

THE ORGANIZATION OF THE PUBLIC ACCOUNTING PROFESSION

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Public accounting today is in reality two professions. The key to the difference between them is not size, quality or credentials but rather in the definition of the word “public.”

The first profession is public in the sense that the accountant holds himself out to the public as being competent to perform accounting services. The second is public in the sense of representing the public in the audit of financial statements.

Neither of these professions are better or worse, but they are different. The first contracts with the client to perform services. The client is basically the sole beneficiary of these services. The accountant in this profession must be qualified to perform services which most commonly are recordkeeping, state and federal tax return preparation and business advice. He is responsible to the client for his success or failure. Attestation is normally not important and when it is performed, it is usually only seen by those who have a direct relationship with the client, such as his banker.

The second profession, on the other hand, contracts with the client but he contracts to serve primarily the interests of outsiders. In those cases where the interests of the client differ from those of outsiders as to what financial presentation will be used, his first responsibility is to the public, and he must serve the public interest before that of his client. He may be held legally liable by third parties who have no contract or contact with him.

Operationally, this distinction between the two professions could probably best be based on the determination of whether the auditor’s relationship is with companies whose shares are traded in the public market place. It is important that the difference between these two professions be recognized since the differences have significance in a number of different areas.

The first difference is in the area of independence. When the client is the sole beneficiary of a service, independence is not of the same importance. This doesn’t mean that independence, in fact, is not important because the client wants an outside professional view, but the problem of the appearance of independence really does not exist. On the other hand, the problems confronted at the SEC as to independence are most frequently problems relating to the appearance of independence. The question of family relationships, consulting services,

ownership of small amounts of shares and effect of litigation are primarily problems associated with the appearance of independence. They are of great importance when one is serving the public and holding oneself out as a representative of the public in reviewing financial statements.

Second, there are differences in the professional skills needed in the two professions and this also has to be recognized. This is not a question of one group needing more knowledge and the other less, but rather that the types of knowledge needed are different. In many respects, this can be the traditional differentiation between the generalist and the specialist. The public representative has a series of specialties which he performs. The man who is primarily serving his client tends more to be a generalist. Both groups need continual updating in a rapidly changing environment. Any professional, and both these groups are professionals, must acknowledge his responsibility to keep up to date with what is going on in the fields in which he is interested. I, therefore, strongly support mandatory continuing education as licensing requirement for all public accountants. It is apparent that the nature of this education must differ depending on the knowledge needed and the services to be performed, but there is no question but that the trend today is in the direction of mandatory continuing education and I think this is important and desirable.

Third, there are some implications in the area of accounting principles. While this can be said to be primarily the difference between private and public companies, it fits into this general discussion. There is a basic accounting model which all accountants are trained to use. It serves all preparers of financial statements. However, the need for specific detailed disclosure and the need for comparability between financial statements is considerably different. Again, it is not a question of first-rate and second-rate financial statements, but rather statements serving different users. Statements serving a client must only meet the test of meeting the client's needs for information. If there are six shares outstanding, it does not make much sense to calculate earnings per share. If cash generation in a period is the most important thing for a client in understanding his business, then that should be emphasized even though the SEC has taken the position that cash flow per share data and cash flow data should generally not be used in

published financial statements. Direct costing, which is not an acceptable accounting method, may be the best method for showing financial results of a particular client. Similarly, tax allocation, which is something of a quagmire which the accounting profession has gotten itself into over a period of years, may be essential in terms of achieving comparability between financial statements but if a client doesn't understand it, and I don't think many clients do, perhaps it should not be used on financial statements prepared for the client.

It may be also that departures from what might be called the traditional accounting model may be needed in statements aimed at a particular user. Current appraisal value may be the most significant type of data for a particular client in a particular situation. There's no reason why his financial statement should not reflect it. In addition, details as to leasing, taxes, compensating balances and other such information may not be particularly relevant. The client can get the information if he needs it, but there is no particular reason why it should be included in his financial statements if he is the user. In these and other ways, therefore, it may be that the standard accounting model is not applicable in best serving the needs of a particular client.

On the other hand, for public companies in our society the needs of the investor are paramount. Comparability among companies who are candidates for investment dollars is important because these financial statements are an important element in the allocation of capital in our economy. It is important that the capital be allocated rationally. We are in an environment of capital shortage and it is important that suppliers of capital have information which will assist them in rational allocation. Comparability is an important element in this respect.

In addition, detailed disclosures in certain areas are essential since the information is not available elsewhere. In a day when discriminatory disclosure of inside information can subject both the discloser and the user to penalties, it is understandable that many of the contacts between users of financial statements and the management of companies have been curtailed. The answer to this to a large extent is to increase the detailed requirements for disclosure so information will be a matter of public record and available to all.

The formal distinction between accounting principles for public and private companies was first made in Accounting Principles Board Opinion Number 28 which dealt with interim financial statements. It set forth different disclosure requirements for public companies and nonpublic companies. I think this is a sensible approach and should be continued.

Fourth, these different professions or groups within a profession, if you prefer, also have different needs for quality controls. Quality is, of course, important in any profession. But, when the cost of error is different, rational policy differentiates in determining the nature of the systems designed to reduce the incidence of error. Quality control of professionals in the first group must primarily be aimed at reducing the possibility of the professional not being aware of information which would assist his client. Several programs have been set up within the profession with this in mind. For example, the Quebec Institute of Chartered Accountants has developed a system of professional practice advisors where individual professionals, both within the Institute and outside, go out and work with individual members. The AICPA has set up a program for small firm review. This could well be a service offered by the National Society of Public Accountants. These are quality control which make sense for the small practitioner or I should say the practitioner who primarily is involved in the offering of services to the public rather than being a public representative.

In the second profession, however, quality control must be aimed at preventing misleading financial statements first and foremost. It is well known that when the cost of errors is sufficiently high, an error rate of 1% is not good enough. In the space program, the tolerances are not at the 1% level, they're at the 1/100th or 1/1000th of one percent level. I don't know what the acceptable error level is in public accounting, but it certainly is less than 1%. If 1% of all the financial statements in the U.S. turn out to be materially false and misleading, we will have substantial lack of confidence in all financial statements. So, public accountants who bat .990 will get into the courts, and not into the Hall of Fame. This means, then, that the costs of quality control – timely reviews, audits of audits, reviewing certain steps, reviewing certain judgments – must be incurred to avoid the very high cost of error.

In looking at this second profession, and its responsibilities, one question which must be faced is whether it is organized in a fashion such that it can readily meet its responsibilities, and here I must confess to some concern. This concern arises out of the fact that there seems to be little institutional recognition of the differences between the two professions. This is most apparent in examining the relationship between the individual and the firm. In serving the public, the second profession is organized almost entirely into firms of various sizes. Individual practitioners are not a significant element in this practice. The public recognizes and relies on the firms. The names and reputations of firms are well known. At the same time, however, the licensing, regulation and professional organizations of the professionals even in this second profession are still organized on the basis of individuals. It seems to me that we must address ourselves to the question of whether this system adequately protects the public which this profession serves. We must also consider whether this approach makes sense in terms of the orderly development of this profession. My own conclusion is that it does not.

In order to consider this problem, we must first look at the nature of a firm and recognize that it is more than just some individual professionals practicing together. The whole must be more than the sum of its parts. A firm represents a bringing together of abilities where specialists are available as needed. The firm is responsible for the actions of all its partners both legally and in terms of reputation. More is therefore expected of the firm than any of its individuals.

The implications of this are significant. In the first place, I believe that it implies that in some way firms should be licensed or accredited. It may be argued that legal liability of firms is sufficient to make any other regulation unnecessary. This, however, seems to be a punitive rather than a preventive approach. We do not wish to impose liability on the profession, even with the laudable objective of achieving excellence, to the point where the partners of public accounting firms are made penurious and their wives and children sold into slavery. This would not be, I think, effective. Nevertheless, liability has played a positive role to date in improving performance, and some liability is necessary, although perhaps it is possible that there will be

some limitations placed upon it. But however necessary, I do not believe it is sufficient. I think a regulatory approach addressed to firms make sense and should be explored.

If there is to be some regulation either through licensing, accreditation or some other device it seems to me to be important that the regulation be on a continuing basis, not on a one-time granting of a certificate. I believe the same thing is true for individuals but even more so in the case of firms.

In the case of a firm, the maintenance of competence is obviously essential. One possible model to be drawn upon is the area of university accreditation. As a former professor, I went through a number of accreditations at my university and other schools. When an accrediting team comes in and looks at a school even though it has been previously accredited, this has a very positive effect. If one looks at regulation on a continuing basis, one has to recognize the fact that there are many problems and no simple answers. But it is important to the public that firms maintain their competence and I think this has to be part of a regulatory scheme.

Third, it seems to me that regulation should discriminate as to firm talent. The same skills are not necessary for all public accounting firms even within what I would call the second profession. For example, all firms may not need sophisticated computer auditing talents, depending on their clientele. Some firms certainly do.

In addition, in discriminating as to firm talents, there are questions as to whether non-audit specialties should be included in firm regulation. There is certainly a case to be made for some form of regulation of tax specialties, consulting specialties and some form of accreditation in these areas.

Fourth, quality control standards must be part of the regulatory framework. I think the recent exposure draft of the Auditing Standards Executive Committee of the AICPA which deals with quality controls within firms is an encouraging sign of concern although it is certainly only a first step and is expressed in very general terms.

Quality control procedures can never supplant individual excellence in achieving public protection but they can reduce the probability of error going undetected until too late. Whatever

form of firm regulation is undertaken, therefore, it must include some standards of quality control.

Fifth, any regulation must include both disciplinary and remedial aspects as well as simple accreditation. It can be argued that one approach to firm regulation is simply to recognize talents but not to penalize. However, I think this is not a realistic approach. Even if you just recognize talent, if at some point you withdraw this recognition you are penalizing. More important, it is vital that whatever regulatory bodies exist have the right to require remedial action. One of the things the SEC has been trying to do in its disciplinary actions against professionals in the past few years is not to punish but to design and require remedial actions which will reduce the likelihood of recurrence of problems.

Sixth, there must be public information about the regulation of firms. The public must be aware of who is accredited and who is not and what steps are being taken to assure adequate performance. It has been suggested, for example, that an annual questionnaire should be filed by all accountants who represent the public setting forth the quality control data about the partners and perhaps financial information. This might go a long way toward achieving the results envisioned by regulation. It is not unlikely that disclosure will be a first step toward firm regulation.

As we look at matters such as firm regulation one generally gets down to the basic questions of how should it be done and who shall do it. I am not prepared to make suggestions or recommendations in this regard today because much consideration must be given before answers can even be proposed. There will certainly be substantial differences of opinion among people in this respect. The only conclusion I am prepared to draw is that it seems to be clearly a problem beyond the state levels. As one looks at the structure of the profession today and the structure of the business community it does not seem feasible to deal with firms on a state level.

One possible answer is professional organizations. I have some hopes that this might be the best route. It could be, for example, that current professional organizations could develop a class of firm membership and the accreditation process could perhaps relate to membership of

firms. Hopefully, it might be that audit committees of boards of directors and other groups would ultimately conclude that they would only hire auditors who meet these criteria and thus achieve firm membership. It might be that rather than deal with current organizations, there could be a new organization of firms established – perhaps the Academy of Accredited Accounting Firms.

Another possibility is some role for government in the process of firm accreditation and control. This might be a supportive role, a supervisory role or a direct regulatory role. For example, a self-regulatory framework such as that of the National Association of Securities Dealers under the supervision of the SEC is one possible approach. Another is a relationship such as the SEC now has with the Financial Accounting Standards Board which is basically supportive although legislative authority exists for full control. Or a direct regulatory relationship approach could be developed. Any government role could be played by a current agency – presumably the SEC – or a new body of some sort might be set up through new legislation.

In any event, it should be emphasized that these are preliminary ideas and much discussion and consultation will be required on many levels before any move takes place in the direction of firm accreditation or firm regulation.

Nevertheless, it is difficult to ignore the fact that the accounting profession is still organized and regulated today on the basis of a framework established to cope with the problems which existed at a time when society was characterized by relatively small economic units, corporate privacy and limited capital markets. In a world of hundred million dollar international accounting firms, billion dollar corporations operating with capital supplied in a public market place, and high public expectation of auditors, perhaps it is time for the regulatory and organizational aspects of the profession to catch up with the world of practice. I have little doubt that this process will accelerate in the years ahead.