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by

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I am honored to be the presenter of the thirty-fifth Emanuel Saxe Accounting Lecture at this distinguished College of this distinguished University. The program refers to this scheduled lecture as "distinguished"; I would have preferred that judgment to be left to you in the audience and to others who read the published results. In preparation for this lecture, I have read many of the previous lectures and some, in addition to being truly distinguished, are relevant to my subject tonight -particularly those by A. Carl Tietjen, William T. Baxter, Robert N. Anthony, and Abraham J. Briloff, the Emanuel Saxe Distinguished Professor of Accountancy.

I am pleased that Professor Briloff is in the audience to witness one of what he has termed the "anointed seven Solons of Stamford," coming down from that high ridge in Stamford -- that "bucolic setting" — to, in the Professor's tongue-in-cheek words, the "contaminating environmental influences of the big city." Professor Briloff and I were together in another big city - St. Louis -- several years ago, when he compared the FASB to the architect and engineers who designed and built the large, imposing Gateway Arch on the riverfront in that city. He glowingly praised the work and precision of those engineers who started the construction at each end, and in a glorious climax to their endeavors put into place the last section that joined the two parts perfectly 630 feet above ground. In contrast, Professor Briloff visualized that the FASB, as the constructor of a conceptual framework for financial reporting, would start at each end, miss at the top, blithely continue on, and complete the project by building twin arches -- okay for a hamburger stand, but not what St. Louis expected.

Tonight I am going to talk about expectations, not of the conceptual framework but rather those concerning professionalism in financial reporting, standard setting, and public accounting.

The brochure publicizing this lecture indicated that I would also review fundamental changes in society's expectations of its business institutions since World War II; describe how those changes have affected standard setting and the accounting profession; discuss the historical progression from no standards a half -century ago to descriptive, non mandatory guidance and ultimately to the proliferation of specific, mandatory standards in the last two decades.

Let that summary suffice for purposes of tonight's lecture. Tonight I would like to concentrate on the here and now, with only an occasional reference as background to the endeavors of the FASB over the past eleven years to contribute to the credibility of financial reporting and to the professionalism of public accounting.

I have spent a good deal of time in my eleven years as a standards setter in the city, in the marketplace, listening to the rationale, analyzing the words, and witnessing the actions of those who prepare, audit, and use financial statements. In a recent visit to the city I participated in a discussion with the Financial

Accounting Standards Advisory Council about what is perceived as a decline in the professionalism of preparers and auditors of financial statements.

When we accountants refer to professionalism or "the profession," we sometimes mean the public accounting profession. But professionalism in the financial reporting area is by no means the exclusive property of the practicing CPA. The essence of professionalism in any field is a voluntary commitment to achieve excellence. In financial reporting, this means commitment on the part of both the corporate manager and the auditor. It means a commitment to upholding technical standards and ethical standards of conduct. Both types of standards are expected to protect the public by assuring objectivity and integrity on the part of preparers and auditors of financial reports. The result expected is credible financial reporting.

The primary reason for the discussion in the Advisory Council was what some observers see as a tendency to bypass the intent of accounting standards. The questions that framed the areas for discussion were the following

1. Do preparers, in exercising their corporate responsibilities, seek innovative transactions or interpretations that are designed to observe the "letter" of an accounting standard but not its "spirit"—and to what extent does this bring them into a matching of wits with auditors? Is there or should there be a different standard of professionalism for preparers and attesters?
2. Does heightened competition among CPA firms encourage a search for ways around the spirit of accounting standards?
3. Are not investment bankers fulfilling their essential role in developing innovative financing arrangements which may, in fact, tend to frustrate the spirit of accounting standards?
4. How does the professionalism issue relate to the question of specific versus broad standards?

The convergence of various events made the subject and questions particularly timely, even though ethical questions are timeless. Ethical questions are always difficult at the individual level and are never satisfactorily answered at the societal level. Somewhere in between the difficult questions and the unsatisfactory answers is the dilemma of professionals trying to perform at a level higher than the minimum required by law but not beyond the capabilities of mere mortals. While difficult, ethical questions must be addressed, particularly when the subject is one like financial reporting which is intended to serve the public interest. Troubled economic times, with the usual business failures, occasional audit failures, and questionable accounting, give added point to such a discussion, as do other recent events that I believe are significant. Those events include:

- The American Institute of Certified Public Accountants' re-looking at its self-regulation, triggered in large part by the profession's own concern about a decline in professionalism.
- A special committee of the AICPA criticizing the FASB for creating too many professional standards.
- The structure committee of the Financial Accounting Foundation urging the FASB to provide more timely guidance, a euphemism for more professional standards.
- An SEC member focusing on "cooked books" and "cute accounting" in a major speech.
- The chairman of a powerful committee in Congress questioning the adequacy of the SEC's oversight of standard setting.

To top it all off, what could be more timely than a March 21, 1984 opinion of the Supreme Court of the United States in a case concerning confidentiality of an auditor's workpapers. In that opinion the ultimate public expectation about the public accountant's role in financial reporting was expressed by Chief Justice Burger as follows:

> ...By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant

> performing this special function owes ultimate allegiance to the corporation's creditors and stockholders as well as to the investing public. This 'public watch dog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

Later in that same opinion the Court said:

> . . . 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. Endowing the workpapers of an independent auditor with a work-product immunity would destroy the appearance of auditor's independence by creating the impression that the auditor is an advocate for the client. If investors were to view the auditor as an advocate for the corporate client, the value of the audit function itself might well be lost.

Let me start with the AICPA's recognition of a decline in professionalism. The speeches and actions of recent chairmen of the AICPA furnish ample evidence of their deer concern that commercialism may be overtaking professionalism, meaning objectivity and integrity in the practice of public accounting. The late William R. Gregory, then chairman of the AICPA, summed it up at the annual meeting of that organization in 1980. He observed that growth in the profession and in the competitive pressures within it "have created in some CPAs attitudes that are intensely commercial and nearly devoid of the high-principled conduct that we have come to expect of a true professional." Mr. Gregory's successors have continued to express that concern.

Recognition of the need for self-examination of the public accounting profession and professionalism is not limited to the AICPA. In a recent newsletter of the National Conference of CPA Practitioners, the chairman, Mr. John F. McMullan, makes the point that "The profession of public accountancy is losing its sense of direction" and maybe endangering its public franchise by expanding services and pursuing growth for growth's sake. He concludes by stating, "If we do not become active in defending our profession and defining what we feel is an appropriate future, then the future will be decided by the actions of others and through our own default."

There seem to be few professional groups that receive as much public attention and governmental scrutiny as the public accounting profession receives. The public importance of the profession accounts for part of that, but the failure to meet public expectations in the past is the prime reason. A favorite source of mine (and others) for insight into this problem is an article by an eminent man of letters, Jacques Barzun, written in 1978 and reproduced, in part, in the March 1984 *Journal of Accountancy*. Barzun notes that in an age of instantaneous communication, openness, egalitarianism, and impatience with authority, professions (all of them) are particularly vulnerable institutions. He notes:

> As a whole, every profession is always horribly average, mediocre. By definition it cannot be anything else. But the public expectation aims much higher than mediocrity, so that in a time of reckoning, when the laity is hot about its rights, general dismay and recrimination are inevitable. What is more, although any art should be judged by its best results, a democratic nation, bent on equality in all things, is sure to judge a profession by its worst exemplars. That is the condition we are in now.

Barzun warns:

> . . . the modern professions have enjoyed their monopoly for so long they have forgotten that it is a privilege given in exchange for a public benefit.

Barzun suggests that:

> . . . what the professions need in their present predicament is, first, the will to police themselves with no fraternal hand, with no thought of public relations.

The one thing to be avoided in the self-policing is, according to Barzun, the "huddling together of members of a guild to hush up their mistakes."

While the FASB plays an important role with regard to professionalism — indeed, some have said it is part of the cause of the problem rather than part of the solution -- the Board has no role at all when it comes to the policy deliberations of the AICPA. I have, however, made it my business to read up on what the AICPA is trying to do in its internal studies of the functions of its Accounting Standards Executive Committee, the SEC Practice Section, and its Code of Ethics. All are being studied in light of the concerns about professionalism.

All of the current internal efforts of the AICPA to enhance professionalism seem pointed in the right: direction. The Public Oversight Board of the SEC Practice Section in its 1982-83 Annual Report has attempted to keep public expectations about the role of private self-regulation within reasonable bounds. In a recent follow-up to that report *(Journal of Accountancy. April 1984).* a member of the Public Oversight Board has publicly described the nature of actions taken by firms in response to deficiencies found in the quality of their work.

It seems to me that the Public Oversight Board is evolving a way to assure the public that the self-regulatory effort is not concerned about public relations - or protecting the huddling members of the guild If a more heroic moral effort is needed to meet public expectations (as Barzun suggests it sometimes is), it must come from the leadership of the SEC Practice Section. I will have more to say about that later.

The AICPA. in addition to its internal efforts, has told the FASB (in the report of the Special Committee on Accounting Standards Overload) that generally accepted accounting principles as presently defined are not meeting the public interest responsibility of financial reporting, particularly for smaller companies. The charge is that there are too many standards. the standards are too detailed, complex. and inflexible. The FASB is called upon to develop and popularize a flexible concept of generally accepted accounting principles in order to avoid dividing the profession, the abandoning of GAAP and the eroding of support for the FASB. Thus, the FASB is seen as a possible contributor to a decline in professionalism because of its perceived sins of commission in writing standards.

But the flip side of that record is the contention that the Board also sins on the side of comssion -- that it does not produce enough standards. For example, shortly before the AICPA completed its "Overload" report, the Trustees of the Financial Accounting Foundation issued a report on the "Operating Efficiency of the FASB". The Trustees' report concluded that generally the degree of specificity in FASB standards had been about right, that the Board was dealing with the right issues, but that there was a need for more timely guidance on implementation questions and emerging issues that have important financial reporting implications. In other words, more standards -- and more specific, less flexible standards -- are needed.

We are trying to deal with the contradictory advice we are receiving, but I must tell you it is a difficult juggling act. We are still working on ways to give more timely guidance and at the same time work with the AICPA on some of the problems in the "Overload" report. The Board has formally responded to that report, but does not consider its job finished, particularly with regard to the concerns of small businesses.

The major new suggestion from the AICPA contained in the "Overload" report was that the Board should consider differential measurement when simplicity and flexibility are not feasible and the needs of users and the ratio of costs to benefits justify it. With all those qualifications attached to "differential measurement," it is impossible not to consider it, but the Board was extremely guarded in its response to that suggestion. The guarded response in part is because at some point "differential measurement" becomes indistinguishable from two sets of generally accepted accounting principles (GAAP). The 'Overload" report points out, correctly I believe, that two sets of GAAP " is an undesirable solution that does not have a sound conceptual basis and is one that would pose a threat of dividing the profession." However, in another part of the report it is suggested that significant departures from the measurement principles of GAAP would be needed to deal effectively with the overload problem.

I hope you can see why the FASB is very reluctant to get onto the slippery slope of "differential measurement." Keep in mind that GAAP is designed to fill a public responsibility of meeting the reasonable needs of the users of financial statements for reliable, comparable information *and* the need to present fairly the financial position and results of operations of an enterprise. Thus, GAAP is a key part of a CPA's professionalism. For these reasons, it seems certain that we cannot grant the massive relief the "Overload" report suggests. Writing as an individual, my fellow Board member David Mosso sums up the reasons much more eloquently than the Board's official response to the "Overload" report. His views, with which I agree, were published in the October 1983 issue of *CPA Journal*. He includes among the major obstacles to substantial relief the fact that CPAs don't agree on the cause of the problem, let alone the solutions. The quest for more guidance leads to more standards. The users of financial statements want a financial statement to be a financial statement, i.e., they do not want to have to shift gears when they move from one class of company to another.

Well, what about the Conceptual Framework for financial reporting? Won't that contribute to professionalism by providing the broad principles needed to guide preparers and auditors? Won't that result in the flexibility suggested by the "Overload" report? Won't that tip the scales away from narrow rules toward broad standards allowing professional judgment? My simple answer to those questions is a regretful, no. Broad accounting principles or standards by themselves are not enough when the Supreme Court believes that financial statements must be *accurate* and that the public must *perceive* them as accurate: they are not enough when users of financial statements clamor for comparability and a U.S. Senate subcommittee calls for uniformity of accounting standards to be a major goal of standard setting. That does not mean that standards must cover every possible circumstance or transaction. Striking the right balance between broad and narrow is a constant challenge. Knowing where the FASB should stop and where the preparer and auditor should be left to exercise their professional judgment also is a challenge that has confronted the Board since its beginning.

When the FASB was organized in 1973, it was the decision of the Board to concentrate its limited resources on broad pervasive issues. The Board also announced the following:

> It should be pointed out that, in connection with existing pronouncements, various interested persons have requested the advice of the Standards Board or its staff regarding the meaning or application of these pronouncements. As a matter of policy, neither the Board nor its staff answers technical inquiries or gives advice on accounting and financial reporting matters, whether by private ruling, personal opinion, or otherwise.

The FASB's posture did not last long because the practicing accountant was unwilling to be left on his own in an uncertain, litigious world. The president of the AICPA, early in 1974, conveyed the concerns of the public accounting profession about the FASB's posture as follows:

> There has been a growing concern among the Institute's members in public practice

> about the need to deal swiftly with the relatively narrow accounting and reporting problems that are frequently encountered in daily practice. This matter was discussed at the February meeting of the AICPA Board of Directors and will be discussed again at its next meeting on April 26th. [ten years ago this very night] It was the consensus of the Board in February that the FASB should be strongly urged to take whatever steps might be necessary to provide timely guidance to practitioners on emerging problems.

Not much has changed in the ten years, has it' except for, possibly, a growing recognition that the problem is not solely technical. Almost ten years ago Carl Tietjen lectured here to the effect that ethical problems cannot be solved by technical standards. (Except possibly after the fact and in very narrow circumstances.)

As an example of this growing recognition let me quote to you from two comment letters to the FASB from a corporate financial executive. The first was dated January 28, 1983 and the second, March 12, 1984. In the first letter the following is said:

> . . . It seems to us, that broad standards, which emphasize substance over form, should be more workable, efficient and cost effective than detailed standards. Preparers and/or their public accountants are capable of determining the bookkeeping requirements. The Board should establish broad parameters, and put the onus of execution on preparers and the accounting profession. The accounting profession (AICPA) should take a much stronger role with respect to practitioners (particularly those dealing with public companies) who interpret standards too loosely.

That commentator went on to say in his first letter:

> ...It would appear that, if the Board completed the Concepts Statement series and if the series were adopted as GAAP, there would be no real need for a plethora of standards. As long as methods and techniques fell within the broad guidelines (developed to emphasize substance over form) and obtained a result which 'presents fairly the financial position and results of operations,'as attested to by the practitioner, the job would be done. The AICPA and State Societies would have to stand up and hold their membership to reasonable interpretation.

In the second letter, written last month, fourteen months after the one just quoted, the same commentator said:

> . . . There is no question that the Proposed Technical Bulletin should be issued at the earliest practical date...Rather than allowing standards setters to gravitate towards broader standards, matters handled such as those in the 'Proposed Technical Bulletin'. . . have the opposite effect on the so-called 'standards overload' and cookbook rules many of us have complained about for years. Perhaps the Board should use this issue to illustrate the problem to the accounting profession and preparers. Loose interpretations of standards crease an environment for more rules rather than less and the profession and preparers thus contribute to the very 'standards overload about which they complain.
>
> ...1 would like to reiterate my prior comments to the Board that loose standards interpretations really are enforcement issues for the AICPA and the SEC rather than more standards, interpretation, or technical bulletins. Nevertheless, I must say that the present issue has made me more aware of and sympathetic to the Board's problems."

Sympathy, however, does not solve the problems of declining professionalism. Neither more nor fewer technical accounting standards can cure the problems. In fact, standards probably can do little more than put a band-aid on the problems. In what David Mosso has described as today's two-platoon accounting process, technical accounting standards can only plug the holes and hold the line against a high-powered offensive unit's attempt to penetrate holes in existing GAAP to get more bottom-line score. In my view, accounting standards setters are not the cause of the problem, but certain accounting standards clearly are symptomatic of the problem.

What, then. *is* the cure'? I would suggest that it is basically a matter of business ethics and professional conduct.

But recognizing that just widens the area in which to look for solutions. The problem is more difficult -- as is every ethical problem -- than the technical problem of plugging the loopholes. In a recent speech to an audience of corporate financial executives I commented that the gentleman's game of golf requires a set of rules -- a very detailed set, I might add. Of course, I said, YOU and I do not read or need those rules because we play every shot as it lays. It because of those "other guys" that we have the rules. Nor do you and I search for ways to keep debt off the balance sheet or research and development costs and executive stock compensation off the income statement. We know the broad principle that liabilities should be in the balance sheet and expenses in the income statement. We know that substance must triumph over form. We don't need rules to tell us what is right, and we know that some things are wrong even if there is no rule that prohibits them.

It is easy to say that the problem arises because those "other guys" do not view the game the same way we do, but that is an oversimplification. As long as an accounting decision is perceived by preparers of financial statements as either winning or losing an advantage, the "other guys" in the financial reporting game will push for rulings. You and I may not like that, and may even consider the others unethical, but aren't they well within their rights to seek advantage and to ask for rulings? After all, is financial reporting any more of a gentleman's game than is the game of golf?

Further, it is not only the seekers of advantage who need and ask for specific rules. In both golf and financial reporting, anyone may encounter unforeseen legitimate problems for which guidance is needed to determine the answer.

For these reasons, broad principles like "follow accrual accounting," "practice full disclosure," and "let substance override form" in financial reporting, and "play it as it lays" in golf, are just not enough to keep the game fair.

With regard to ethical questions, if solutions are to be sought -- and I think they should be -- let us first briefly examine whether the players in the game, other than the public accounting profession, can enhance professionalism in financial reporting. Corporate Directors, Chief executive officers, Chief financial officers, and financial analysts all have a large stake in credible financial reporting. Financial reporting is one aspect of larger societal concerns about corporate performance and responsibility. The long-run interests of those who believe in our economic system require recognition that responsible, credible financial reporting is inseparable from responsible corporate performance. Organizations such as the Business Roundtable, the Financial Executives Institute. and the National Association of Accountants have taken steps by enhance objectivity and integrity in management and financial reporting and in corporate conduct and integrity in management and financial reporting and in corporate conduct in general. The Financial Analysts Federation, through its Corporate Information Committee has for thirty five years identified those companies whose financial reporting is relevant, objective, clear, complete, timely, and understandable -- and therefore credible.

More needs to be done on a voluntary basis to further enhance the professionalism of those who prepare and issue financial reports. It would help to enhance the credibility of the entire corporate governance system, and that may be essential to ensure success of efforts by the public accounting profession. After all, the financial statements are those of the corporation. The reporting decisions contained therein are those of corporate management. Corporate management should not hide behind GAAP or the opinion of the auditor. Questionable decisions accepted by auditors are not solely the auditor's responsibility. In fact, questionable reporting practices almost always originate with the preparers of financial reports. How to achieve more professionalism on the part of preparers, I leave for another time. (In fact, at this time I do not have a good suggestion to achieve the objective.)

I would like to conclude by focusing on the public accounting profession.

The "capsule summary" of this lecture contained the following lowing quote from the "Overload" report:

> Standards should not be written to deal with accounting practices designed to obscure the substance of transactions or to serve the needs of the profession to curb unethical practitioners. Appropriate disciplinary bodies should be used to achieve those objectives.

To a certain extent, I agree with the AICPA suggestion that disciplinary bodies *could* be used to curb unethical practitioners who promote or accept accounting practices that obscure the substance of transactions. The fact is, however, that for the past thirty years, at least, the accounting profession has relied on technical standards, rather than ethical standards, as the primary means of preventing financial reporting abuses and eliminating undesirable reporting practices. The worst of human behavior has caused the writing of auditing standards and accounting standards. The authoritative literature contains ample evidence of it.

The process of writing standards itself also is instructive in this regard. A good deal of time at the FASB is spent in sorting out and understanding the substance of transactions in specialized areas. We are asked to deal with row subjects like savings and loan combinations, research and development partnerships, sales of receivables with recourse, collateralized mortgage obligations, junior stock, and in-substance defeasances. In part. we are asked because of honest differences of opinion that arise from the fact that substance, like reality, cannot always be easily identified. On the other hand, however, there are cases where we are convinced that poor judgment, aggressive marketing of services, client pressures, and the search for loopholes are the reasons requiring FASB action. The distinctions among honest differences of opinion, poor judgment, and unethical behavior are sometimes difficult to draw, but we seem to be seeing more problems that tall into the last two categories.

The FASB has no enforcement powers, and I hope it stays that way. Let the Board deal with the technical problems, but let's see what can be done within the AICPA to enhance professionalism. Again, I emphasize that the problem is not solely that of the public accounting profession. The solution, if it exists, cannot be achieved solely by the public accounting profession.

I mentioned earlier that the various committees of the Institute are studying the right subjects but that I am not privy to the policy deliberations of the AICPA. I have not participated in a peer review, nor does my familiarity with the procedures followed go beyond a reading of the Institute's Quality Control Standards. These views are my own, but seeds for my own thoughts come from my fellow Board members, present and past.

Let's try to avoid more pious words in a code of ethics -- in part because I am not a moralizer, in part because lawyers will discourage it because it is unenforceable. Let's concentrate on where the power is, where a large part of the problem is, and where political risk is-the SEC Practice Section. Let's recognize that attitudes about professionalism start at the top and permeate professional organizations. Let's ask each firm to develop its own code of professional conduct on the kinds of issues that are troublesome to the profession. Let's at first refrain from making judgments about those codes, but only determine, through the peer review process, whether they exist and are followed. Let peer pressure shape those codes and test their truthfulness and: then require their public disclosure. The objective would not be to have boilerplate, profession-wide platitudes, but honest descriptions of how individual firms conduct themselves, how they make decisions and set policies for matters such as:

1. soliciting clients
2. bidding for audit engagements
3. ensuring that adequate work is performed regardless of fee
4. advising management, audit committees, and boards of directors on the most appropriate possibility from among reporting choices
5. setting growth goals affecting the audit practice
6. protecting the integrity and objectivity of the audit partners and staff
7. advising non-clients on accounting matters
8. taking positions on FASB proposals independent of client viewpoints

Let's not try to legislate morality; it can't be done. But let's try what Professor Briloff has suggested: "let every flower grow." Let each firm develop its own code of professional conduct, then test its viability in practice and through the peer review, let the marketplace know what each firm's ideas about professional conduct are.

Agreement among partners on a statement of their firm's policies should be a highly educational experience. The process itself should broaden understanding of what professionalism means -- and, one would hope, deepen the commitment to it.

I said earlier that the essence of professionalism in any field is a voluntary commitment to achieve excellence. In financial reporting and public accounting it also requires that the public interest overrides self-interest. Such a commitment is easy to state -- and easy to depart from. But when the commitment is made specific in particular areas of a firm's activities, it has the potential to provide meaningful guidance in the day-by-day conduct of a practice.

There may be other viable ways to "cure" the problem of a decline in professionalism. I urge that they be considered and discussed and that action be taken on one or more of them sooner rather than later. Society's high expectations and its tendency to judge a profession by its worst exemplars require action to enhance professionalism, to insure its triumph over commercialism.

Of two things I am certain: relying on the FASB to provide more and more band-aids will not cure the problem; neither will radical surgery by government regulation.

Expressions of individual views by members of the FASB and its staff are encouraged. The views expressed in this text are those of Mr. Kirk. Official positions of the FASB on accounting matters are determined only after extensive due process and deliberation.