared that they had gotten away with it, but even the most elaborate and ingenious scheme must fail if it departs from economic reality. Such spectacular failures have repercussions throughout the economy, but when they do occur, we should learn from them and find ways of making productive use of the information gained even if it is only through using them to demonstrate that no company or individual can profit indefinitely on a basis of deception or delusion.

As I stated earlier, we all have the same objectives in mind, and apparently we are all also subject, in varying degrees, to the same kinds of pressure. When a failure receives wide publicity, the public wants to know what is being done, and it turns to Congress. Congress turns to the SEC. The SEC turns to the accounting profession. The accounting profession turns and there is no one else there. So we know that the responsibility is ours, and we accept that responsibility.

The accounting profession working together with the legal profession and with the Securities and Exchange Commission will continue to make progress to assure the reliability and usefulness of financial information. Usually, that progress will result from our own momentum. Sometimes it will be spurred along by spectacular failures and by prods from the regulators, but the progress will continue.

There will inevitably be occasions when judgments made in good faith will turn out to be incorrect, but these can be withstood provided we are not at the same time having to overcome the effects of intentional misrepresentation or unfounded judgments. We must continually examine the nature of our responsibility. We may do so out of a sense of obligation, or because it just makes good sense, or because we recognize that our survival depends upon it. But whatever the motive, we must be willing to study changing needs for disclosure and adjust to them.