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A DELICATE ASSIGNMENT: THE REGULATION OF ACCOUNTANTS BY THE SEC *

ROBERTA S. KARMEL **

The Securities and Exchange Commission, the arm of the federal government charged with regulating accounting, has been criticized both for acting too timidly and for acting too vigorously in carrying out its mandate. In this Article, the author attempts to clarify the role of the SEC in regulating the accounting profession. In so doing, she examines regulation of both accounting principles and auditing standards.

INTRODUCTION

One of the most significant and difficult responsibilities of the Securities and Exchange Commission (the SEC or the Commission) is the regulation of accountants. Although accountancy¹ is a learned profession that ought to engender the same respect and legal protection as any other profession, accountants have historically been regulated somewhat differently from their professional peers. This discrepancy in treatment can be explained, in part, by accountants' independence from their clients.²

Although accountants serve the particular enterprises that retain them, their work is intended for the use and benefit of third parties who have an interest in the financial statements of those enterprises. The opinion of certified public accountants attached to the financial statements of an enterprise is a representation to the users of such financial statements that the statements have been prepared in conformity with generally accepted accounting principles and audited in conformity with generally accepted auditing standards.³

* Adapted from the book *Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America*, by Roberta S. Karmel. Copyright © 1982 by Roberta S. Karmel. Reprinted by permission of Simon & Schuster.

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¹ Accountancy is the body of principles and standards by which financial information is presented. For a more comprehensive definition, see P. Grady, *Accounting Research Study No. 7, Inventory of Generally Accepted Accounting Principles for Business Enterprises 4* (1965).

² This independence has been viewed as an affirmative duty that the accountant owes to the public. *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112, 122 (S.D.N.Y. 1974), modified, 540 F.2d 27 (2d Cir. 1976); see *Touche, Niven, Bailey & Smart*, 37 S.E.C. 629, 670 (1957).

³ See T. Fiftis & H. Kripke, *Accounting for Business Lawyers* 645-46 (2d ed. 1977).

Accounting is an international business language that must follow uniform conventions in order to be useful either to particular business enterprises or to the public. Uniform auditing standards and accounting principles are necessary for government, business, and labor to understand and assess the strengths and weaknesses of the economy and the entities that comprise it. This does not mean that the language of accounting is merely economic and objectively verifiable. To the contrary, accounting is becoming more and more subjective, political, and capable of being manipulated to achieve particular objectives. In the absence of some form of government regulation, it would not be possible to achieve or assure an acceptable standard of uniformity in either auditing standards or accounting principles.

The government wields critical power in its control over the language by which corporate America reports its successes and failures. The SEC is the only arm of the federal government that has been given the mandate to regulate accounting, but the extent of the Commission's authority to do so is unclear. This has left the Commission vulnerable to the contradictory criticisms that it (1) has acted too timidly and thereby been co-opted by the accounting profession and (2) that it has acted too vigorously and thereby exceeded its jurisdictional authority.

Despite the current trend toward deregulation, I do not believe that it would be either feasible or prudent for the federal government to relinquish its responsibility to regulate accounting. Further, in order to avoid undue politicization of accounting principles and auditing standards, an independent agency should continue to regulate accounting. The Commission should also continue to involve the private sector in the regulatory process, since it would otherwise lack the expertise needed to resolve the critical and difficult problems facing accountants and their clients. Maintaining this delicate balance between public and private sector responsibility has never been easy. In fact, during the 1970's, the SEC's regulatory relationship with the accounting profession was severely tested and at times seemed almost at a breaking point.

This Article will explicate that crisis in the hope that we are entering a period of decreased confrontation between government and business. Perhaps in a calmer time of greater cooperation, a sounder regulatory structure can be created for the future regulation of accountants—regulation that will protect the public against fraudulent financial statements without subjecting accountants to excessive government regulation or undue civil liability.

I

THE POLITICAL CRISIS

During the late seventies, policymakers had particular difficulty formulating proper policies with respect to the regulation of accountants. This difficulty was exacerbated by the fact that the accounting profession was caught in a crisis of conflicting public policies. On the one hand, the consumerism that flowered in the 1960's continued to influence public opinion, leading to increased pressures for greater professional accountability. Until at least 1977, Congress and the courts were busy formulating more rigorous legal standards for assessing accountants' liability to users of financial reports.⁴ On the other hand, the simultaneous growth of an antiregulatory attitude made Congress unreceptive to, and the SEC wary about, new ideas and laws for government-mandated regulation of the accounting profession. In addition, the appellate courts began to reject some of the more tenuous theories of accountants' liability, for example, requiring intentional or reckless misconduct to be a predicate for accountants' liability under the antifraud provisions of the Securities Exchange Act.⁵

The accounting profession was blamed for the creative accounting which led to the collapse of many of the companies whose securities were the "high flyers" of the bull market of the 1960's.⁶ The

⁴ See, e.g., *Herzfeld v. Laventhol, Krekstein, Horwath & Horwath*, 378 F. Supp. 112 (S.D.N.Y. 1974), modified, 540 F.2d 27 (2d Cir. 1976) (finding defendant accounting firm liable under federal and state securities laws as well as common law fraud to purchasers of securities who relied on misleading financial reports). One commentator believes that, at a minimum, the district court's decision "stands for the proposition that qualifications in [accountants'] opinions may be insufficient notice of the defects to which they relate." Slain, *Fair Presentation*, 8 *Rev. Sec. Reg.* 983, 985 (1975). See generally Note, *Accountants' Liability for Negligence—A Contemporary Approach for a Modern Profession*, 48 *Fordham L. Rev.* 401, 419 (1979). The congressional response to these developments is discussed throughout this Article.

⁵ See Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(j)(b) (1976); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Although the Supreme Court held that a private civil action for damages cannot be maintained under rule 10b-5 in the absence of scienter, *id.* at 193, the opinion explicitly noted that there was no need to "address here the question whether, in some circumstances, reckless behavior is sufficient for civil liability," *id.* at 193 n.12. Since *Hochfelder*, the courts in seven circuits have ruled that recklessness meets the scienter requirements. E.g., *Croy v. Campbell*, 624 F.2d 709, 715 (5th Cir. 1980); *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1023 (6th Cir. 1979); *Nelson v. Serwold*, 576 F.2d 1332, 1337 (9th Cir.), cert. denied, 439 U.S. 970 (1978); *Coleco Indus., Inc. v. Berman*, 567 F.2d 569, 574 (3d Cir. 1977), cert. denied, 439 U.S. 830 (1978). See *Dondanville, Defending Accountants' Liability: Trends and Implications*, 15 *Forum* 173, 188 (1979).

⁶ See *Fiflis, Current Problems of Accountants' Responsibilities to Third Parties*, 26 *Vand. L. Rev.* 31 (1975). See also Subcomm. on Governmental Efficiency and the District of Columbia of the Senate Comm. on Governmental Affairs, 96th Cong., 1st Sess., *Oversight of the Account-*

accounting profession was also blamed for the business scandals of the post-Watergate period, most notably illegal political contributions and questionable foreign payments.⁷ Congress and the SEC expressed a self-righteous dissatisfaction with the performance of the profession in not detecting management misconduct during the audit process, and proposed more rigorous regulation. This mood led to the enactment of the bookkeeping and internal accounting control provisions of the Foreign Corrupt Practices Act.⁸

At the same time, however, skepticism about the government's ability to improve matters was deepening. Because the public did not seem to have any more trust and confidence in the government than in the accounting profession, the problem of generating renewed trust and confidence in the reliability of audited financial information became acute. Both the SEC and the accounting profession were confused and uncertain about what to do. Perhaps because self-regulation had been a part of securities regulation for so long, the Commission, under the leadership of Chairman Harold M. Williams, advocated self-regulation as a political compromise between those activist proponents of more direct government regulation of accountants and those who strongly resisted all such proposals.⁹

After forty years of neglect, the structure and regulation of the accounting profession became the subject of intense congressional

ing Profession 2 (Comm. Print 1979) [hereinafter Oversight Report]; Subcomm. on Governmental Efficiency and the District of Columbia of the Senate Comm. on Governmental Affairs, 95th Cong., 2d Sess., Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role 1-2, 151 (Comm. Print 1978) [hereinafter 1978 SEC Report to Congress]; Subcomm. on Reports, Accounting & Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess., Improving the Accountability of Publicly Owned Corporations and their Auditors 1, 2 (Comm. Print 1977) [hereinafter Metcalf Report]; Reform and Self-Regulation Efforts of the Accounting Profession: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 1 (1978) [hereinafter Moss Hearings].

⁷ See S. Rep. No. 114, 95th Cong., 1st Sess. 7-8, reprinted in [1977] U.S. Code Cong. & Ad. News 4098, 4104-06; 1978 SEC Report to Congress, *supra* note 6, at 2-3, 151; *id.* app. II, at 1196; Metcalf Report, *supra* note 6, at 1, 2; Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Federal Regulation and Regulatory Reform, H.R. Doc. No. 134, 94th Cong., 2d Sess. 40 (1976) [hereinafter Moss Report]; Moss Hearings, *supra* note 6, at 1.

⁸ Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78m(b), 78dd-1, 78dd-2, 78ff (Supp. IV 1980)); see S. Rep. No. 114, 95th Cong., 1st Sess. 7-8, reprinted in [1977] U.S. Code Cong. & Ad. News 4098, 4104.

⁹ Subcomm. on Governmental Efficiency and the District of Columbia of the Senate Comm. on Governmental Affairs, 96th Cong., 1st Sess., Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role 297-327 (Comm. Print 1979) [hereinafter 1979 SEC Report to Congress]; Moss Hearings, *supra* note 6, at 363 (statement of Harold Williams, Chairman of the SEC).

scrutiny during the mid-1970's. Despite governmental ambivalence toward the regulation of accountants, there was a much greater direct federal interest in financial reporting than had previously existed. Substantial federal assistance to failing or failed corporations such as Penn Central Corporation and Lockheed Aircraft Corporation, as well as greater involvement by private sector accounting firms in public sector accounting, helped to precipitate congressional inquiry.¹⁰ Both the 1976 Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, chaired by Congressman John Moss,¹¹ and the 1977 Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs, chaired by Senator Lee Metcalf,¹² undertook an extensive examination of the accounting profession. Congress was very critical of the process by which accounting standards were set and enforced within the profession¹³ and of the domination by the "Big Eight" accounting firms.¹⁴

Although the Metcalf Subcommittee staff had recommended broad federal involvement in the regulation of accountants,¹⁵ during hearings held by the Subcommittee the accounting profession pledged to institute reforms in the profession and the SEC pledged to use its oversight role to encourage the private sector's efforts.¹⁶ On the basis of these assurances, the Metcalf Subcommittee's report endorsed reform through self-initiated action by the profession in cooperation with the Commission.¹⁷ The Subcommittee's decision to give the profession and the Commission some time to implement the regulatory structure underscored the need for change in order to increase the public's confidence in the independence of accounts. After Senator Metcalf's death, this generally critical scrutiny of SEC regulation of accountants was continued under the direction of Senator Thomas

¹⁰ See 1978 SEC Report to Congress, *supra* note 6, at 2-3; Metcalf Report, *supra* note 6, at 1; Staff of the Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Operations, 94th Cong., 2d Sess., *The Accounting Establishment 2* (Comm. Print 1976) [hereinafter *Establishment Report*]; *Accounting and Auditing Practices and Procedures: Hearings Before the Subcomm. on Reports, Accounting and Management of the Senate Comm. on Governmental Affairs, 95th Cong., 1st Sess. 3 (1977)* [hereinafter *Metcalf Hearings*].

¹¹ See Moss Report, *supra* note 7.

¹² See Metcalf Report, *supra* note 6.

¹³ See 1978 SEC Report to Congress, *supra* note 6, at 3-4; Metcalf Report, *supra* note 6, at 7, 8.

¹⁴ See Metcalf Report, *supra* note 6, at 17-18; *Establishment Report*, *supra* note 10, at 19, 43-46.

¹⁵ See Metcalf Report, *supra* note 6, at 20-21, 22; *Establishment Report*, *supra* note 10, at 20-24.

¹⁶ See Metcalf Report, *supra* note 6, at 4.

¹⁷ *Id.*

Eagleton.¹⁸ Among other things, the Commission agreed to make an annual report to Congress on its oversight role.¹⁹

During the House Oversight Subcommittee hearings in 1978, Congressman Moss repeated his intention to "introduce legislation to create a self-regulatory organization under direct SEC oversight" if the accounting profession did not "adduce persuasive evidence that it is taking effective steps on its own to improve the quality of audit work and the responsiveness of accountants to public needs."²⁰ This legislation was then unveiled as the "Public Accounting Regulatory Act."²¹ The Moss bill proposed a self-regulatory organization for accountants patterned after the National Association of Securities Dealers (NASD).²² It would require registration with this self-regulatory organization by accounting firms that audit financial statements filed with the Commission and would authorize disciplinary action against the registered firms and their principals.²³

One of the findings set forth in the Moss bill was that the profession "appears unable to establish . . . a satisfactory self-regulatory arrangement."²⁴ But the Commission repeatedly expressed the view that although legislation might be necessary if the profession was unable to develop an effective self-regulatory structure, the profession should be given time to develop its own structure. Experience with self-regulation would enable revisions and improvements to the system and provide the Commission and Congress with enough information to better judge the need for greater federal involvement through legislation.²⁵

¹⁸ See 1979 SEC Report to Congress, *supra* note 9, at 1; 1978 SEC Report to Congress, *supra* note 6, at 3.

¹⁹ See Subcomm. on Governmental Efficiency and the District of Columbia of the Senate Comm. on Governmental Affairs, 96th Cong., 2d Sess., Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role at iv (Comm. Print 1980) [hereinafter 1980 SEC Report to Congress]; 1979 SEC Report to Congress, *supra* note 9, at 2; 1978 SEC Report to Congress, *supra* note 6, at 471; Metcalf Report, *supra* note 6, at 21.

²⁰ Moss Hearings, *supra* note 6, at 2 (statement of Subcomm. Chairman John Moss).

²¹ H.R. 13,175, 95th Cong., 2d Sess., 124 Cong. Rec. H5746 (daily ed. June 16, 1978), reprinted in Moss hearings, *supra* note 6, at 536.

²² *Id.*; see 1978 SEC Report to Congress, *supra* note 6, at 2; Moss Hearings, *supra* note 6, at 2. For a description of the organization and activities of the NASD, see 2 L. Loss, Securities Regulation ch. 8C, at 1365-89 (2d ed. 1961).

²³ H.R. 13,175, 95th Cong., 2d Sess., 124 Cong. Rec. H5746 (daily ed. June 16, 1978), reprinted in Moss Hearings, *supra* note 6, at 536.

²⁴ *Id.* § 2(a)(3).

²⁵ See 1980 SEC Report to Congress, *supra* note 19, at 1-4, 18-21; 1979 SEC Report to Congress, *supra* note 9, at vii-ix, 2-8, 28-37, 99-142, 302-03; 1978 SEC Report to Congress, *supra* note 6, at 5-7, 15-27, 44-47, 471.

There are two different ways in which the accounting profession has traditionally engaged in self-regulation to formulate and enforce professional standards. One is the development of accounting principles; the other is the development of auditing standards.²⁶ From the beginning, the SEC has deferred to usual and customary business practices of issuers and their auditors in articulating accounting principles and auditing standards. Since 1973, authoritative accounting principles have been formulated and articulated by the Financial Accounting Standards Board (FASB).²⁷ Since 1977, professional discipline and the enforcement of auditing standards primarily through practice standards and peer reviews have been the responsibility of the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA) Division for CPA firms.²⁸

In a memorandum submitted to the Metcalf Subcommittee, the SEC stated that it had "sufficient authority to oversee the setting of auditing and accounting standards, effect registration and financial disclosure by accounting firms, review the work of independent auditors and discipline those which do not meet minimum standards, and subpoena information from uncooperative accounting firms."²⁹ Personally, I regard this analysis as a prosecutor's brief, and believe that the nature and extent of the SEC's authority to regulate accountants is unclear in many significant respects. Although the SEC has ample plenary power to establish accounting principles, its power to enforce auditing standards is much more questionable.

II

THE REGULATION OF ACCOUNTING PRINCIPLES

When Congress was debating passage of the Securities Act of 1933,³⁰ certain congressmen proposed that a corps of government auditors be established to audit public companies.³¹ Representatives of the accounting profession and others, however, urged Congress to reject this proposal and rely instead on the private sector to perform

²⁶ See T. Fafilis & H. Kripke, *supra* note 3, at 645-46, for an explanation of the relationship between the two: auditing standards are those procedures of quality of performance to be followed by the independent auditor in determining whether the statements in question have been prepared in conformity with generally accepted accounting principles consistently applied.

²⁷ See Strother, *The Establishment of Generally Accepted Accounting Principles and Generally Accepted Auditing Standards*, 28 *Vand. L. Rev.* 201, 219-20 (1975).

²⁸ See text accompanying notes 61-63 *infra*.

²⁹ Metcalf Report, *supra* note 6, at 20.

³⁰ 15 U.S.C. §§ 77a-77bbbb (1976 & Supp. IV 1980).

³¹ See, e.g., Hearings on S. 875 Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess. 57 (remarks of Sen. Adams), 57-59 (remarks of Sen. Reynolds) (1933).

this function.³² Accordingly, Congress required that financial statements filed with the SEC be certified by an independent certified or public accountant, and gave the Commission power to prescribe the detail and content of such financial statements.³³ In addition, the SEC was empowered to define the "accounting, technical, and trade terms, used in [the statute and to] prescribe the form . . . in which required information shall be set forth, the items . . . to be shown in the balance sheet and earning statement, and the methods to be followed in the preparation of accounts."³⁴

The Commission has adopted Regulation S-X, and similar regulations to implement these provisions.³⁵ Nevertheless, the Commission has also assigned considerable responsibility for formulating new accounting principles to private sector organizations, specifically the FASB and its predecessors. This has been accomplished by providing that "principles, standards and practices promulgated by the FASB . . . will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support."³⁶ The theory underlying SEC reliance on the FASB is that the accounting profession has greater resources, expertise, and ability to detect emerging accounting problems at an earlier stage than does the Commission. This relationship has been attacked, however, notably by Professor

³² See, e.g., *id.* at 56-62 (testimony of Col. A.M. Carter, President of the New York Society of Certified Public Accountants).

³³ See Securities Act of 1933, ch. 38, Schedule A, Items 25-27, 48 Stat. 74 (codified at 15 U.S.C. § 77aa, Schedule A, Items 25-27 (1976)); Securities Exchange Act of 1934, ch. 404, §§ 12(b)(1)(J), 12(b)(1)(K), 13(a), 48 Stat. 881 (codified at 15 U.S.C. §§ 78l(b)(1)(J), 78l(b)(1)(K), 78m(a) (1976)); Public Utility Holding Company Act of 1935, ch. 687, § 14, 49 Stat. 803 (codified at 15 U.S.C. § 79n (1976)); Investment Company Act of 1940, ch. 686, § 30(e), 54 Stat. 789 (codified at 15 U.S.C. 80a-29(e) (1976)).

³⁴ Securities Act of 1933, ch. 38, § 19(a), 48 Stat. 74 (codified at 15 U.S.C. § 77s(a) (1976)). Similar authority is found in the Securities Exchange Act of 1934, ch. 404, § 13(b), 48 Stat. 881 (codified at 15 U.S.C. § 78m(b) (1976)) and the Public Utility Holding Company Act of 1935, ch. 687, § 20(a), 54 Stat. 789 (codified at 15 U.S.C. § 79t(a) (1976)).

³⁵ See 17 C.F.R. § 210.2-01 (1981) (independence and good standing requirements); *id.* § 210.2-02 (requirements concerning audit representations and opinions); *id.* § 210.4 (general rules of form, content, and method of presentation of financial statements); *id.* § 256 (prescribing an accounting system to be used by certain types of companies); *id.* § 257 (regulations concerning the preservation of books and records).

³⁶ Accounting Series Release No. 150, 39 Fed. Reg. 1260 (1974), 3 S.E.C. Docket 275 (1973-1974). This policy reaffirmed a policy taken in Accounting Series Release No. 4, 11 Fed. Reg. 10,912, 10,913 (1938), 5 Fed. Sec. L. Rep. (CCH) ¶ 72,005, wherein the presumption that "financial statements . . . prepared in accordance with accounting principles for which there is no substantial authoritative support [were] misleading or inaccurate" was first announced.

Homer Kripke, as an unlawful delegation of government power pursuant to which the regulators have been co-opted by the regulated.³⁷

This charge bothered me a great deal when I was on the Commission because I felt it had some merit. Yet I was convinced that a corps of government accountants would not have the flexibility or insight to serve adequately the needs of the capital markets in developing and adapting accounting principles. I was thus keenly aware of the significance of the Commission's action in mandating the development of "reserve recognition accounting" for oil and gas companies,³⁸ thereby overturning the FASB's determination that oil and gas companies should follow the "successful efforts" method of accounting.³⁹ The Commission's decision proved impossible to implement, and the SEC was forced to return the burden of developing practical value-based accounting disclosures for gas and oil companies to the FASB.⁴⁰

The SEC's original action in overturning the FASB's determination in this instance raises another useful point. Despite the difficult political and accounting questions involved in determining an appropriate method of accounting for oil and gas reserves, I believed that the Commission's admittedly controversial decision was very healthy for the SEC's long-term relationship with the accounting profession. Even if the Commission's decision was wrong on the merits, I would defend it on the ground of political sagacity. On the one hand, the Commission demonstrated that it has both the final responsibility for rules governing financial data prepared to comply with the securities laws, and the capability to exercise effective oversight of FASB standard setting. On the other hand, since the SEC's oil and gas reserve recognition accounting decision was made pursuant to the peculiar provisions of the Energy Policy and Conservation Act of 1975,⁴¹ the Commission was able to assure the accounting profession that it had not embarked on a campaign to change the SEC's longstanding reliance on the private sector for standard setting.⁴²

³⁷ See H. Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose* 150-51 (1979).

³⁸ Accounting Series Release No. 253, 43 Fed. Reg. 40,688, 40,688, 40,712 (1978) (current version at 17 C.F.R. § 210.4-10 (1981)).

³⁹ See Financial Accounting Standards Board, *Statement of Financial Accounting Standards No. 19, Financial Accounting and Reporting by Oil and Gas Producing Companies* (1977).

⁴⁰ See Accounting Series Release No. 289, 46 Fed. Reg. 15,496 (1981).

⁴¹ 42 U.S.C. § 6383 (1976).

⁴² In fact, the SEC stated in its 1979 Report to Congress that "[t]he fact that the Commission reached an independent judgment in this particular proceeding which differed from that of the FASB does not represent any change in the Commission's basic policy of looking to the FASB for the initiative in establishing and improving accounting standards." 1979 SEC Report to Congress, *supra* note 9, at 50.

Very shortly after the SEC's decision concerning the appropriate method of oil and gas accounting, the Commission reverted to its more customary role by relying upon the FASB to develop accounting principles that reflected the impact of inflation and changing prices.⁴³ Even in this instance, however, the FASB's action, which the SEC deemed an adequate response to a very troublesome problem, came only after the SEC proposed its own rules.⁴⁴ The general SEC support for the work of the FASB reflected by the inflation accounting example is extremely important because of the FASB's ongoing work in developing a much needed conceptual framework for addressing accounting problems.⁴⁵

III

THE REGULATION OF AUDITING STANDARDS

Although the legal framework and SEC-FASB working relationship for the accounting principle setting process is well established, surveillance of auditing practices and standards is another story. Here, the SEC and the AICPA are working hard to erect an appropriate regulatory structure. In my opinion, however, this is a house of cards that could well be toppled unless supportive congressional action is taken. Auditing standards for accountants who certify financial statements filed with the SEC are indirectly regulated by the Commission, primarily through enforcement proceedings.⁴⁶ There

As an aside, let me note that I regarded the political atmosphere in which this decision was made as extremely dangerous for the SEC and the private sector standard setters. The manner in which those oil companies committed to either "successful efforts" or "full cost" accounting managed to lobby the Congress to exert pressure on the Commission's decisionmaking process exemplified the value of maintaining independence in a regulatory agency with respect to certain kinds of technical policymaking decisions. I hope that it will be a long time before another accounting issue becomes so improperly politicized.

⁴³ See Accounting Series Release No. 271, 44 Fed. Reg. 62,888 (1979) (codified at 17 C.F.R. § 210.4-09 (1981)) (deleting regulation requiring disclosure of current replacement cost data in financial statements since the FASB had adopted such a requirement).

⁴⁴ Accounting Series Release No. 190, 41 Fed. Reg. 13,596 (1976) (previously codified at 17 C.F.R. § 210.4-09 (1981)). The SEC rule required that disclosure of current replacement cost be made in a footnote to the financial statements.

⁴⁵ See 1980 SEC Report to Congress, *supra* note 19, at 50-59; 1979 SEC Report to Congress, *supra* note 9, at 43-45, 188; 1978 SEC Report to Congress, *supra* note 6, at 30-31, 278-80.

⁴⁶ Accountants are licensed and directly regulated, however, under state law. Although there is a uniform CPA exam, "standards for entrance differ widely [among states] and virtually no mechanism exists for policing professionals on a post-entrance basis." Burton, *The Profession's Institutional Structure in the 1980's*, *J. Accountancy*, Apr. 1978, at 63, 66. A disciplinary mechanism is being developed by the SEC Practice Section of the AICPA and the Public Oversight Board, with the support and encouragement of the SEC. See text accompanying notes 60-66 *infra*.

are two major weaknesses in the disciplinary mechanisms for accountants who practice before the SEC. The first is the lack of clear SEC authority to discipline accountants. The second is the lack of any legal authority outside the securities laws to compel accountants to adhere to auditing standards enunciated by either the AICPA or the SEC.

The SEC has long disciplined accountants and accounting firms under rule 2(e) of the Commission's Rules of Practice.⁴⁷ That rule purports to give the Commission authority to discipline and sanction "any person" by means of a suspension or a permanent bar from practicing before the Commission, if that person is found:

- (i) not to possess the requisite qualifications to represent others, or
- (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws . . . , or the rules and regulations thereunder.⁴⁸

These are very general and amorphous standards. Some are ethical, such as integrity, character, and improper professional conduct. Another relates to competence: the qualifications to represent others. Another is a legal concern: willful violation of the federal securities laws. Further, the rule does not distinguish between discipline as applied to accountants, attorneys, or any other professionals.

Before I became a Commissioner, as well as during my tenure in office, I frequently expressed concern about the Commission's use of rule 2(e) as a general enforcement tool to discipline attorneys.⁴⁹ Some of the same questions concerning the Commission's legal authority to promulgate rule 2(e) and the appropriateness, as a policy matter, of professional disciplinary power in a prosecutorial agency, are applicable to accountants as well as to attorneys. I believe, however, that the Commission does have a stronger basis for asserting administrative jurisdiction to discipline accountants than lawyers.⁵⁰ Nevertheless, since this power is not explicit, it must be implied if it is to be found at

⁴⁷ 17 C.F.R. § 201.2(e) (1981).

⁴⁸ *Id.* § 201.2(e)(1).

⁴⁹ See Darrell L. Nielsen, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,297, at 62,782 (1981) (Karmel, C., dissenting); Keating, Muething & Klekamp, [1979] Fed. Sec. L. Rep. (CCH) ¶ 82,124, at 81,992 (Karmel, C., dissenting); Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 Emory L.J. 747, 762-65, 784-90 (1975).

⁵⁰ The SEC's authority is greater with regard to accountants since the securities laws explicitly give the Commission the power to regulate the form and content of financial statements and require certification of the statements by a public accountant. See text accompanying notes 32-34 *supra*.

all. Accordingly, such a disciplinary power should be narrowly construed and should be exercised only where improper conduct directly interferes with the Commission's administration of specifically granted responsibilities.

I start my analysis with the basic enabling statutes for the regulatory work at the SEC, to which any court must refer in determining the existence and extent of the Commission's authority. No provision in any of the federal securities laws expressly authorizes the Commission to discipline accountants administratively. Indeed, federal law makes the licensing of accountants a state, not federal, function.⁵¹ Furthermore, the express provisions dealing with accounting, auditing, or accountants in the securities laws are at best ambiguous with respect to the issue of professional disciplinary authority.

The only express provisions of the securities laws concerning accounting are those that give the Commission the authority to define "accounting, technical, and trade terms" and to require that financial statements filed with the Commission be certified by an independent public or certified accountant.⁵² Whatever authority does exist simply derives by implication from the general powers given to the Commission to make such rules as may be "necessary" or "appropriate" to implement the express provisions of the securities laws.⁵³ Thus, the issue of whether the Commission can discipline an accountant for defective auditing, when there is no express provision of law giving it authority over auditing standards or procedures, is a very real one.

The Commission's adoption and utilization of rule 2(e) must be sustained (if it is indeed sustainable) on the theory that the SEC has implied authority to proceed against accountants administratively as a necessary and appropriate corollary to these express statutory provisions. In *Touche Ross & Co. v. SEC*,⁵⁴ the Court of Appeals for the Second Circuit upheld rule 2(e) as a disciplinary tool against accountants, as "a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general."⁵⁵ My personal view is that using this implied authority to

⁵¹ See Administrative Procedure Act, § 1(1)(A)(c), 5 U.S.C. § 500(c) (1976) ("an individual who is duly qualified to practice as a certified public accountant in a State may represent a person before the Internal Revenue Service . . .").

⁵² See text accompanying notes 32-34 *supra*.

⁵³ E.g., Securities Exchange Act of 1934, § 23(a)(1), 15 U.S.C. § 78w(a)(1) (1976) ("The Commission . . . shall . . . have power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter . . .," although no liability may be imposed for "any act done or omitted in good faith in conformity with a rule, regulation, or order of the [SEC].").

⁵⁴ 609 F.2d 570 (2d Cir. 1979).

⁵⁵ *Id.* at 582 (citation omitted).

discipline accountants by an administrative proceeding is at best a barely sufficient legal basis for rule 2(e), at least as it is now drafted. The Second Circuit itself, and Judge Kaufman concurring, in *Touche Ross* expressed some doubt as to whether a rule 2(e) case should be brought against a large firm for the auditing failures of one of its partners or employees.⁵⁶ Any use of this regulatory authority, therefore, ought to be strictly confined to financial presentation or independence requirements.

Further, if the Commission is going to exercise general disciplinary authority over accountants, at the very least it ought to concede or specify the bounds of its authority and articulate the standards it is using in applying rule 2(e), something it has never done. An inherent weakness of any implied power is the lack of defined standards. When the government acts without reference to a regulatory standard which circumscribes such action, there is always the danger that such action will be arbitrary or capricious. The effects of such discretionary authority are particularly severe when disciplinary actions are involved. While there is a tendency to rely on the courts to curb excessive action by government agencies, it is time that regulators took the initiative in articulating standards and in exercising self-restraint. This is why I have advocated that the Commission should discipline an accountant only where there is a clear and direct link—a nexus—between the accountant's conduct and the Commission's express authority and its regulatory processes. The Commission should not be using rule 2(e) as a general enforcement tool against incompetent or unethical auditors.⁵⁷

Although the Commission has brought numerous cases against large accounting firms, it has never taken the pains to articulate the legal standards by which it has based the imposition of sanctions.⁵⁸ Lurking in the Commission's decisions and pronouncements is the notion that an implied representation of quality is made in the accounting firm's certification of financial statements. Yet, judicial decisions requiring scienter in fraud cases⁵⁹ cast doubt on the SEC's ability

⁵⁶ *Id.* at 582 n.21; *id.* at 583 & n.1 (Kaufman, J., concurring).

⁵⁷ See Darrell L. Nielsen, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,297, at 62,782 (1981) (Karmel, C., dissenting).

⁵⁸ See, e.g., Ernst & Ernst, 6 Fed. Sec. L. Rep. (CCH) ¶ 72,270, at 62,735-36 (1978); Touche Ross & Co., 6 Fed. Sec. L. Rep. (CCH) ¶ 72,175, at 62,360-63 (1974); Touche, Niven, Bailey & Smart, 5 Fed. Sec. L. Rep. (CCH) ¶ 72,100, at 62,221-22 (1957); Haskins & Sells, 5 Fed. Sec. L. Rep. (CCH) ¶ 72,092, at 62,197 (1952).

⁵⁹ See, e.g., Aaron v. SEC, 446 U.S. 680, 691 (1980); Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976); Investors Research Corp. v. SEC, 628 F.2d 168, 178-79 (D.C. Cir.), cert. denied, 449 U.S. 919 (1980) (scienter required for aiding and abetting liability in action brought under § 17(e)(1) of the Investment Company Act of 1940, 15 U.S.C. § 80a-17(e)(1) (1976)).

to use this type of a "shingle" theory to impose sanctions without proof of intentional wrongdoing. If such sanctions are of doubtful validity, the legality of various compliance procedures imposed by the Commission on accounting firms, such as peer reviews in consent settlements, is even more dubious. For all of these reasons, and because I believe the Commission has abused whatever powers may justify the use of rule 2(e) for professional discipline, I think that rule 2(e) is a poor oversight weapon for the SEC to wield in trying to survey and improve auditing practice and standards.

In its July 1979 report to Congress on the accounting profession, the Commission stated that it "continues to believe that the independence and professionalism of accountants are critical to the credibility and usefulness of their reports. Further, the Commission continues to believe that the initiative for establishing and improving accounting and auditing standards should remain in the private sector, subject to Commission oversight."⁶⁰ At a time when the public generally has been questioning the validity of increased governmental regulation, the Commission has been urging that the accounting profession experiment with self-regulation subject to SEC oversight. But in terms of laying a foundation for the future relationship between the Commission and the profession, it is important that whatever oversight the Commission exercises over discipline be on firm legal ground. If the Commission's authority to act is not clear, its regulation is unlikely to be effective. Because the Commission's reliance on an implied power is so equivocal, it is difficult for its professional responsibility program to be coherent in either objective or implementation under rule 2(e) as currently drafted.

Furthermore, the Commission has no other authority with which to discipline accountants directly. This might not be so serious, if the ability of the SEC Practice Section of the AICPA Division for CPA firms to engage in a program to discipline accountants were resting on a stronger legal foundation.

The SEC Practice Section was created in response to government and public criticism of the accounting profession, and was lauded by the SEC as a major accomplishment towards the development of self-regulation.⁶¹ Membership within the Section is voluntary and consists principally of firms serving publicly held and other corporations subject to direct SEC regulation. A Public Oversight Board serves as an oversight and advisory committee to the Section. The

⁶⁰ 1979 SEC Report to Congress, *supra* note 9, at 8.

⁶¹ See *id.* at 9, 31, 88, 104-41; 1978 SEC Report to Congress, *supra* note 6, at 6, 15; *id.* § F, at 1-70.

Board is composed of distinguished individuals from outside the profession. Initially, the Chairman of the Board was John J. McCloy, and two former SEC Chairmen—William Cary and Ray Garrett—were members.⁶² The membership requirements of the SEC Practice Section include mandatory peer review, continuing professional education, second partner review, audit partner rotation, and an implicit agreement to cooperate with any disciplinary measures imposed by the Executive Committee of the Section.⁶³

The manner in which the AICPA set up this new Section was challenged in a suit filed in January 1978 by eighteen partners and senior members of small- and medium-sized accounting firms. At the end of July 1978, New York Supreme Court Justice Kassal ruled that the AICPA's council had acted within the AICPA bylaws when it approved the new classifications of groups of members in the organization.⁶⁴ Although the decision was welcomed as a significant triumph for the profession's self-regulatory efforts, it did not deal with potentially more troublesome hurdles to the long-term viability of the AICPA's self-regulatory scheme under the federal antitrust laws. As Sandy Burton, former Chief Accountant to the SEC, has pointed out, the "antitrust laws make it extremely difficult for [any] profession to develop a process with real disciplinary teeth."⁶⁵ Moreover, the present legal environment creates difficulties in terms of establishing an unregulated system that would be beyond attack.⁶⁶

Compulsory membership in the SEC Practice Section of the AICPA, in conjunction with the power to discipline members, would basically amount to a combination in restraint of trade under the federal antitrust laws.⁶⁷ Arguments can be made, however, that regulation of accountants could be effectively exempted from the antitrust laws. The powers of an organization such as the SEC Practice Section might be sustainable, despite antitrust regulations, because accountancy is a learned profession and because ethical norms effectuated by disciplinary procedures serve to regulate and promote

⁶² See 1979 SEC Report to Congress, *supra* note 9, at 68, 88-89, 109-24.

⁶³ See *id.* at 69-70, 91-93, 125-41; 1978 SEC Report to Congress, *supra* note 6, § F, at 1-57, 62-70; Moss Hearings, *supra* note 6, at 15-16, 25-31, 48-56.

⁶⁴ *In re Alam*, N.Y.L.J. Aug. 2, 1978, at 6, col. 3, 4 (N.Y. Sup. Ct. Aug. 1, 1978).

⁶⁵ Burton, *supra* note 46, at 66-67.

⁶⁶ *Id.* at 67.

⁶⁷ Sherman Act § 1, 15 U.S.C. § 1 (1976); cf. *Sugar Inst. v. United States*, 297 U.S. 553, 599-602 (1935) (trade group that compelled adherence to advance price announcements, although established to correct industry faults, actually restrained price competition, held violative of § 1).

competition.⁶⁸ A more likely exemption would be implied immunity from the antitrust laws based on SEC oversight.⁶⁹ However, in prior cases in which SEC oversight has been the basis for a limited implied repeal of the antitrust laws, the Commission has had both the clear statutory authority to affect or alter the outcome of self-regulatory action, and it has exercised effective oversight through the use of this statutory authority. At the present time, the Commission does not have any direct oversight authority with respect to disciplinary actions taken by the SEC Practice Section. Therefore, it cannot effectively assure that the procedures of the AICPA comport with due process, or that they do not impose any unnecessary or inappropriate burden on competition.

Of course, since membership in the SEC Practice Section is voluntary, the need to formalize SEC oversight in order to achieve antitrust immunity is still inchoate. Yet, the inability of the AICPA to bring all firms that do SEC work into the Section is a troublesome problem.⁷⁰ This problem will become more serious if the Section attempts to discipline any member. Further, if the Section does not embark on a program to discipline members who do not come up to standard, its self-regulatory program will not be sufficiently credible or effective to command the respect of the public.

The conclusions that others have drawn from this kind of analysis of the difficulties of purely private sector regulation of auditing standards is that the securities laws should be amended to provide for a statutorily authorized self-regulatory body subject to direct SEC oversight, analogous to the NASD.⁷¹ Although I have considerable sympathy for this proposal, I am very reluctant to urge its adoption. In large part, this is because I believe that the 1975 Amendments⁷² to the securities acts imposed intolerable legal burdens upon the concept of self-regulation. These amendments were aimed at giving the SEC increased power to exercise more effective oversight of the stock exchanges and other self-regulating organizations in the securities indus-

⁶⁸ See *National Soc'y of Prof. Eng'rs v. United States*, 435 U.S. 679, 696 (1978) (recognizing that ethical norms which serve to promote competition in a profession may fall within the rule of reason exception, but rejecting application of that exception to the facts of the case); *Goldfarb v. Virginia State Bar*, 421 U.S. 773, 778 n.7 (1975) (certain public service aspects of the learned professions may support practices which, in a business context, would be violative of the Sherman Act).

⁶⁹ *United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694, 721-22, 729-301 (1975); *Gordon v. New York Stock Exch.*, 422 U.S. 659, 685-86 (1975).

⁷⁰ See 1980 SEC Report to Congress, *supra* note 19, at 47-49.

⁷¹ E.g., *Burton*, *supra* note 46, at 67.

⁷² Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 16, 89 Stat. 146 (codified at 15 U.S.C. § 78s (1976)).

try. Nevertheless, the complex and burdensome procedural requirements applicable to rulemaking and disciplinary proceedings by self-regulation militate against creative and flexible regulation.

The accounting profession does not need a more adversarial and more legalistic relationship with the SEC. Indeed, one of the positive effects of the joint resistance of the SEC and the accounting profession to the kind of federal legislation suggested above, and proposed by Congressman Moss, has been greater understanding and cooperation between the government and the profession in working toward practical solutions to current problems.

Yet, I do feel that some clarification of the SEC's disciplinary power with respect to accountants and accounting firms is in order, if such a power is to serve as an effective "shotgun in the closet" to encourage private sector improvements in auditing practices.⁷³ For example, the SEC's present authority to proceed against persons who make false filings with the Commission⁷⁴ could be enlarged to include the imposition of specified sanctions against accountants and accounting firms. If, at the same time, Congress provided the SEC Section of the AICPA with some degree of limited immunity under the antitrust laws, the regulatory burdens that would flow from a scheme of compulsory federal licensing of accountants could perhaps be avoided.

CONCLUSION

Although the political mood of the country shifted in the late seventies so that the Moss and Metcalf Reports did not result in remedial federal legislation to regulate the accounting profession, I do not believe that the federal government's interest in accounting will diminish. Financial statements are too critical an indicator of economic health for the government to lose interest. Moreover, as the political power of the "Big Eight" accounting firms has grown with their involvement in auditing the government and multinational enterprise, accounting and the regulation of accountants have become political issues. In addition, public distrust of the accounting profession continues.

Some of this distrust is the result of frustrated expectations that never should have been encouraged in the first place. Accounting, though an international business language, is neither objective nor exact. The purpose of audits is to enhance the value of financial

⁷³ Further, the SEC's responsibility for formulating auditing standards (without reference to their enforcement) should be made express.

⁷⁴ E.g., Securities Exchange Act of 1934, § 15(c)(4), 15 U.S.C. § 78o(c)(4) (1976); Investment Company Act of 1940, § 8(e), 15 U.S.C. § 80a-8(e) (1976).

information disseminated to external constituencies, and not to provide a deep pocket to pay investor losses when a corporation fails.

I do not minimize the difficulties that must be surmounted by the SEC and the accounting profession to regain the public's confidence in the value and reliability of financial reporting. Yet, such confidence is an indispensable ingredient of capital formation. If the Commission would become a more reasonable regulator, perhaps those it regulates would be less afraid to seek congressional assistance in legitimizing the Commission's oversight authority. In the case of the regulation of accountants, the need to utilize the SEC's expertise to enforce and promote better accounting principles and auditing standards is critical. As pointed out by one commentator:

Disturbing cross-currents are at work. While a strong push for greater certainty and uniformity in financial statements is occurring, the uncertain economic atmosphere casts a pall over all accounting deliberations. Some of the stresses and strains are familiar such as management's desire to put the best face on the company's financial statements; others are unfamiliar, for example, double-digit inflation and its implications for an accounting system grounded on historical cost.⁷⁵

In this kind of environment, where the public and private sectors need to better understand the ways in which economic events are recorded, and to improve methods for such recording, preoccupation with the imposition of liability for mistakes is counterproductive. When communications are scrutinized primarily for the purpose of avoiding potential liability, there is little incentive for creativity. The challenge of assessing and meeting the needs of the capital markets to raise capital must assume paramount importance. Throughout the decade of the seventies the SEC endeavored to conscript accountants to help enforce the securities laws, an objective that the courts have begun at least to question.⁷⁶ The general governmental attitude on this subject was probably best expressed in the Metcalf Report as follows: "Potential legal liability for negligence is the most effective mechanism for assuring that independent auditors perform their public responsibilities competently and diligently."⁷⁷

I strongly disagree with this conclusion. My own view is that if the regulators and the regulated are distracted by debates over how to compensate particular individuals for losses realized in their invest-

⁷⁵ Hawes, *Truth in Financial Statements: An Introduction*, 28 *Vand. L. Rev.* 1, 1 (1975).

⁷⁶ See *SEC v. Arthur Young & Co.*, 590 F.2d 785, 788 (9th Cir. 1979).

⁷⁷ Metcalf Report, *supra* note 6, at 19.

ments, or how to punish everyone who was possibly responsible for such losses, the general welfare will suffer because our society's creative energies will not be channeled into more productive pursuits. Furthermore, risk is an inherent element of investment, and the public should be educated to understand and accept loss as well as gain in securities investments. There is an urgent need for the SEC to encourage the accounting profession to develop better methods for communicating the accomplishments and vulnerabilities of U.S. business, so that investors will be able to place capital where it is most needed and will be most efficiently utilized.