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UNITED STATES GENERAL ACCOUNTING OFFICE
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ADDRESS BY
ELMER B. STAATS
COMPTROLLER GENERAL OF THE UNITED STATES
UNITED STATES GENERAL ACCOUNTING OFFICE
BEFORE THE
FINANCIAL EXECUTIVES INSTITUTE

THE ACCOUNTING PROFESSION
FEDERAL REGULATION AND PAPERWORK

No one among us can possibly be unaware of the turmoil that has dominated the national scene for the last 10 years. We have undergone and survived the riots and demonstrations of students and other groups on our campuses and in our cities. We have undergone the agony of Southeast Asia and Watergate, and have survived the rejection of two successive presidents and the defeat of a third at the polls. We have witnessed a continuing parade of disclosures of actions and practices in Government and the business world of bribery, theft, embezzlement, incompetence, and whatever.

And in this latter situation, a great deal of the blame has come to rest in the lap of the accounting profession. This even though there is no clear understanding of just who and what is included in the accounting profession, and no clear understanding of why some other persons and groups are excluded.

It is not my purpose this morning to resolve that mystery but I am going to assert a few definitions and boundaries so you will know where I am coming from.

First, I will adopt the position that the first line of responsibility for the selection of accounting procedures, and for the accuracy of financial and other reporting rests with management. Other persons who are engaged in the development of useful accounting procedures, and in the independent examination of managements' conduct and reporting of corporate affairs also have a share of this responsibility. But any notion that any number of accountants and auditors--however skillful; or that any degree of uniformity and utility that might be worked out in accounting procedures; or that any level of governmental regulation and supervision, can protect the public against a widely ranging assortment of skillfully dishonest, or incompetent managers is nonsensical.

But even so, when things get as bad as some of our recent history, there is plenty of discredit to go around and we need not be picky about who or which group was most at fault.

Having made the point that the primary obligation for guarding the public interest as it relates to corporate business in the North Central Area is here in this room, we can now move along to the topics that Archie Long suggested. These include the Washington climate for development of financial accounting standards; GAO's role under the Alaska Pipeline Act in administering the Federal Reports Act, and the burden of Federal paperwork.

The accounting profession has been under fire in recent years for several reasons among which are the accounting practices used by corporations in reporting financial and related information to the public. Attention has focused on these matters because of clandestine wrongdoings by a relatively small number of large corporations that have now been

revealed, and because of a series of recent corporate failures which were caused by financial problems. In some cases the problems were caused or aggravated by the use of accounting practices that failed to accurately disclose the substance of corporate business activities.

It is further claimed that improprieties such as the use of inappropriate accounting practices or embezzlement are often not detected by auditors because independent auditors have failed to follow general accepted auditing standards.

THE METCALF STUDY

The situation led to a Senate review of these matters in 1976 and a report entitled "The Accounting Establishment," prepared by the Subcommittee on Reports, Accounting and Management, of the Senate Committee on Government Operations. It was chaired by Senator Lee Metcalf (now deceased) and is usually referred to as the Metcalf study. It points out that the Congress gave the Securities and Exchange Commission broad authority to establish accounting and reporting standards as part of its mandate to administer and enforce the provisions of the Federal securities laws. However, SEC decided to rely on accounting standards established in the private sector as being protective of the public interest--so long as these standards have substantial authoritative support.

During the past 40 years the American Institute of Certified Public Accountants has created three successive bodies to mastermind the development of accounting principles and it has also always assumed a large share of the task of overseeing their use. But even now, criticism still is heard that accounting principles are too permissive and don't always convey economic reality. Moreover, many believe these problems have been intensified

by what the Senator claims is a lack of independence and dedication to public protection by the large accounting firms which perform the key function of independently examining and attesting to the fairness of the financial information reported to the public by large corporations.

The Subcommittee held extensive hearings in April and May of 1977 and recommended that the accounting profession, rather than the Federal Government, be relied on to police itself, subject to closer SEC review. The report unanimously approved by all Subcommittee members, made important recommendations including:

1. Creation of a self-regulatory organization having disciplinary powers similar to those of the New York Stock Exchange or the National Association of Securities Dealers and with SEC oversight. All firms that audit publicly-held companies would be required to join. In order to perform audits, a firm would have to meet the organization's performance and behavioral standards and would have to undergo quality reviews by independent reviews teams at least once every 3 years. Reports of the reviews would be submitted to the SEC and made available to the public.
2. Disclosure of financial and operating data by all auditing firms with publicly held clients.
3. Auditors found negligent in their audits would be legally liable for damages suffered by private parties.
4. Management advisory services would be restricted to areas related directly to accounting. In the report's words:

"Nonaccounting management services such as executive recruitment, marketing analysis, plant layout, product analysis and actuarial services are incompatible with the public responsibilities of independent auditors and should be discontinued."
5. Restrictions on advertising, on talking with another firm's clients, and on talking with another firm's employees about possible employment without first informing that firm should be eased.
6. Independent audit committees of outside directors would be established for all publicly-owned corporations.

The report does not call for immediate congressional action; but suggests that if the profession "moves too slowly" in putting the Subcommittee's recommended changes into practice, new legislation may be necessary. Further hearings by the Subcommittee are planned in July when the SEC submits its report on the status of the accounting profession.

THE MOSS HEARINGS

The question of whether self-regulation is sufficiently effective or whether Federal legislation is needed now to improve the accounting profession's performance was also the theme of hearings held in early 1978 by the House Subcommittee on Oversight and Investigations, chaired by Congressman John Moss. H.E. MOSS

The Institute took the position that legislation to regulate the profession is unnecessary or counterproductive, and submitted a formal statement to the Subcommittee outlining steps it has taken over the past months. The statement discusses four types of actions:

- Regulation of CPA Firms,
- Discipline of Individual CPA's,
- Independence of Auditors, and
- Auditing Standards and Performance.

In regulating CPA firms, the Institute has established an SEC Practice Section and a Private Companies Practice Section. The purpose is to regulate for the first time those firms which practice before the SEC and audit publicly-held companies. Under the SEC Practice Section, self-regulation would be accomplished by

- mandatory peer review,

- sanctions of firms for failure to meet requirements of the section,
- mandatory rotation of audit-engagement partners,
- public reporting of certain firm information, and
- monitoring of all section activities by a public oversight board.

The Institute proposed that instead of legislation, a procedure be established to permit the Subcommittee to monitor the program as it develops.

The Institute is of the opinion that implementation of these actions, coupled with existing SEC regulation, disciplinary actions by State boards of accountancy, and the pressures stemming from civil actions against CPA firms should be adequate to assure a high level of audit performance. Consequently, it says, Federal legislation should not be necessary.

SEC ACTIONS

The Chairman of the SEC, in testimony last February, urged that the accounting profession be given additional time to set up its own system, pointing to recent progress. By recent progress, he undoubtedly refers to the proposals of the Institute, together with actions taken or proposals made by several of the "big 8" public accounting firms, notably Arthur Andersen and Company, and Price, Waterhouse and Company, in their presentations before the Metcalf Subcommittee. These included several stringent professional requirements for firms of accountants who audit corporations that report to the SEC.

The SEC is expected to submit a report to the Congress by July 1 which will review the progress of the profession's efforts. SEC will be looking at such matters as:

- The thoroughness, quality and independence of the mandatory peer review program.
- Development of an effective disciplinary structure.
- The profession's response, whether through the division for CPA firms or some other appropriate vehicle, to the final recommendations of the Commission on Auditors' Responsibilities.
- Steps taken by the Public Oversight Board and the Peer Review Committee and whether they are living up to expectations.
- The success of individuals, firms and professional organizations within the profession in enhancing independence.

The actions being taken by the profession to restore confidence in self-regulation are persuasive evidence of a determination to strengthen the overall effectiveness of the profession.

In my opinion the profession should be given further opportunity to regulate itself without new legislation. Of course we are awaiting with keen interest the report that SEC will submit to the Congress on the progress that the profession and the Commission have made. As part of our continuing oversight of the activities of SEC, we will review and evaluate the effectiveness with which it carries out its responsibility in this area.

The statements submitted by the Institute at the Moss hearings spell out additional actions to be taken and can serve as a prudent set of objectives against which attempts at improvement by the profession can be measured. By carrying out these actions effectively and promptly, the profession can show the public that it is serious about restoring public confidence in its work.

Another way to regain some of the confidence that the profession has lost might be to show the public that there is no mystery, surrounding

what auditors do. It is an obligation of all professions to inform the public about their capabilities and limitations. The public should be shown how to accommodate itself to what can reasonably be expected from an audit.

At the same time, the profession must look at how it goes about its work and, where it can, it must meet those public expectations that are reasonably achievable. The objective should be to align as closely as possible what the public expects with what the profession can provide.

Related to all this is the present climate in Washington for developing financial accounting standards. Not all of the criticism leveled against the Financial Accounting Standards Board and the private sector's standards setting process comes from voices inside the Federal Government. As many of you know, the Board has encountered substantial opposition to its Statement No. 19, "Financial Accounting and Reporting by Oil and Gas Producing Companies." Earlier Board statements have also been controversial and some, such as Statement No. 8 on foreign currency transactions continue to draw strong criticism from the private sector. Never before, however, have opponents to a Board statement openly requested the Federal Government to intervene. These opponents are asking in effect for SEC to make a "cost-benefit" judgment.

Last fall, soon after the Board issued its exposure draft on oil and gas accounting standards, several independent producers stated that the standard, if put into practice, would hinder their ability to raise needed exploration and development capital, and jeopardize the national goals of stimulating supply development and competition in the oil and gas industry. Senators Haskell and Bartlett introduced an amendment to an unrelated energy

bill that some interpreted to mean that the Board should not develop uniform standards of accounting and reporting for oil and gas producers. The Haskell-Bartlett amendment was rejected when the bill went to conference. However, the conference committee reported that the SEC was to conduct a public hearing on the position taken by the Board and evaluate the potential economic impacts of the Board's position before SEC decides whether or not to endorse it. The SEC does, of course, have the statutory authority to set accounting and reporting standards; it could overturn the Board or remand the issue to the Board for further consideration.

The SEC conducted eleven days of hearings on the Board's oil and gas draft in March and April during which views of more than 100 persons were heard. While the hearing focused specifically on Statement No. 19, many of the issues raised reach far beyond the specifics of oil and gas accounting. Fundamental questions regarding the objectives of financial accounting standards and the role of the private sector in setting standards also were raised. The following questions are illustrative of those raised by the SEC:

- What weight should the SEC give to decisions of the Board on technical accounting matters?
- On what basis should the SEC overturn a Board statement or remand it to the Board for reconsideration?
- What role should considerations of adverse economic impact and national policy goals play in setting financial accounting standards?

The SEC's decision and the rationale they follow in this issue will establish fundamental lines of responsibility between the private and Federal sectors in setting accounting standards, and will outline some of the primary objectives of financial accounting standards.

FEDERAL GOVERNMENT
FINANCIAL REPORTING TRENDS

Of course the need for better accountability and reliable financial reporting also extends to all forms of government--State and local, as well as Federal. At that level, extensive use of deficit financing and an increase in pension liabilities have accentuated the need for the Federal Government to provide better overall financial reports that more clearly show the Congress and the public the critical aspects of its financial position in relation to its obligations.

We at GAO endorsed the concept that comprehensive, periodic financial statements covering the full range of Government activities be prepared in brief, easily understandable form. I have participated, as a member of the Advisory Committee on Federal Consolidated Financial Statements to the Treasury Department, in its effort to prepare such statements.

Last July when the Secretary issued the second prototype report of these statements we endorsed the concept of comprehensive financial statements covering governmental financial activities, but we have cautioned that the statements must be considered preliminary and that many aspects of presenting information and determining appropriate amounts for Federal assets and liabilities will require further study before fully satisfactory financial statements can be achieved. We particularly stress the need for a "family" of statements--not just a single balance sheet.

Once these issues are resolved, the development and publication of Federal consolidated financial statements prepared on an accrual basis should then bring more responsible accounting to the U.S. Government. They will help to identify emerging financial problems so that actions can be taken before a crisis stage arrives. These statements should also

help decisionmakers recognize the impact of their decisions on future fiscal flexibility. And they should reveal to the public in easily understandable terms the financial condition of their National Government.

It should be noted that as far back as 1952, GAO established accounting principles to guide Federal Government agencies in their accounting work. These have been revised periodically to reflect changes in accounting theory and practice. Agencies responsible for 98 percent of the Government's accounting systems have agreed to follow these principles in their accounting work. Consequently, a good base from which to prepare the comprehensive statements is developing. It is our hope that these consolidated statements ultimately will make the Government's financial situation more comprehensible to everyone.

FEDERAL GOVERNMENT PAPERWORK

Now, I'd like to turn to a brief discussion of an issue with which I'm sure you are all too familiar--Federal Government paperwork. The term seems to encompass a number of problems and issues associated with Government programs, and frequently serves as a surrogate for complaints about Government controls and regulations of all types. There is no question that the amount of reporting required of business, local government, and individuals has become an issue of national concern.

In GAO we became heavily involved in the paperwork issue late in 1973 when the Congress transferred responsibility for reviewing independent regulatory agencies' information-gathering proposals from the Office of Management and Budget to GAO. This transfer was made in an amendment to the Federal Reports Act which was attached to the Alaska Pipeline Act. This has caused caustic references to GAO's "Alaska Pipeline Act" responsibilities which, of course, have nothing whatever to do with the pipeline. Some of you will remember that the proposed FTC

line of business reporting issue indirectly caused the OMB responsibility to be transferred to the GAO.

Essentially, we were given the task of reviewing independent regulatory agencies' information gathering proposals to determine two things: first, that the information requested was not already available somewhere in the Federal Government; and second, that providing the information would not constitute an excessive burden on the businesses or people concerned. The final decision as to the need for the information was left to each of some fourteen regulatory agencies.

We have found it very difficult to evaluate the burden on the public with relation to the need for information by the agencies. These differences make up the elements of a cost-benefit equation which must be considered in determining if information should be collected. We have done our best to carry out this responsibility and will continue to do so. However, we remain of the view that the reports clearance process should be centralized within one agency, having greater authority than we have in GAO.

The requirements of the 1973 Reports Act amendment and the nature of the clearance process itself tend to limit our effectiveness in controlling the growth of paperwork burdens on the public. The Act requires that we complete our review within 45 days after receipt of a submission from a regulatory agency. This is ample time for simple requests but many of the regulatory agency proposals are complex, costly to respondents, and contain controversial issues—all difficult or impossible to resolve in a short time.

The reports clearance process has some inherent limitations which restrict its value as a control mechanism. It occurs at the end of a report development process which, in some cases, has been working for months

or even years. Agency positions have hardened and policy decisions have been made which are difficult, if not impossible, to alter at the stage when information-gathering requirements are submitted for review.

We use two basic tools in assessing how well the agencies have done in minimizing reporting burdens and in determining that the information requested is not already available. These tools are a rather detailed supporting statement by the agency seeking to collect information, and comment by those in the public who will be affected.

We require each agency to submit a detailed supporting statement

--justifying its need for the information sought,

--outlining the steps taken to limit the burden on respondents,

--identifying reasons why existing information will not serve its needs, and

--showing how the information will be used in carrying out the agency's mission.

This statement is carefully reviewed by our staff and questions are raised, as appropriate. The statement also is made available, upon request, to anyone wishing to provide public comments on the agency's proposal.

We have been criticized by some agencies and by some public representatives for our use of the public comment process. Since the criticisms come at us from different directions and take different forms, we have allowed ourselves to hope that the process must be worthwhile.

Some agencies have expressed the view that public comment is redundant in those instances where an agency already has obtained comments in developing a regulation. To some degree, this criticism is valid. On occasion we receive no more in the way of comments than already has been provided to the agency. We have, however, concluded that, in many instances, comments

provided to an agency do not focus on the information-gathering requirements associated with a rulemaking proposal. A corollary point is that the information-gathering requirements contained in a rulemaking are frequently changed considerably by the time they are submitted for GAO review. Consequently, our method provides more certainty of public comment on the agencies' final version of the information requirement.

Public criticisms of GAO's comment process usually take the form of complaints about the short period of time provided. We are able to allow only about 18-20 days for receiving and reviewing comments because we must complete our review within the 45-day statutory limit. Obviously, there is little we can do to extend the time for comments and this relatively short period frequently brings public cries of outrage and understandably so.

However, those cries of anguish have served to strengthen our belief that it is right to provide the opportunity for public comment and it will continue to be an integral part of GAO's review process.

I'd like to mention that we at GAO have come to know and respect Bill Schofield of your Washington office through his efforts in coordinating comments on financial reporting issues to our staff. GAO people first got to know Bill in connection with his representation of FEI on the Business Advisory Council for Federal Reports, which has been of great help to us along the way. Bill wrote an excellent article on GAO's reports clearance process in the Financial Executive last year, so he is a fine source of information on how we do our business.

On a somewhat broader basis, I'd like to outline for you now, some of the things GAO will be doing in trying to improve the quality of data reported to the Federal Government, and to reduce the growth of burdens

on those of you who must provide that data. Our Federal Reports Act clearance responsibilities have perhaps been the most visible effort to the public to date, but by no means do they encompass all of our work in this area of concern.

GAO'S ROLE IN FEDERAL PAPERWORK

I have established what we at GAO call "issue areas" to help us focus on problems in the management of the Federal Government's myriad of programs and services. Essentially, an "issue area" is a planning mechanism, allowing GAO to focus top management attention on issues of broad national importance.

Three issue areas deal specifically with paperwork:

- statistics and other information obtained from non-Federal sources,
- information management by the agencies, and
- improving program and budgetary information reported to the Congress.

We have budgeted about \$5 million in fiscal year 1978 for work on these subjects.

The first involves the collection of information from non-Federal sources--individuals, businesses, and others--and the use of information by the Federal agencies. It covers what the public generally has in mind when it refers to paperwork burden.

Information collection addresses both paperwork and statistical issues.

The more important sub-issues are

- enhancing the utility of information the Government collects from non-Federal sources,
- reducing the burden of the Government's information demands,
- improving management controls over Government information collection efforts, and
- carrying out GAO's Federal Reports Act responsibilities.

Our work is directed at reducing the burden on respondents while seeing that the Government agencies collect the information they need to manage their programs efficiently. Our work also involves reviewing the Federal statistical agencies' activities to insure that the agencies are accurately and reliably compiling statistics for policymaking, program operations, and general information for the Government and the public.

The second area involving paperwork covers the creation and management of information or records by Federal Government agencies. The important issues we have identified include:

- reducing the Federal Government's ever-increasing paperwork burden and the corresponding spiraling costs;
- determining whether the Privacy Act, Freedom of Information Act, and Sunshine Act result in more openness in Government; and
- determining whether, because classified records are exempt from the Freedom of Information Act, Federal agencies use their classification authority to restrict public availability of information.

FEI has been very cooperative in making suggestions and providing information when we have asked for your help in these matters and we appreciate it.

The third area concerns the improving of program and budgetary information for congressional use. This includes working with congressional committees and Federal agencies to eliminate duplicate and nonessential reports which are currently required by the Congress.

This work was directed by the Legislative Reorganization Act of 1970, as amended by the Congressional Budget Act of 1974. In October 1977, we initiated, with all the congressional committees, a review of the more than 1,500 reports submitted to the Congress on a recurring basis by the various Federal agencies. This review resulted in the identification of about 130

reports which were no longer needed or which could be modified to reduce the paperwork burden. The results of our work are described in more detail in our report to the Congress entitled "Progress in Improving Program and Budget Information for Congressional Use" (PAD-77-73, August 30, 1977).

We are pursuing our work with the committees to refine the list of reports that can be eliminated or modified. Ultimately we will be developing legislative proposals to cover the results of our work. In a similar review made several years ago approximately 40 reports were eliminated.

We have also started a major project to look into the feasibility of greater standardization of accounting rules and reports required by various regulatory agencies. A large portion of the information gathered by regulatory agencies is financial information. We understand that there is a lack of consistency both in the principles of accounting prescribed by various regulatory agencies and in the requirements and the formats for reports of financial information.

As a final matter, but still in the context paperwork and the administrative burdens of Federal regulation, I want to tell you something about our concern with costs and benefits at the Cost Accounting Standards Board. As you know, the Congress instructed the Board to develop cost accounting standards "designed to achieve uniformity and consistency in the cost-accounting principles followed by defense contractors. . . ." The Board's basic legislation further provides that in its promulgations "The Board shall take into account. . . the probable costs of implementation, including inflationary effects, if any, compared to the probable benefits, including advantages and improvements in the pricing, administration, and settlement of contracts."

The Board has, since its inception, been mindful of both requirements-- the duty to achieve greater uniformity and consistency, and the duty to consider the probable costs of implementation compared with the probable benefits. In the area of costs and benefits we have a problem faced by many Federal agencies. That is, we have great difficulty in finding quantitative measures of either costs or benefits.

One major point which could have been considered is the likely shift of incurred cost among contracts or types of work. The Board has long recognized that a Cost Accounting Standard may result in a shift of cost to or from Government contracts. From the beginning we made the decision not to count such shifts either as "costs" or "benefits" in our evaluations.

We have always been interested in possible techniques for improving the comparison process. We had an evaluation conference in Reston, Virginia, last October and there sought advice from interested parties. We got an adequate amount of criticism, which was not surprising, but we got relatively little advice, which was disappointing. The Financial Executives Institute was an exception; your group gave us a good suggestion for a formal feasibility study. This FEI suggestion was a significant factor in our decision to ask a group of outside consultants to undertake an independent review of the situation and to give us suggestions as to procedures the Board might follow in the future.

We have selected a group of consultants and have furnished them a quantity of background materials. Members of the group are:

Robert Anthony, Harvard Business School
Solomon Fabricant, National Bureau of Economic Research
Lacy Thomas, The Brookings Institution
Arthur Toan, Retired Partner, Price, Waterhouse & Co.

We expect them to begin work in June and they will meet with the Board in the late summer or early fall to discuss their suggestions with us.