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Remarks by

Walter P. Schuetze
Chief Accountant
Securities and Exchange Commission
of the United States of America

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A Mountain or a Molehill?

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I want to speak this morning about auditor independence. The Commission has stated repeatedly that the independence of auditors, both in appearance and in fact, is crucial to the credibility of financial reporting and, in turn, the capital formation process.

I want to emphasize, however, that these remarks represent my views and not necessarily those of the Commission or other members of the staff. This routine disclaimer perhaps is more appropriate today because, in a moment, I am going to discuss an independence issue that, as the Commission's Chief Accountant, I have found personally very troubling when dealing with registrants' accounting issues.

John L. Carey was, for many years, the senior staff officer of the American Institute of Certified Public Accountants. In his 1946 book entitled Professional Ethics of Public Accounting, Mr. Carey wrote as follows about independence:

> Only a moment's reflection is necessary to perceive why independence is the keystone in the structure of the accounting profession.... The prime purpose of...[the audit] opinion is to add to the credibility of the statements in the eyes of outsiders who for one reason or another are interested in the financial position and operating results of the business--for example, credit grantors, stockholders, government regulatory agencies, potential investors and financial analysts. Clearly they would set no great store by the certified public accountant's opinion or certificate if they were not confident of his independence of judgment, as well as his technical competence. Technically competent accountants may be employed by corporations as part of their own staffs to keep accounts and make up their statements. The basic differentiation between privately employed accountants and professional practitioners is in their responsibilities, moral or legal, to the corporation or the public, and in the extent to which their relationship may tend to influence their judgment. In the last analysis, therefore, it is his independence which is the certified public accountant's economic excuse for existence.
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> Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the certified public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It means, in simplest terms, that the certified public accountant will tell the truth as he sees it,

> and will permit no influence, financial or sentimental, to turn him from that course. Everyone will applaud this ideal, but a cynical world requires more than a mere declaration of intention if it is to stake its money on the accountant's word. Therefore the profession has publicly laid its heaviest penalties on those who breach the unwritten contract of independence, and, in addition, has proscribed specific acts and models of behavior which might raise a question as to the independence of its members. In other words, the rules not only provide for punishment of members who are not independent; they also prohibit conduct which might arouse a suspicion of lack of independence. Objective standards of independence have thus been introduced into the code. It is not enough for the member to do what he thinks is right. He must also avoid behavior which could lead to an inference that he might be subject to improper influences. The accounting profession must be like Caesar's wife. To be suspected is almost as bad as to be convicted.

Not long after I arrived at the Commission in January 1992, the Chairman of a special committee of the AICPA asked for an appointment with my staff and me to discuss auditor independence and more specifically to discuss a draft of a new approach to determining auditor independence. The proposed approach would have replaced the reasonable outside investor's approach to independence with the approach that a well-informed auditor would take to the question of independence. The draft would have done away with the concept of auditors' maintaining the appearance of independence from their clients and would have focused solely on independence in fact. That focus would have been achieved by eliminating much of the specific guidance contained in current AICPA independence requirements.

My office reacted negatively to that draft. While I personally do not like the present situation where there is a large volume of detailed rules relating to independence issues, principally issues arising out of family relationships between auditors, auditing firms, and their audit clients, I do not see a practical way out of this situation.

Moreover, I think that eliminating the concept of appearance of independence is not viable. I personally would not favor its elimination. Prior Commissions have looked at the need for auditors to avoid being "suspected" of "improper influences," to use Mr. Carey's words, and concluded that requiring auditors not only to be independent in fact but also to be independent in appearance was appropriate and necessary if investors are to maintain confidence in the reliability of the financial statements that daily provide the basis for investment and lending decisions. Moreover, the Supreme Court emphasized appearance in the Arthur Young case in 1984, as follows:

> The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries. It is therefore not enough that financial statements be accurate; the public must also perceive them as being accurate. Public faith in the reliability of a corporation's financial statements depends upon the public perception of the outside auditor as an independent professional....

The concept of auditor independence under the Federal securities laws, therefore, was designed not only as a means to have better financial information reported to the public, but also to enhance investors' perceptions regarding the reliability and accuracy of that information. Starting from this vantage point, it is easily understood why the staff resisted the approach taken by the AICPA Committee that independence issues should be viewed from the standpoint of a "reasonable auditor." To the staff, the key question is whether a reasonable investor, knowing all the facts and circumstances, would consider the independent accountant to have impartial and objective judgment on the questions confronting him or her during the audit.

I want to turn now to an issue that has vexed and bewildered me since I came to the Commission two years ago, that is, auditors not standing up to their clients on financial accounting and reporting issues when their clients take a position that is, at best, not supported in the accounting literature or, at worst, directly contrary to existing accounting pronouncements. To me, auditors giving way to their clients, subordinating their views to their clients', raises a nasty issue about independence both in appearance and in fact. In my opinion, an auditor's independence, whether called appearance or fact, is jeopardized as much by his or her subordinating judgment about a financial accounting and reporting issue as it is by investing in securities issued by a client, loaning money to a client, or borrowing money from a client--perhaps even more so. At least insofar as money matters are concerned, if there were disclosure to the investor about that fact, then the investor would be on notice and could be guided by the facts, although I would not, definitely not, advocate such an approach. Not so with the subordinated judgment, which is insidious. There is no way to communicate impaired or colored judgment. No disclosure about it ever could be complete, or be trusted. Nor is there any way for an investor to make judgments about the effect of impaired or colored judgment on the part of the auditor.

In a speech in August 1992 to the annual meeting of the American Accounting Association, I raised the issue of auditor independence in connection with what I called "incredible" accounting proposals. By incredible accounting proposals, I meant unsupportable conclusions regarding accounting issues that were

being proposed by registrants with the support of their auditors. Accounting proposals that in my opinion were wrong. Not just debatable or arguable, but wrong. Sometimes that support was in the form of a signed and unqualified opinion, and sometimes that support was in written or oral presentations to the SEC's staff before the registrant's financial statements were issued and the independent auditor reported on those financial statements.

Some senior people in the profession privately suggested that I was making a mountain out of a molehill in that 1992 speech. Some, including the AICPA's Public Oversight Board in its March 1993 Special Report entitled "In the Public Interest," suggested that a few engagement partners, on their own and without consultation within their firms, might have inappropriately supported some liberal accounting proposals. Others privately suggested that the few incredible accounting proposals that were put forward to SEC's staff had to be taken in the context of the thousands of audits of public companies' financial statements that take place every year, where those companies' financial statements are based on good and thorough applications of generally accepted accounting principles.

It is true, as some have suggested, including the Public Oversight Board, that many new and complex issues reach my desk because there is an honest difference of opinion based on well-reasoned positions on all sides. In these cases, the staff works with the registrants and their auditors to resolve those issues through discussion, analysis of analogous literature, and compromise in many cases. Addressing those kinds of issues is a challenging and interesting part of my job, and I encourage registrants and their auditors to continue to bring these issues to the staff. I also am aware, because I practiced in public accountancy for many years, of the thousands of decisions that are made by auditors in their work where they insist on adjustments to financial statements that reduce net assets and income or otherwise insist on financial statement reporting and disclosures that managements of their clients would rather not make--none of which is ever publicized.

However, there have been too many times where accounting arguments made by registrants lack any reasonable foundation and, without being able to cite any authoritative support for the registrant's position, the auditor has acquiesced.

I was hopeful, after the August 1992 speech, that the profession would have gotten the message and would have stopped the practice of supporting their clients' incredible accounting proposals. My hopes have not been fulfilled, however. Since then, we have had the following proposals, among others, by registrants and their auditors. And not supported by just an engagement partner in a firm without consultation within the firm, but by partners from the national offices of the firms as well.

1. An airline company spends money to overhaul aircraft engines and airframes. Some airline companies defer those overhaul costs and amortize the costs over the estimated future benefit period. One such airline, with the support of its auditor, actually two auditors because one auditor was being succeeded by another auditor, proposed to classify as a current asset at the most recent balance sheet date the portion of the deferred costs that were to be amortized to expense in the following year. I cannot fathom how an equipment expenditure made in a prior period credibly can be said to be a current asset at any subsequent balance sheet date.

2. A registrant was committed to make cash payments under a noncancellable lease for the use of a building. The lease, for accounting purposes, was classified as an operating lease. The lease payments were based on a rental rate of, say, $25 a foot, which was the fair market rental when the lease was entered into some years ago. Because of an oversupply of commercial real estate, the market rental rate for comparable space over the remaining lease term is not $25 but, say, $15 a foot. The registrant was going to sublease the building to another company and receive from that sublessee so-called barter credits that could be exchanged for, among other things, advertising by the Company and discounts from certain vendors. The Company asserted that the value of the barter credits for the advertising and the discounts was equal to the value of the lease payments based on a rental rate of $25 a foot. The registrant, with the support of its auditor, therefore proposed not to recognize the loss of $10 a foot. The problem, of course, is the Company's assigning a value to the barter credits based on the subjective nature of the value of the right to advertising and trade discounts, rather than basing the value of the barter credits on the more objective, and independently verifiable, current rental value for comparable property--$15 per foot. How could anyone credibly support the argument that a sublessee would pay something of value worth $25 a foot when the fair value of the rent was $15 a foot?

3. Registrant A acquired Company X. When A delved into X's records, it found that X's liabilities for certain payroll taxes were understated. A and X, with the auditor's support, proposed that the adjustment to X's payroll tax liability not be reported in X's income statement in periods prior to the business combination but be included in the adjustments arising in purchase accounting. How could anyone credibly support a proposal that X's payroll costs did not need to include the necessary payroll taxes in X's income statements for periods prior to the business combination?

4. Company H acquired majority but not total ownership of Company Z. Company Z had outstanding stock options held by employees, which if exercised would have had adverse tax consequences for Company H. The options were deep in the money and were vested and exercisable. Company H wanted to enter into new contracts with Z's employees, which would have postponed exercise of the options and protected the amount by which the options were in the money if the value of the underlying stock declined. Companies H and Z argued, with the support of their auditor, that the terms of the outstanding options had not been changed, no new measurement date had occurred under Accounting Principles Board Opinion 25, and therefore no amount of compensation cost need be recognized. How can anyone credibly argue that a new agreement that protects an employee holding a stock option deep in the money from any decline in the price of the stock is not a new stock option agreement that triggers a new measurement date and consequent compensation cost?

Those are a few specific registrant examples, of which there are more. If these were the only examples, they perhaps could be excused as anomalies. But, there are other cases that are more broadly applicable, and they involve many companies. And, in these cases, it is again clear that the auditors' actions are not individual engagement partners acting on their own, but that the actions are undertaken with the knowledge of the national offices of the firms. For instance, last year, the FASB's staff and the SEC's staff had to force prompt consideration of the issue of "funded catastrophe covers" by the Emerging Issues Task Force, which is reported in EITF Issue 93-6. This issue involves companies in the property-casualty industry paying reinsurers premiums for catastrophes such as Hurricane Andrew and Typhoon Iniki in years before, during, and after the year of the catastrophic event. The reinsurance contract was such that, if no catastrophe happened, a portion of the amount of the premium, say, 85% thereof, went from the reinsurer back to the insurer in the form of cash; if a catastrophe happened, the reinsurer paid the loss but then the insurer had to repay the amount of the loss to the reinsurer plus interest. The insurers were recognizing expenses for the catastrophe losses in years before the catastrophic event, the year of the event, and years after, as premiums were paid to the reinsurers, instead of in the year or quarter in which the catastrophe happened, all with the concurrence of their auditors. FASB Statement 5, "Accounting for Contingencies," issued in 1975, specifically deals with the accounting for such events and says that a loss should be recognized in expense in the year in which the event happens--not sooner or later. A number of registrants have changed their accounting as a result of the FASB staff's and SEC staff's intervention. This episode led to an article in <u>The New York Times</u> on September 5, 1993 entitled "Cooking Books: How Hurricane Losses Vanished." The <u>Times</u> article said, in part:

> How, you might wonder, could any companies have gotten away with this obvious phony accounting, given that all the Big Six Accounting firms agree it is wrong? In fact, auditors from each of those firms accepted the accounting, although some tried to resist and allowed slightly less liberal accounting.
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> "When there is somebody down the street who will say yes," commented one accountant who studied the issue, "other firms find themselves under enormous pressure to also say yes."

I do not see how registrants and their auditors credibly could argue that they did not have to pay attention to the official accounting literature.

Another issue arose last year, which affected many companies. Our staff began to question the rates that registrants were using to discount their estimated future cash payments for pensions and health care benefits for retirees. The official literature explicitly requires that the discount rate be based on the current level of interest rates, and the literature refers to the yield on high-quality corporate bonds. Many registrants instead were using old, outdated interest rates that were much higher than current rates on high-quality corporate bonds. Consequently, their pension and retiree health care benefit obligations were significantly understated. As our staff got into the issue, it became clear that many registrants, without objection from their auditors, were not following the authoritative literature in selecting their discount rates. It took a letter from the Chief Accountant to the FASB's Emerging Issues Task Force dated September 20, 1993 to challenge both registrants and their auditors to pay attention to the literature. In many cases, the effect of not following the literature was, without any doubt, material. The press has covered this issue extensively in recent months. USA Today, on November 18, 1993, wrote as follows, in part, about corporations' using a too-high rate to measure pension liabilities:

> It's an open secret in the pension field that companies have been using out-of-date assumptions about interest rates, says Gordon Webb, a pension consultant at Foster Higgins in San Francisco. "Employers are playing it fast and loose, and the auditors are letting them get away with it," he says.

There now is a substantial number of companies that will be changing their discount rates as a result of the SEC staff's intervention. This noncompliance with the literature comes on the heels of what we observed in 1992 when many banks, thrifts, and insurance companies, with the concurrence of their auditors, were not following the literature in classifying their debt securities holdings as between "held for investment" and "held for sale,"

which was corrected only through SEC staff intervention. How can registrants and their auditors ignore the literature and then expect investors, regulators, Congress, and the public generally to put credence in what they say?

It also appears to me, and other outside observers, that CPAs may have become cheerleaders for their clients on the issue of accounting for stock options issued to employees. (I should make clear here that the Commission has not considered the issue of the accounting for stock options issued to employees.) In 1978, in response to a proposed interpretation by the FASB of the existing accounting rules for stock options granted to employees, six of the then Big Eight accounting firms wrote to the FASB suggesting that the FASB should reconsider the accounting rules for stock options granted to employees. In the early and mid-1980s, the AICPA, through its Accounting Standards Executive Committee, twice asked the FASB to re-examine the accounting for stock options issued to employees. In 1982, the AICPA said, "...the principles [of Accounting Principles Board Opinion 25] should be changed so that compensation expense is recognized for most plans." In 1984, the AICPA said, "AcSEC is pleased that the FASB has undertaken a project on a broad reconsideration of the principles that underlie APB Opinion 25.... AcSEC believes a major change in accounting for compensation plans is necessary." The AICPA, in the 1984 letter, went on to say that compensation cost should be based on the fair value of the option at the grant date and recommended that the so-called minimum-value method be used to measure the value of the option.

In 1984 and 1985, in response to the Invitation to Comment that began the FASB's reconsideration of the existing accounting rules for stock options granted to employees, all of the then Big Eight accounting firms except one wrote to the FASB supporting (a) reconsideration of the accounting rules and (b) a charge to compensation cost/expense for all options granted to employees.

But, in February 1993, even before the FASB issued its exposure draft on the subject on June 30, 1993, all of the Big 6 accounting firms joined forces with certain members of industry and a group of users to recommend to the FASB that there be no formal recognition for the cost of stock options. (I understand that the AICPA's Accounting Standards Executive Committee recently changed its mind and now will recommend to the FASB that there be no recognition for the cost of fixed stock options.) The Big Six accounting firms did not, in February 1993, offer an explanation for their change of mind. I would be the first to say that anyone could change his or her mind. I have changed my mind on several accounting issues over the years. But, I think that the public deserves an acknowledgement of that change of mind by the firms and the reason why. Such a change in position, without a corresponding change in the underlying concepts and issues that led the firms and the AICPA initially to support the FASB's project, has left some

members of the public with the impression that the switch was in response to the fear of losing clients or other forms of retaliation. I do not know if this is true. However, if public companies are pressuring their outside auditors, and the Accounting Standards Executive Committee of the AICPA, to take particular positions on financial accounting and reporting issues, and outside auditors are subordinating their views to their clients' views, can the outside auditor community continue to claim to be independent? Could continuation of such a trend be anything other than an invitation to Congress, the SEC, and other regulators to regulate more heavily, and directly, the auditing profession in particular and financial accounting and reporting in general? Could continuation of such a trend lead investors, particularly institutional investors, to find alternative ways to corroborate issuers' representations in their financial statements?

The independence rules promulgated by the AICPA and the SEC principally address the appearance of independence because it is impossible to regulate an individual's state of mind. The independent mind set, however, is the most basic independence requirement. The advocacy of weak and unsupported client accounting positions speaks loudly about independence in fact. The preceding examples have been gleaned from the numerous issues that have been considered by the Office of the Chief Accountant since August 1992. In that context, the specific and general examples cited represent a small--some even might argue, insignificant--number of exceptions to the generally outstanding manner in which the accounting profession carries out its duties as "public watchdog." Individual practitioners and firms need to be mindful, however, that the number of such instances that may poison the well with regulators, legislators, investors, and the general public is small indeed.

I make these comments with a heavy heart. As many of you know, these comments do not come from an ivory tower. I have lived and worked in the accounting profession for more than thirty years. I know the realities of saying "no" to a client. I know the disappointment some clients express when the auditor makes a decision to support an accounting proposal that may reduce those clients' reported earnings. I know the long and often heated telephone calls and client visits, the emotional strain, and the financial cost that follow such decisions. But I also know the rewards--a clean conscience, not having to worry about losing law suits based on the merits, and pride in the profession and the credibility of financial accounting and reporting. I hope that the profession and registrants will, through self-restraint, take a fresh look at these independence issues and, as Mr. Carey suggested, let nothing stand in the auditor's way of telling the truth as he or she sees it.

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