RESEARCH IN ACCOUNTING REGULATION

Editor: GARY JOHN PREVITS

Associate Editors: LARRY PARKER
SHYAM SUNDER
ORACE JOHNSON

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A Research Annual

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PREFACE

Research in Accounting Regulation seeks to present quality work across a broad spectrum of regulation issues. This number includes papers which cover the following topics:

Economics	The economic role of the audit.
Government Regulation	The "Oversight Cycle" hypothesis.
	SEC sanctions of CPAs.
Legal	Litigation under Rule 10b-5 after the Hochfelder case.
	The role of the courts in establishing the nature of goodwill.
Self Regulation	Standard setting for governmental accounting.
	"Public Interest"—traditional views vs. the views of the Anderson Report.
Technology	Artificial intelligence applications for regulation.

In addition, the opinions of Robert Sack, Chief Accountant of the Division of Enforcement at the SEC, are provided as they relate to the role of the auditor. The issue also contains perspective essays of a legal and historical character; review essays on recent books which provide interesting insights into regulation and its processes; and a reference glossary to aid those who study or teach in the areas related to Securities Law and Accounting.

Gary John Previts
Series Editor

REGULATION:
THE FORCES INFLUENCING ACCOUNTING PRACTICE

Larry M. Parker and Gary John Previts

THE PURPOSE OF RESEARCH IN ACCOUNTING REGULATION

Regulation topics in accountancy encompass forces that influence the practice of accounting professionals. Regulation is a powerful and complex social device which is difficult to comprehend. *Research in Accounting Regulation* seeks (1) to increase understanding of the forces that influence our discipline; (2) to help academics and practitioners better relate to these forces; (3) to stimulate an interest in accounting regulation research; (4) to provide a forum for conceptual and empirical research by accounting scholars, commentaries by opinion leaders, reviews of recent literature, and other items relevant to accounting regulation.

Research in Accounting Regulation, Volume 1, pages 1–4.

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UNDERSTANDING THE INFLUENCES ON THE ACCOUNTING PROFESSION

Some may view the main issue in accounting regulation to be the contrast of alternatives of self regulation and government regulation. Since continued coexistence of both is likely, the main issue becomes how the two types of institutions may effectively and positively interact—not an easy matter to resolve.

Government institutions—legislative, executive, judicial and regulatory agencies—all affect accounting practice, and often give conflicting and changing signals to the profession. Legislative initiatives such as the Wyden bill suggest that the profession assume a role akin to that of a government agency—responding directly to the federal government in certain instances. The Federal Trade Commission's (FTC) rulings and suits against professionals have influenced the Code of Ethics and the competitive practices of professional accountants. The FTC seems to view the professions as no different from any other business. Yet, in the March 1984 Supreme Court decision, then Chief Justice Warren Burger reminded professionals of their unique duties toward the public interest.

Is the profession of accounting a type of government agency (Wyden) a business like any other business (FTC), or a unique, independent profession with a duty to the public interest (Supreme Court)? The answer, of course, is that it is all (or some combination) of these at a given point in time.

The accounting profession is influenced by several levels of types of institutions (represented below), and the signals from each level are likely to be as conflicting as those from the first level (The Federal Government) alone.

1. Federal Institutions, e.g., courts, legislatures, agencies.
2. National Institutions, e.g., stock exchanges, Federal Reserve System, major insurance companies.
3. State Governments. e.g., courts, legislatures, Boards of Accountancy, banking commissions, utilities commissions.
4. Institutions Supported by the Accounting Profession. e.g., Auditing Standards Board, Financial Accounting Standards Board, Government Accounting Standards Board, Public Oversight Board.
5. Professional Organizations. e.g., American Institute of Certified Public Accountants, American Accounting Association, National Association of Accountants, Institute of Internal Auditors, Financial Executives Institute, Business Roundtable.
6. Each Individual CPA Firm's Policies.

A matrix of these institutional influences would be complex, and further conditioned by the economic, technical and social environment which surrounds the profession. Some examples of these factors are:

1. The number of business failures. The climate and incidence of business misconduct.
2. Perceptions of the level of public trust and understanding of the accounting profession—expectation gaps.
3. The potential and actual use of microcomputers and artificial intelligence. The effect of initiatives such as the SEC's Electronic Data Gathering, Analysis and Retrieval systems (EDGAR) and other electronic data base reporting projects.
4. Litigation and liability insurance.
5. Competitive pressure—maintaining quality and reducing costs.
6. Complex financial transaction (including mergers, acquisitions, and leveraged buyouts) in international financial markets.
7. Society's increased consulting and information management needs, and the appropriate role of professional accountants in meeting these needs. Perceptions of auditor independence.
8. Increased specialization and segmentation in the accounting profession.

Research in Accounting Regulation proposes to consider these issues in order to gain an understanding of the institutions, environmental factors, and processes or interactions involved in accounting regulation.

REACT, OR ANTICIPATE? THE PROFESSION'S ROLE IN DIRECTING THE FORCES THAT AFFECT ACCOUNTING PRACTICE

Accountants have been useful for centuries because they have responsibly met society's needs and expectations. As society changed, so did accountants. In the past it may have been adequate for the profession to be reactive. That is, when the profession perceived a need in society, accountants *reacted to the present*. But it is no longer adequate to be reactive. The profession must, to the best of its ability, anticipate the future needs of society and the pressures of regulatory institutions, and *react to the future*—i.e., be *proactive*. Even so, unanticipated factors will appear and the profession will have to react, but to a lesser degree in these cases. We feel that the profession should structure itself to be flexible enough to react quickly. A ponderous process of change is not acceptable. The profession must, at a minimum, be committed to a planned program to be proactive—anticipating the environmental options that it faces.

But anticipating the future is only the minimum role for accounting today. The discipline of accountancy is a powerful force in commerce, but accountants have preferred a background profile. The profession can become a direct force in shaping the future in an ethical and positive manner, developing into a voice for the future of society. There are risks to such a role, and it should not be assumed lightly. We will encourage papers which explore and evaluate the appropriate role for the profession and the processes for achieving it.

MAIN ARTICLES

THE ECONOMIC ROLE OF THE AUDIT IN FREE AND REGULATED MARKETS:

A REVIEW

Wanda A. Wallace

ABSTRACT

Since 1980, research has enhanced our understanding of the economic role of the audit in free and regulated markets. This paper discusses how this research ties into key sources of demand for the audit, supply issues, and regulatory activities. In addition, changes in the audit environment and cost function faced by CPAs and auditees alike are described. Implications of recent research are summarized and suggestions for future research are provided.

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I. INTRODUCTION

Over the past decade, academicians and practitioners have developed a keen interest in understanding the role of auditing in the economy. This interest has been sparked by increased competition in the market for audit services, as well as increased surveillance of this market by the U.S. Congress, government agencies, and other interested parties. In 1980, a monograph entitled *The Economic Role of The Audit in Free and Regulated Markets* [Wallace, 1980] provided a first step in summarizing our understanding of the role of auditing. Since this monograph, we have learned more about the auditing environment itself and the important issues in this environment.

Numerous theoretical developments and empirical studies have provided added insights as to the role of the audit in both the free market and the regulated sectors of the economy. Certain changes in the audit environment have shifted the relative importance of the varied sources of demand, as well as the nature of the cost function faced by CPAs and auditees alike. The objective of this paper is to provide a perspective on the auditing research that has taken place over the past decade—that is, to reflect on how the Wallace monograph could be updated to describe more effectively our current understanding of the audit function. To facilitate the integration of such an update into the materials developed in the original monograph, this paper is organized into 10 parts corresponding to the 10 chapters of the monograph. Familiarity by the reader with the original monograph or the concepts developed therein is assumed. However, care is taken to summarize the important issues involved in each component of supply and demand. Specifically, the relevant questions asked, the extent to which research has shed light on these questions, and the lines of inquiry left to future research are described. In addition, an explicit linkage is made among sections to ensure an integrated picture of the auditing environment.

II. THE MARKET EVIDENCE

This section addresses the demand for audit services in various markets both past and present. The common characteristic that is shared by these various markets is that audits were not required by law. In studying these markets, insights are provided about the nature of the demand for auditing. Recent research not only provides prima facie evidence that audits are demanded in free markets, but also tests the various markets for the consistency of observed demand with theoretical concepts detailed in the literature. Examples of this latter type of research are integrated throughout this article, in tandem with discussions of the primary sources of demand for audits and supply-related issues.

Pre-SEC demand for audits has been modeled empirically by Chow [1982]. Specifically, in 1926 companies that chose to be audited by a professional auditor tended to have a larger number of debt covenants written in accounting numbers than those companies which did not undergo an audit. This research corroborates the fact that voluntary audits were common among both the New York Stock Exchange and Over-the-Counter companies prior to SEC regulation and also implies a tie into agency theory as a source of demand for audits.

Pre-U.S. demand has been documented in depth by Watts and Zimmerman [1983]. They trace audited reports in England back to the late sixteenth century joint stock companies and even earlier to merchant guilds. A far more in-depth analysis of 1900–1940 is provided by Edwards [1981]. As the author notes: "Directors voluntarily published a great deal more financial information than the law required" [p. 54] and, in particular, the Companies' Act introduction of a compulsory external audit requirement had already been met long before legislation, in a "laissez-faire" environment [p. 46]. Other evidence of extensive voluntary audits is provided by Jones [1981] who reports that over 50 percent of the fee income in 1985 of a predecessor firm to Ernst & Whinney was earned through auditing activities.

Non-SEC demand is empirically documented for the municipal sector in Wallace [1986]. Initial audits by municipalities span the entire 1900s, well before any explicit regulation affecting such practices. Moreover, when the timing of an initial audit is modeled as a function of joint demands for monitoring, information, insurance, and operating cost savings, adjusted for the cost of the audit (including potential "bad news" effects), correct prediction of pre1956 audits exceeds 70 percent. Specifically, municipalities with professional managers consistently undergo initial audits at an earlier point in time than those run by mayors. In addition, the operating characteristic of utility ownership (expected to enhance operating cost savings from an audit and to increase the likelihood of an auditable information system) is a significant indicator of early audits. Bond rating classification is one of the most important predictors of audit timing, suggesting that decisions to initially contract with an auditor in part reflect the municipal leaders' desire to improve the municipal unit's bond rating to reduce interest rates. Indeed, the study demonstrates that interest cost savings do accrue from contracting for an initial audit (the reduction is statistically significant at a .008 level).

Beyond merely addressing the incidence of an audit, O'Keefe and Westort [1985] explore the quality of municipal audit reports as measured by conformance to generally accepted auditing standards' reporting provisions. They find that quality increases as the client's accounting system improves, the number of auditing firms in the client's geographical area increase, and the engagement's partner's CPA exam performance improves. Hence, a market exists for nonSEC audits of high quality and these audits' occurrence ties to attributes of the auditee, auditor, and the marketplace.

Through research support by the National Association of Accountants (NAA) and the Financial Accounting Standards Board (FASB), Abdel-Khalik [1986] was able to explore the demand for auditing by private companies. He identifies hierarchical complexity and wealth of the auditee as the main determinants of the discretionary choice of hiring external auditors. The theoretical rationale is based on the concept of organizational loss-of-control. This rationale can be viewed as an agency problem between owner-manager and employees or as an information problem in tracking performance within an organization, given the unobservability of actions as the chain of command gets longer. The findings imply that as the level of economic resources subjected to the hazards associated with a loss of control increases, the demand for an external audit also increases. Moreover, if the number of hierarchical levels increase, so does complexity and the associated demand for an audit. Of particular interest is an observation concerning the choice among internal compensatory control systems and external audits:

> The ability of external auditing to provide expert examination independently of constraints inherent in the organizational design of the auditee renders it a reliable compensatory control device. As such, external auditing is not limited by the constraints faced by "native" systems of internal auditing or internal control. (p. 24)

An interesting survey research paper [Oliverio and Newman, 1985] revealed 107 of 117 companies' top managers (five of which were private companies, with the remainder being Fortune 500 Industrial Companies) stated that they would have an annual audit by a public accounting firm even if it were not required by the Securities Exchange Act of 1934. The most commonly cited reasons for such demand included the discipline imposed on the entire financial system (74 percent of responses) and the increase in the credibility of financial statements (68 percent). Over a third of the respondents indicated that the banks required an external audit. Eight of the 10 who stated that they would not have an audit cited alternatives available through use of internal audit staffs. However, the question of whether an alternative to the annual audit by an outside accounting firm should be allowed by the Securities and Exchange Commission resulted in virtually a unanimous "no."

Research indicates that there is a demand for audits in the absence of regulatory requirements. However, the arena for such research is shrinking. In 1979, the 1976 federal legislation requiring municipalities to undergo audits on a triennial basis became a constraint for those units receiving $25,000 or more revenue sharing funds [Local 1977]. Approximately 11,000 of the 40,000 state and local governments in the United States are constrained [Pacter, 1980].

Nevertheless, many research avenues exist. The extent of damage to relatively unregulated sectors (not-for-profit organizations) has received limited attention (i.e., Rowe and Giroux [1986] indicates that 26 of 117 dioceses (territories) of the Roman Catholic Church had no auditor). Similarly, inquiry into international auditing practices has been limited. Primarily, past research has classified auditing practices into groupings based on economic, legal, and social differences. For example, Hussein et al. [1986] demonstrate an association with the environmental factors of level of securities markets activities, the origin of the legal system, who set standards, and the presence of codified auditing standards. By investigating such markets, a more comprehensive understanding of why a particular type of audit is demanded may evolve [related issues are explored by Jones, 1981, Edwards, 1981, and Previts, 1985]. The availability of such resources as the inventory of data sources for governmental and other nonprofit organizations [Government, 1985] prepared by the Government and Nonprofit Section of the American Accounting Association should facilitate such inquiry in the nonbusiness sector.

As discussed, private markets have been explored only to a limited degree. Of particular interest are audit-related requirements placed upon private companies by bankers and creditors. Under what circumstances are such requirements imposed? This market-generated source of demand, both its occurrence and form, can shed light on the relative importance of various determinants of demand, as well as the form of supply likely to meet such demand. The plausible sources of demand described in the extant literature include agency theory, information theory, and an insurance hypothesis which ties to both investors and regulators. We will now direct our attention to each of these distinctive determinants of demand.

III. AGENCY THEORY: THE STEWARDSHIP (MONITORING) HYPOTHESIS

This section addresses the demand for audit services due to the existence of agency relationships. In essence, agency theory holds that agents or stewards charged with certain decision-making responsibilities on behalf of principals have an incentive to be monitored in order to assure the principal's best interests. Moreover, in the absence of monitoring, principals would assume divergent actions by the agents and "price-protect" themselves by lowering compensation to those agents. Of interest is when monitoring takes the form of an audit.

The lines of research which have been explored in the context of agency literature can be characterized as representing two major streams of inquiry. One line of research, utilizes analytical modeling to mathematically derive optimal incentive contracts and information systems; Scott [1984] provides a review of analytical agency research tracing the demand for audit services. Information as to effort, not totally contained in the observed payoff, is expected to be demanded. An audit enhances knowledge of the payoff by all parties and may also shed light on effort. Analytics suggest that agents' demand for an audit is greater when their payoffs are low; this is apparently due to their wish to demonstrate that they are relatively blameless for an unfortunate state of nature. While intuitively appealing, such implications are limited by two key problems: (1) a focus on single-period models, when multiperiod decision-making exists and (2) the presumption that the auditor is a virtual "machine," rather than "a rational decision-maker," capable of error [Scott, 1984, p. 185]. An extension to three-person models introduces coalition problems and interaction effects between auditors and managers [see Antle, 1984], precluding analytical conclusions. Empirical examination of lending officers' perceptions as to auditors' ability to resist management pressures indicates that clients in good financial condition are more likely to obtain their preferred outcome than are clients in poor condition, particularly if the conflict concerns a matter not dealt with precisely by the technical standards [Knapp, 1985]. Interactions among auditors, managers, and third parties warrant further investigation both analytically and empirically.

The other major stream of empirical inquiry tests the predictability of agency theory [see Kelly, 1983; Watts and Zimmerman, 1986 for a review]. For example, Eichenseher and Shields [1985] demonstrate that auditor choice can be explained, in part, by agency relationships of a company—in particular, the higher its debt-to-total-assets ratio, the more likely the use of a Big-Eight auditor. The trend of this stream of research toward increasing detail at a micro level is reflected in Healy [1985]. Attention to detailed contracts, bonus plans, and board of directors' composition is expected to produce measurable results of agency theory, whereas most have discounted the plausibility of detecting effects on market prices [Holthausen and Leftwich, 1983]. Perhaps, with such attention to detail, those characteristics of an agency relationship leading to an audit in lieu of other monitoring devices is isolated. For example, it may be that a board-member banker, aware of a particular incentive plan's effectiveness in aligning the interests of owner and manager, does not demand an audit. Conversely the banker in a similar position, in the absence of some form of stock incentive plan, typically requires an audit. This is the type of question likely to be explored within this second stream of research.

Of special interest is the recent application of agency theory to the international market [Chow, 1985]. A significant and positive relationship between the extent of voluntary disclosure by 53 Mexican corporations was linked to firm size. Chow points out the role of the audit by a public accountant in deterring direct audits by tax authorities. Moreover, the personal legal liability of the individual certifying the financial reports is noted to persist regardless of the form of organization of an accounting firm. Such factors would be expected to encourage more effective disclosure. Yet, the research focuses on accounting disclosure rather than exploring auditing issues. If detailed audit practices in countries with differing agency relationships were studied, insights could be gained as to which attributes of an agency relationship appear to lend themselves to an audit as a monitoring device. Since the costs and benefits of an audit are likely to depend on institutional characteristics, attention to details is essential.

In exploring historical events, researchers have been warned by Merino et al. [1986] of the need for an adequate historical inquiry before proceeding with a particular research design. One example they cite is the fact that Greco/Roman economies did not have the type of market incentives posited by agency theory; hence researchers were required to explain the relevant context before proceeding to interpret "facts" to fit theory (fn. 28). The authors pose some interesting research questions worthy of attention. Direction concerning specific historical analyses that would be capable of testing whether agency theory has explanatory power is provided.

A theoretical development related to agency theory is the application of transaction cost economics as a means of evaluating corporate governance [Williamson, 1984]. This theory reduces contracts to its lowest common denominator—the transactions encompassed by such contracts. The ideas developed have the potential to anticipate the demand for auditing and other accounting services. In theory, these ideas imply that general purpose assets do not require the protective governance structures, such as representation on the board of directors, which may be needed when transaction-specific assets are involved, requiring special purpose technology. It may well be that the nature of assets is systematically tied to the demand for auditing. Inquiry into this linkage between monitoring practices and whether or not assets are of a special-purpose nature will have to focus on voluntary markets and analyze those conditions under which audits are observed. Of particular interest is the work by Fama and Jensen [1983], which explains that the organizational form of audit firms works as a bonding mechanism between auditors and the users of financial statements. In a sense, the auditor is the agent of the public and the litigious exposure of the auditing firm provides assurance that actions of the CPA will be in line with users' expectations.

Little doubt exists that systematic relationships exist between agency-based measures and diverse monitoring practices, particularly alternative accounting practices. However, research into the dimensions of the demand for auditing as they relate to agency theory is in its infancy. For example, little is understood about the selection of auditors, and the use of annual, versus periodic audits on a less frequent basis [see Berry and Wallace, 1986 for a discussion of governmental auditing practices that provide examples of the latter], or the interaction among managers, owners, and auditors. Both analytics and predictability studies can enhance our understanding of the role of agency theory by creating the observed demand described in Section II. Integrally linked to agency theory is information theory. In fact, the sole difference is the source of demand for information, including the audit. Asymmetry of information in an agency setting creates demand by the agents, because it was presumed that principals could either forego contracting or price-protect themselves. In contrast, an information market would reflect demand from a diverse set of users, including both principals and agents. With this sole distinction and recognized overlap along other dimensions, we turn to the information hypothesis as an explanation of observed demand.

IV. THE INFORMATION HYPOTHESIS

Benefits of information to decision making, including the reduction of risk, the enhancement of decisions, and an increase in profits, potentially accrue from audits. Interest is questioned when audits are the preferred form of information, and to what extent do public good attributes of information influence the level of production of audited information?

Perhaps the most visible development in the study of information is the use of laboratory market experimentation in accounting and auditing research. Simplistically, this approach mimics certain characteristics of a real market place in a laboratory setting and tracks transactions among subjects (commonly students) to infer the effects of differential information, market structures, and monitoring devices on decision making. DeJong et al. [1985] describe the relevancy of this research approach to a variety of policy issues in auditing. An example of such a study is DeJong et al. [1986]. Here alternative ways of controlling audit quality are explored. Specifically, the relationship between collusion, pricing, and product quality is examined. It was determined that collusive opportunities result in price fixing and higher profits but can enhance the quality of the product. Price disclosure lowers profits and decreases quality, rather than enhancing stability or price competition. Market efficiencies did not result from collusion or price disclosures, but along the lines of quality dimension. The research supports professional organizations' exercise of some degree of control over the audit process.

The timing of information flow and the speed of market adjustment have been the focus of research in the accounting arena [Patell and Wolfson, 1982], and would appear to have influenced information dissemination practices of the Securities and Exchange Commission (SEC). Specifically, the SEC has moved toward on-line data bases of publicly filed information. This development may have key implications for the auditing profession, since untimely filings will be increasingly evident to users of financial statements [Whittred and Zimmer, 1984] and details of filings reflecting audit services will be more widely disseminated. This dissemination may well deter selective reporting practices in annual reports [Williamson, 1984]. Another reporting development which may have implications for the information hypothesis is the practice recently endorsed by the SEC of disseminating summary annual reports. This supplement to reporting requirements would contain condensed financial statements and other key financial data more accessible to the public. Complete audited financial statements would be an appendix to proxy materials rather than a part of the traditional annual report [DH&S, 1987]. Whether condensation will lose information as any aggregation procedure is expected to do [Lev, 1969] in a manner which offsets the communication advantages endorsed as desirable is an empirical question. Obvious audit-related issues include the form of auditor association reported and possible litigation linked to incomplete disclosure via summary reporting practices. The recent promulgation of attestation standards [AICPA, 1986] has created the possibility of a broad spectrum of reports by CPAs [Stilwell and Elliott, 1985], delineating any type of written assertion. Related research questions are detailed by Wallace [1987] and include a number of uncertainties as to the value of the information to be provided in attest reporting engagements.

As signaling becomes less available via the timing of filings and inclusion of full-audited financial statements within annual reports, the role of signaling through audit firm selection may become more pronounced. Similarly, uncertainty related to the nature of diverse attestation services may lead to greater emphasis by users on the reputation of the firm making the attestation. Recent research has explored the so-called *"reputation-effect"* of auditors in private college selection process, as well as in the initial public offerings market. Specifically, Lomax and Wilson [1985] investigate whether auditor selection is a means of signaling insiders' knowledge of superior performance. They find weak support for the hypothesis that higher quality institutions engage national audit firms. Beatty [1986] presents empirical evidence that employment of a nationally known CPA firm increases the price received on initial public offerings. Of particular interest is the finding that more risky clients in the initial public offerings market employ non Big-Eight CPA firms which, in turn, take a longer time period to register their client's securities.

Such findings raise questions concerning audit-related information disseminated by a variety of entities. While evidence exists that clean audit opinions accrue market rewards [see Wallace, 1981a, for evidence in the municipal market, Chow and Rice, 1982a, for findings involving share prices, and Dodd et al., 1984, and Dopuch et al., 1986, for market reactions to qualified audit opinions], do such occurrences carry over to the not-for-profit sector? Do nonprofit entities that issue audited financial statements receive greater contributions? Future research will explore such disparate markets and likely clarify the concept of "reputation" as it relates to the audit function.

V. THE INSURANCE HYPOTHESIS

Aside from agency- and information-related incentives for demanding audits, the insurance dimension of an audit creates additional demand. This insurance trait appeals to two key audiences. The first audience includes trustees, investors, and creditors who wish to both demonstrate their exercise of prudent care and insure against losses. The second audience includes a diverse set of regulators who are able to insulate themselves from criticism by requiring auditors' involvement. Evidence that public officials commit greater public resources to auditing when political competition is high than when competition is low is provided by Baber [1983]. This evidence is consistent with regulators' demand for "insurance," as well as their desire to provide information concerning their performance to various supporting interests.

Perhaps no dimension of the market for audit services has received the attention recently directed to the insurance hypothesis and the "deep pockets" problem. Major lawsuits against large CPA firms worldwide aggregate $2 billion in requested damages, or fourfold the total capital of these major accounting firms [Berton, 1985a]. In an atmosphere where one private civil lawsuit is being filed for every 15 Americans, the cost of litigation has become a significant component of business operations [Collins, 1985]. This environment has led to the observation by Joseph E. Connor, the Senior Partner of Price Waterhouse, that: "The economic viability of the profession hangs on whether we can bring some sanity to the liability process" [Berton, 1985a, p. 10].

Research has analytically demonstrated that the apparent insurer status is inconsistent with a monitoring role as auditor [Callaghan et al. 1985]. In lieu of an auditor-as-guarantor approach or the deep-pockets theory, DeJong and Smith [1984, p. 32] apply agency theory to demonstrate that "the intrinsic risk faced by an auditor is a function of the information risk faced by the investor." The courts translate the costs of reducing such information risks, in part, by assigning audit responsibilities. One major implication of such a theory is that disclosure will occur even though existing standards do not require such disclosure, provided the costs of possibly violating firm confidentiality requirements are not believed to be excessive. Analysis of the circumstances in which auditors find themselves in court has been provided by St. Pierre and Anderson [1984]. Specifically, they find that public companies in certain industries when negative financial information is disclosed are more likely to be involved in auditor litigation. Newer clients are most often involved, and the interpretation of accounting principles and auditing standards is the focal point of the disputes. The authors point out that none of the 129 cases they examined involved errors in undervaluation of assets, unrecorded revenue, or excessive expenses, suggesting that the conservatism principle should be strictly enforced. Research by DeJong [1985] models the effect of alternative litigation privileges on representative investor and lawyer incentives to litigate. It has been documented that small stockholders litigate more often with class-action privileges and contingent legal fees than larger stockholders. Empirical evidence suggests a dramatic increase in litigation after class-action privileges were extended. This increase in litigation is expected to improve the quality of audits and is cited as one reason for the large increase in the number of new auditing standards. Market effects of litigation are documented by Kellogg [1985]. This evidence suggests that a decline in stock price may prompt litigation. This implies possible use of the market as an early warning signal to auditors that effects of the insurance hypothesis may well be observed in the near future. This premise is explored in Wallace [1986a].

The market is experimenting with offshore captive insurance companies [Berton, 1986a], to restrict liability exposure, and alternative regulatory approaches to address the rebukes of politicians (particularly by the Dingell Committee) [see Hearings, 1985]. The implication of the political insurance hypothesis is that proposed regulation will not remove the audit process from the private sector.

The liability crisis has affected auditors both directly and indirectly. Directors and officers (D&O) liability insurance has grown to crisis proportions, leading to the resignation of outside directors from a number of boards. Peat Marwick recently placed an ad in *The Wall Street Journal* asking the business community to respond to a survey questionnaire intended to identify a reasonable approach to the D&O liability problem. A concern is expressed that:

> The growing popularity of irresponsible liability suits is creating an endangered species. . . . Before the outside director becomes extinct, and before the quality of American corporate governance seriously suffers, something has to be done. [Peat, 1986, p. 9]

Of particular interest is a study by Eichenseher and Shields [1985] which provides evidence "consistent with the notion that the recent trend toward audit committee formation and the movement toward Big-Eight auditors, are responses to increased legal exposure of the board of directors" [p. 13].

Future research concerning the insurance hypothesis will likely investigate (1) the extent to which business risk has been compensated by the courts, (2) the incidence with which trustees and other investors or creditors routinely involve auditors, and (3) alternative means by which regulators impose sanctions on the profession without removing the audit process from the private sector. Knowledge of such practices and economic consequences can enable the auditing profession to both anticipate and respond to changes in the legal and regulatory environment.

Inextricably tied to these three primary sources of demand for an audit are product attributes of the audit process, including control dimensions, complementary services, enhanced reliability of the information system, and regulatory compliance. We now turn to these joint products of the audit process.

VI. PRODUCT ATTRIBUTES OF THE AUDIT

Management advisory services (MAS) have been the topic of public hearings by the Public Oversight Board [1979], a required disclosure under the SEC's Accounting Series Release (ASR) (now known as Financial Reporting Releases or FRRs) No. 250 which has since been rescinded, and the subject matter of ASRs 126 and 264. Of interest is the empirical observation that opponents to CPAs' provision of MAS, who testified at public hearings, tended to be competitors in the marketplace, such as management consulting firms. Descriptive research provides evidence on the type of MAS services provided by auditors and the fact that these average about eight percent of audit fees [Cowen, 1980]. MAS contributed 11 percent of total fees of Big Eight firms in 1977 and 16 percent by 1984 [Burton and Fairfield, 1982]. Survey research indicates that high confidence in the auditor's independence persists across a wide variety of management services [Reckers and Stagliano, 1981]. Previts [1985] traces the history underlying the current scope of CPA services and, in particular, implications concerning the concept of independence. Simunic [1984] analyzed the possible efficiencies from the joint supply of two services, which he refers to as the "spillover effect" on audit fees. Empirically, companies purchasing joint services are similar to those which do not use the auditor for MAS services; somewhat surprisingly, those purchasing joint services were observed to have a significant increase in the audit fee. The obvious question is whether a clear distinction can be made in the price of MAS versus audit services when the supplier is billing joint services.

The prevalent role of control and the relationship of auditing services as a complement to the controls that are present is empirically documented by Kreutzfeldt and Wallace [1986] and Libby et al. [1985]. This is further demonstrated in research concerning the effect of internal audit activities on external auditors [Wallace, 1984a,b; Margheim, 1986]. Specifically, demand for auditing services by independent accountants, as measured by audit fees, is reduced in the presence of investments in an internal audit department—presumably, an enhancement of overall control [consistent evidence is provided by Mautz et al., 1984 and Previts 1985]. Hence, not only does an external audit enhance control, but once controls are in place, the product attribute of the audit which is related to control becomes less important as a source of demand. Yet, total demand nonetheless may increase due to extended services more likely to be demanded as controls improve, such as reports on internal accounting control [examples of these reports in the municipal sector appear in Wallace, 1981b].

Enhanced reliability of information is expected to result from an audit and may vary by auditor. Simunic and Stein [1986] describe the audit service as containing three principal attributes—control, credibility, and product line. They postulate that firms' brand name reflects their level of credibility and that this is the principal determinant of auditor choice by top management. In an empirical study of the market for new issues, they conclude that "audit services are not homogeneous across potential suppliers" [p. 98]. [Research by Shields, 1984, Shockley and Holt, 1983, and Simon, 1985, would appear to corroborate the presence of supplier differentiation.] Beyond scale economies of larger firms, managers' stockholdings and the riskiness of company cash flows are determinants of auditor choice, as are both the form of the offering and the reputation of the underwriter.

The reliability of a CPA firm has an important interaction with the offering of CPA firms' complementary services. Anecdotal evidence exists that companies are asking CPA firms to provide such services as recommending software because the clients value the credibility of CPAs and the typical long-term association with their CPA firm. From the perspective of incentives, managers have reportedly cited one-time consultations (with other than their CPAs) regarding software as lacking dependability, due to the absence of long-term accountability by the consultants. Investigation into the role of auditors' reliability in creating demand for complementary services is likely to be a fruitful line of research. An example of research currently under way is the investigation of actuarial services offered by auditing firms [Addy and Morris, 1986]. Specifically, which types of clients select their CPAs' actuarial services as their supplier?

With the advent of new regulation, such as that observed in the municipal sector of the economy, the nature of those entities which delay obtaining an audit until regulation is imposed is of particular interest. Is there a common trait among such units? Research has focused on determinants of demand largely by examining entities which are audited; future inquiry should investigate the complement of those companies (i.e., the entities which postpone audits until mandated by regulators to have an examination).

Regulators' attention and losses in the courtroom suggest the importance of giving attention to early warning signals of companies' operations. Demand exists for some projection of business risk and the CPA is being asked to provide such information. Going-concern evaluations are one aspect of this responsibility. While perceptions of the going-concern opinion have been studied [see Mutchler, 1984], the effectiveness of such perceptions needs to be investigated to assess the feasibility of extending product attributes to more directly address business risk. [Levitan and Knoblett, 1985 address this issue, as does the body of research on bankruptcy predictions, but much of this research is plagued by a prevalence of Type I errors—bankruptcy is indicated but does not occur.] Of interest is the historical fact that insolvency work accounted for over 73 percent of total fee income in 1848 of a predecessor of Ernst & Whinney, yet was barely .2 percent by 1960 [Jones, 1981]. A somewhat different dimension of insolvency—its projection—is beginning to preoccupy the accounting profession [Berton, 1986b].

Since information economics underlies the evaluation of varied attributes of the product of auditing, such as when an initial audit occurs and when complementary services are demanded, we turn to more in-depth research concerning the concepts introduced in Section IV.

VII. INFORMATION ECONOMICS

Information economics concerns (1) the role of information in contracting; effects of the moral hazard phenomenon; (2) the possibility of adverse selection stemming from asymmetry of information; (3) the act of signalling; information attributes of noise, bias, and fineness; (4) incentives for private and public production of information; and the costs of information. Beyond applications of transaction cost economics and laboratory market experimentation to information economic issues, signalling has been the center of a number of research studies. In the auditing arena, of particular interest is the signalling possibility of certain auditee actions such as switching auditors [Chow and Rice, 1982b; Nichols and Smith, 1983; McConnell, 1984; Schwartz and Menon, 1985; Francis and Wilson, 1986; and Wilson, 1986]. This has received acute attention by the SEC in the form of prescriptions concerning "opinion shopping."

Another line of inquiry utilizes game theory to demonstrate that decision theory can lead to errors in estimating audit risk, due to audit influences on auditees [Fellingham and Newman, 1985]. This application is consistent with auditors' approaches to gathering information using a randomized strategy. The idea of explicitly considering behavior's interaction with information, in the spirit of identifying implications of the moral hazard phenomenon, is likely to be a major stream of future research. Behavioral lab experiments such as that by Uecker et al. [1985] have similarly addressed information gathering and information evaluation in a principal-agency setting. This study by Uecker et al. demonstrates how information evaluation theories can be generalized to a principal-agent setting, beyond the typical focus on the information evaluator-decision maker. It also shows that expected utility theory is outperformed in terms of predictive ability in the area of information evaluation by prospect theory, a linear model, and a multiplicative model. Moreover, use of a compensatory model for prospect theory is demonstrated to be superior to a noncompensatory model. This research is relevant to both the auditors and users of auditors' services in evaluating whether particular types of information are cost-beneficial.

Public information production via government regulation has been reduced in the recent wave of regulators' attention to costs and the potential for deregulation. Nevertheless, recently proposed Congressional legislation would mandate reports on control and seems to represent a reversal of the decision at the turn of the decade not to mandate reports on control, due to no apparent demand by market participants [SEC, 1980]. Related issues are being actively debated as revisions are made to proposed bills. Continuing attention to the costs and benefits of mandated information is merited.

A great deal of research attention has been paid to the cost of auditing since Simunic's 1980 study. These include Taffler and Ramalinggam [1982], Wallace [1984a,b], Francis [1984], Francis and Stokes [1985], Maher [1985], Firth [1985], Palmrose [1986], Wallace [1986]. Since few studies have directed their sampling in a manner that sufficiently addresses industry peculiarities, the results would appear to be tentative. For example, some contend that banks incur lower audit fees because they are a source of potential customers for the CPA. Others would argue that the audit of a manufacturer with large investments in inventory is so different from a multilocation retailer or a service industry, that audit fee models are unlikely to be homogeneous across such industries. The presence of regulation in certain industries, such as utilities, is likely to have differential cost implications with respect to audit services. Indeed, Mautz et al. [1984,

Table C-5] report average dollar expenditures on external audit fees per million dollars of revenue in 1984 to be $480 for manufacturing, $408 for oil/mining, $1,007 for financial, $243 for insurance and utility, and $268 for retail and service. Such diversity warrants further study. Yet, trends in the literature are discernible, including significant relationships to auditee size, measured as the log of assets and sales or the square root of assets in Australia, New Zealand, and the U.K.; as well as significant relationships in the United States with the number of subsidiaries, number of industries, foreign assets percentage, receivable and inventory proportions, the size of the audit firm, and expenditures on internal audit. Competitive bidding behavior has been modeled as largely a function of cost [see Beck and Barefield, 1986]. Despite theoretical developments on "low balling" [DeAngelo, 1981a], empirical evidence has not documented the prevalence of such practices.

Future inquiry on information economics should focus on the detail, emphasizing homogeneous samples within industries or within certain size strata. For example, the effect of switching auditors are likely to be different for private versus public companies, as well as stable versus growing companies. The moral hazard effects on the propriety of sampling may, in part, depend on the extent of audits performed by both internal and external auditors. Attention to prospect theory in a compensatory form may better describe decision making in both the acquisition and evaluation of information. In particular, when are certain controls or audit procedures no longer cost-beneficial? Most assuredly our understanding of audit costs will not be enhanced until more "like" comparisons are made within single industries across time. Finally, the economic consequences cf regulation will continue to hold the attention of researchers and regulators alike.

VIII. THE SUPPLY OF AUDITS

Having cited costs of audits, the next obvious step is to consider the underlying process which leads to the audit fees observed in the market. The supply side of the question concerns inputs and outputs, the audit production function, and why the audit profession takes its current form. Asymmetry of information and potential barriers to entry within a particular market can greatly influence market structure.

Research concerning inputs to the audit process and the process itself has exploded in scope and depth [see Felix and Kinney, 1982 for a review]. Major streams of inquiry include auditor judgment [such as Biggs and Wild, 1985], expert systems [Bailey et al., 1985; Biggs et al., 1986], sampling procedures [Beck and Solomon, 1985; Duke et al., 1985; H. Tamura, 1985], Bayesian statistics [Crosby, 1985], computer information systems

[Amer et al., 1986; Davis and Weber, 1986], evidential planning [Wright and Mock, 1986], interaction with internal auditors [Abdel-Khalik et al., 1983; Schneider, 1984, 1985; Messier and Schneider, 1986] and the nature of accounting populations [Ham et al., 1985]. Literature related to quantitative applications in auditing is reviewed by Kinney [1983]. Presumably, such advancements, integrating current technology, have led to operating efficiencies. A widely discussed concept among practitioners is "leveraging." This refers to the shift in the structure of CPA firms from a pyramid organizational structure to a narrower-based structure, due largely to technology's displacement of the need for a large number of professional staff performing clerical tasks. Of course, the effects of such a shift include: (1) a need for more refined hiring practices, due to the lower turnover rate feasible in a more streamlined operation; (2) greater expenditures on hardware, software, and other technologically-based resources, including access to various data bases and development of expert systems; and (3) potential economies to scale being reflected in the marketplace. The implications of these effects are discussed by Burton and Fairfield [1982] and Benston [1985].

The market for audit services has been evaluated from the perspective of industry-specific auditor concentration [Eichenseher and Danos, 1981; Danos and Eichenseher, 1982; Danos and Eichenseher, 1986]. A positive relationship exists between auditor concentration and both the degree of client-industry regulation and capital market activity. No substantial upward shift has occurred in Big Eight market share, yet within the Big Eight it is clear that competition has increased for nonregulated clients. Evidence has been provided that interlocking directorates have explanatory power in describing the selection of auditors [Davison et al., 1984]. An empirical survey of companies changing auditors suggests that fees and working relationships (defined as CPA firms' responsiveness to companies' needs) are key determinants of auditor selection [Eichenseher and Shields, 1983]. Agency-related variables are investigated, per industry, by Palmrose [1984], but the models presented are dominated by size rather than theory-based attributes. Additional research with larger samples is needed, controlling for size effects. The interaction of size and audit quality has been theoretically developed by DeAngelo [1981b], which ties back to the reputation effect, discussed earlier. Schroeder et al. [1986] survey audit committee chairpersons and audit partners as to their perceptions of audit quality. Audit-team factors such as the level of partner/manager attention given to the audit are far more related to quality perceptions than are firm factors such as the relative significance of the client's fees. Partners' perceptions were similar to those of the board members. Means of obtaining regulators' attention to these types of quality measures warrant examination.

The types of services supplied by CPAs have increased in scope, particularly with the advent of attestation standards [AICPA, 1986], but as yet there has not been sufficient time to assess the demand for such services. Ample media attention has been directed toward the increasingly competitive market for audit services [Berton, 1985b,c]. Substantial declines in external audit fees over the past decade are documented by Mautz et al. [1984, Table C-5]: an average dollar expenditure on external audit fees per million dollars of revenue was $698 in 1974 and only $481 in 1984. Participants in the marketplace may very well move to a broader scope of attestation services as a means of maintaining total revenue, while fiercely competing on the price of individual services. Such a scenario is likely to attract additional attention by regulators, in light of their past concerns regarding independence [see Previts, 1985 for an in-depth discussion]. If combined services lead to million-dollar engagements growing fourfold, or even tenfold, regulators' concern that individual clients' pressures will grow in intensity can be expected. This may lead to attempts to restrict the revenue base which a CPA firm can receive from a single client. Of course, this type of restriction would lead to inefficiencies due to joint product attributes of an audit and would differentially harm smaller companies.

The question of whether the CPA exam serves as a potential barrier to entry was examined by the Federal Trade Commission (FTC). Its study indicated that the national average pass rate on the CPA exam climbed from 13 percent in 1921 to approximately 20 percent between 1973 and 1976. The FTC collected statistics on the success in four states of "serious candidates" (those taking and retaking the exam up to six times). The result was that with perseverance, 80 to 90 percent of such candidates passed; as discussed by Dopuch and Simunic [1982], the FTC's study supported the idea that the exam is a competency test and not an effective barrier to entry.

An empirical study of licensing laws has compared the malpractice coverage and fee structure of CPAs with noncertified counterparts, concluding that licensure leads to higher costs for accounting services with no evidence of higher quality [Young, 1986]. Further research would seem appropriate since the evidence collected focuses on hourly fees which may substantially differ from realized fees. Moreover, how can the quality of audit services be calibrated for comparison? Work is needed on effective measurement devices.

Many of the research questions detailed by Felix and Kinney [1982] and Berry and Wallace [1986] have yet to be addressed. The multivariate nature of the audit has not been effectually analyzed by the dominance of univariate research designs. For example, neither the manner in which audit evidence is aggregated across account areas nor the means by which materiality is allocated among accounts is well understood. These are key areas for future inquiry. Indicative of multivariate designs likely to dominate future work is a study by Wallace and Kreutzfeldt [1987] which concurrently evaluates the role of auditee competence, integrity, financial condition, management controls, and detailed controls in auditors' assessments of the error-generation propensities of a particular client. In examining such inputs and outputs of the audit process, as well as the production function and market structure, attention must be directed to the regulatory environment, a topic to which we now turn.

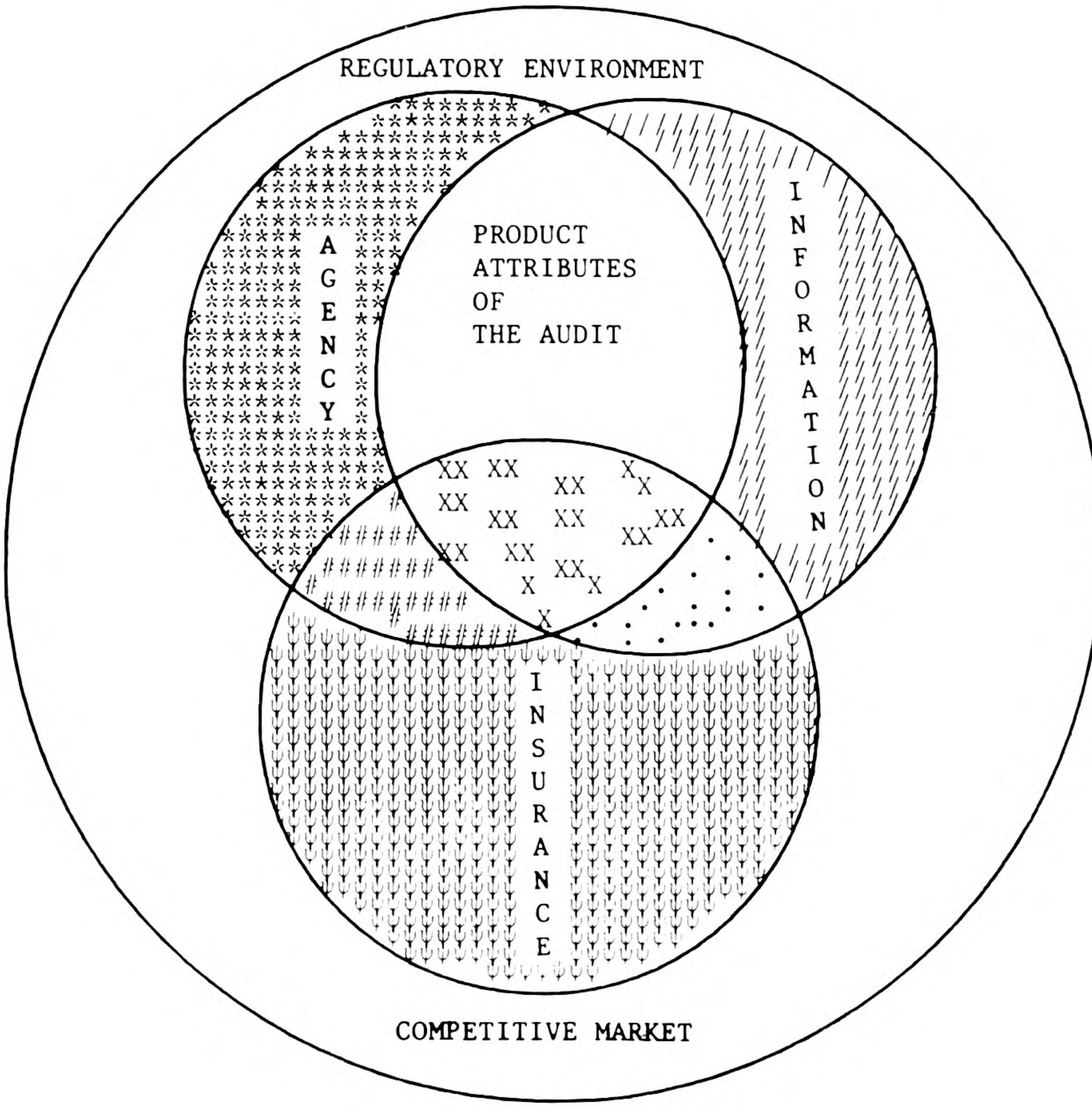
IX. A LOOK AT REGULATION

A set of ideas known as Public Choice, developed in the 1960s by James Buchanan, Gordon Tullock, William Niskanen, and several others has become conventional wisdom. The types of insights commonly accepted are that "bureaucrats and politicians seek their own gain and respond to incentives just like the rest of us" [Poole, 1986, p. 11]. Some have pointed out that government creates winners and losers within the private sector and that "change, not stability, creates political power." This suggests powerful incentives for politicians and regulators to "churn the account, changing the rules on a regular basis." [Leone, 1986]. Indeed, the politicians have periodically "churned" the private sector's public accounting profession through its subcommittees. Wallace [1986c] discusses issues facing the profession, including attention to regulation in the international sector. Of special interest is the question raised in past literature of whether the SEC with its attendant regulations can be effectively circumvented by raising capital outside the U.S. [Longstreth, 1983]. One development in the legal system suggests that future interpretations of the law may reflect increasing attention to costs and benefits. An intellectual movement dubbed law and economics, fueled by Judge Richard A. Posner, has raised the level of economic literacy in the federal judiciary [Barrett, 1986, p. 1].

Much research attention is being directed toward regulatory activities [see Wallace and Campbell, 1986, a study of positive enforcement activities by state boards of accountancy, as one example]. Self-regulatory actions are being reviewed [see Moran and Previts, 1984] and restructuring proposed [the Anderson Committee Report, AICPA, 1986]. In a sense, the self-regulatory actions are viewed as the principal means of forestalling regulation.

Of course, one element of self-regulation is audit standard setting. Kin-

Exhibit 1 The Interrelationship of Theories



|*****| Demand Generated By Agents

|/////| Demand Generated By Principals

|ψψψψψ| Provides For Financial Coverage of Losses

|XXXXX| Signals The Exercise of Due Care

|#####| Encourages Contracting By Reducing Losses Tied To Moral Hazard

|.....| Protects Against Losses Tied to Moral Hazard

ney [1986] investigates factors associated with audit firm positions on the Auditing Standards Board and finds a correlation of voting behavior in favor of proposed statements with relatively structured audit technologies [detailed by Cushing and Loebbecke, 1986]. Kinney observes that lower staff-to-partner ratios are associated with greater technology and more affinity for proposed statements. Such voting behavior has implications for future auditing research, as detailed by Kinney [1986].

Auditing has a pervasive role in the securities market which becomes a focal point whenever a fraud is discovered or a business fails [Krogstad et al., 1986]. As a result, regulators' oversight is likely to be continuous and the consequences of alternative regulatory approaches are of continuing interest. Given the different regulatory environments within states and across countries, comparisons of those rules affecting auditors could provide insights concerning the relative costs and benefits of both past and proposed regulation. Loeb [1984] details a number of research questions relevant to the self-regulation process and the professionalization of all sectors of the accounting occupation which deserve attention as public policy makers deliberate concerning alternative regulatory proposals.

X. SUMMARY

The evidence has mounted on the key role of agency, information, and insurance-based theory in explaining the market for audit services, as well as regulatory activities relative to such services. Exhibit 1 provides a graphic interpretation of how these theories interrelate, emphasizing the all-encompassing role of both the competitive market and the regulatory environment. Developments in transaction economics and public choice literature, as well as the legal system's increased attention to economics, provide further insights concerning each of these sources of demand. Many unanswered questions persist as to the relative strength of the competing sources of demand, as well as the key determinants of supply. The ever-changing regulatory environment continually creates new research questions. While the past decade of research has improved our understanding of the economic role of the audit, it has also highlighted those aspects of the market for audit services and the audit process which have yet to be explored.

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RECENT EPISODES IN THE "OVERSIGHT CYCLE" OF ACCOUNTANCY SELF-REGULATION

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ABSTRACT

Recent changes in the self-regulation of accountants, including the Division for CPA Firms within the AICPA, coincide with increased public pressure on the profession, including Congressional investigatory hearings in both the 1970s and the 1980s. However, these two initiatives are more than coincidental. Rather, the path of professional self-regulation in accounting is seen as a response to external forces. These forces appear predictable, if not with respect to the time at which they are active, then at least with respect to the direction in which they are moving the accounting profession. However, clear predictions of the future course of professional self-regulation cannot be made until the institutional interactions and relationships within the regulatory process are more fully understood.

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In recent years, the accounting profession has been subjected to unprecedented public scrutiny, beginning with the Moss and Metcalf committees of the 1970s and continuing through the recent Dingell committee hearings. Simultaneously, the profession has undertaken several initiatives designed to increase self-regulation of the profession, including the Division for CPA Firms within the American Institute of Certified Public Accountants (AICPA).

These two initiatives are more than coincidental. The path of professional self-regulation in accounting appears guided more by forces external to the profession than from within. Further, these external forces display some degree of predictability, if not with respect to the *time* at which they are active, then at least with respect to the *direction* in which they are moving the accounting profession.

If self-regulation is guided by external forces, and if these forces are predictable, then we may be able to characterize the future of professional self-regulation. However, our present incomplete understanding of the institutional interactions and relationships within the regulatory process makes it impossible to formulate a clear prediction. However, we can identify areas in which further research might enhance understanding of the factors influencing self-regulation.

Our paper begins by outlining the current structure of professional regulation in accounting in order to distinguish those areas we consider to be self-regulatory initiatives from those we consider to be external regulation. Next, we review the pressures placed upon the profession during the seventies and the eighties, to demonstrate that the steps taken by the profession toward greater self-regulation were responses to these pressures. We then compare the episodes of the seventies and eighties, in order to demonstrate those similarities which suggest the operation of a predictable process. Finally, we point out potential areas for further research, and suggest directions such research might take.

THE CURRENT STRUCTURE OF PROFESSIONAL REGULATION IN ACCOUNTANCY

The public accounting profession is subject to both external regulation and self-regulation. As individuals, certified public accountants (CPAs) are subject to mandatory regulation by boards of accountancy created under state laws in each of the fifty states. Under circumstances and following procedures that vary from state to state, a CPAs certificate can be suspended or revoked and the individual can be barred from practicing as a CPA.

The Securities and Exchange Commission (SEC) also regulates, in some sense, individual public accountants under its Rule 2(e) [17 C.F.R.

201.2(e)]. Under Rule 2(e)(1), the SEC may deny the right to practice before it to any person found (a) not to possess the requisite qualifications to represent others, or (b) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (c) to have willfully violated or willfully aided and abetted the violation of any provision of Federal securities law. Under Rule 2(e)(2), any accountant whose license to practice has been revoked or suspended or any person convicted of a felony or of a misdemeanor involving moral turpitude is suspended from appearing or otherwise practicing before the Commission. This constitutes mandatory regulation of conduct for individuals who wish to practice before the SEC.

Self-regulation is administered by voluntary professional associations such as the AICPA and the state CPA societies. The most severe penalty available to professional associations such as the AICPA and the state CPA societies is expulsion from membership. The AICPAs bylaws provide for two types of disciplinary action. Membership in the AICPA is automatically terminated upon conviction for:

- commission of a felony;
- willful failure to file a tax return; or
- filing or aiding in the preparation of a fraudulent tax return.

In addition, membership is automatically suspended upon suspension of the CPAs certificate, and terminated upon revocation of the certificate, by a state board of accountancy.

In addition to these automatic disciplinary actions, the AICPA may assess disciplinary measures at the discretion of the Professional Ethics Division. Discretionary sanctions include letters of constructive criticism or administrative censure, acceptance of resignation, and suspension of or expulsion from membership. Sanctions may be imposed for:

- infringement of AICPA bylaws or provisions of its Code of Professional Ethics;
- conviction of fraud;
- commission of acts discreditable to the profession;
- declaration of insanity or incompetency;
- failure to cooperate with the professional ethics division in a disciplinary investigation.

An AICPA disciplinary hearing on an alleged ethics violation is conducted by one of several regional trial boards. A national trial board hears appeals from an action of a regional board as well as original complaints. Since 1975, ethics enforcement at the national and state levels has been integrated under the Joint Ethics Enforcement Program (JEEP), which assigns a complaint to either state or AICPA jurisdiction.

Since 1977, the AICPA has also had a voluntary membership category for CPA firms. The Division for CPA Firms is composed of two sections, one for firms in SEC practice (the SEC Practice Section, or SECPS) and one for all other firms (the Private Companies Practice Section, or PCPS); a firm may join either or both sections. Each section has the authority to conduct investigations and to discipline its own members. The most severe penalty either Section can administer is expulsion from membership in the Section.

Although the basic structure of self-regulation has been in place for many decades, the Division for Firms and JEEP were created during the 1970s. The next section reviews the external forces operating on the profession during the 1970s and the 1980s and the profession's response to these forces.

EPISODE OF THE 1970s

Early in the 1970s, public attention focused on a series of spectacular business failures in which auditors were accused of negligence and even collusion. In connection with the demise of National Student Marketing, for example, a partner and an employee of Peat Marwick Mitchell were found guilty of criminal fraud. Two Arthur Andersen partners were indicted but later acquitted following the collapse of Four Seasons Nursing Homes; the trial of a third Arthur Andersen employee resulted in a hung jury. And in the most spectacular failure of the period, Equity Funding, three former auditors were convicted on multiple counts of securities fraud and making false statements in filings with regulatory authorities.

Congressional interest was piqued by these alleged audit failures, and by other events as well: the Watergate investigation, a portion of that delved into campaign financing, had uncovered evidence of illegal or improper campaign contributions by several large corporations [U.S. Senate, 1973]. The SEC instituted a program of voluntary disclosure under which more than 200 corporations eventually revealed questionable payments—most in connection with overseas operations—totalling over $300 million [SEC, 1976]. In several instances, the existence of questionable payments from corporate "slush funds" had been known to the auditors but disclosure to the public had not been required.

These revelations, coupled with business failures, led the staff of the Subcommittee on Reports, Accounting, and Management of the Senate Committee on Government Operations to undertake a year-long study of the accounting profession, which culminated in the issuance in December

1976 of a staff report entitled *The Accounting Establishment* [U.S. Senate, 1977a]. The report was harshly critical of the profession, especially the large firms, which the report claimed dominated the AICPA. In his transmittal letter to the full committee, Senator Lee Metcalf, chairman of the subcommittee, set the tone for the report and the hearings which were to follow:

> I am disturbed . . . by the alarming lack of independence and lack of dedication to public protection shown by the large accounting firms which perform the key function of independently certifying the financial information reported by major corporations to the public. [U.S. Senate, 1977a, p. v]

Other issues which appeared in the staff study or that arose during the ensuing Congressional hearings included:

- lack of representation of the public interest in accounting and auditing standards-setting;
- lack of availability of operational and financial data on large accounting firms;
- whether the performance of extensive management advisory services for a client impairs the independence of the audit function;
- whether auditors should use the audit opinion to signal impending trouble for creditors and investors;
- whether auditors are responsible for detecting and reporting illegal acts committed by client personnel;
- whether the auditor's legal liability for negligence should be limited, as the Supreme Court ruled in *Hochfelder*.[1]

When the Metcalf committee convened hearings in April 1978, accountants were its chief target. Wallace Olson describes the profession's mixed response to the Metcalf hearings:

> The CPAs who appeared before the subcommittee were far from uniform in their positions. Most opposed portions of the staff recommendations, and nearly all suggested changes in the profession. In general, representatives of the smaller firms agreed with the report's conclusions that the large CPA firms controlled the AICPA and the profession, and they complained about what they considered to be unfair competitive practices. Representatives of large firms tended to dispute the staff's conclusions about the profession and appeared to vie with each other in suggesting programs for improvement. Unfortunately, no consistent pattern of recommended changes arose; by the time the hearings had been concluded, the CPA witnesses had suggested virtually every imaginable reform. [Olson, 1982, p. 48]

Of the many proposals made by members of the profession during the Metcalf hearings in the Senate and during the Moss hearings in the House early in 1978, three emerge as key: (1) a proposal by John C. Biegler of Price Waterhouse [Biegler, 1977]; (2) a proposal by John C. Burton [Burton, 1978]; and (3) a proposal by the AICPA [AICPA, 1977]. We consider each proposal in turn.

The Biegler Proposal

Wallace Olson describes the Biegler proposal as "the most surprising testimony" of the Metcalf hearings. John Biegler was a former managing partner of Price Waterhouse and a former member of the board of directors of the AICPA. Biegler's position within the profession made his proposal even more significant, because it represented an open break with the rest of the Big Eight and other large firms.

Biegler called for mandatory registration of CPA firms directly with the SEC as a condition of practice before the SEC. Registered firms would have been subject to peer reviews every three years, conducted under SEC supervision and covering specific audit engagements. Registered firms would also have been required to report certain financial and operating information to the SEC annually. The SEC would also have set rules for the proper nature of management advisory services which could be performed by firms. Finally, Biegler would have opened meetings of the FASB and the Auditing Standards Executive Committee (AudSEC) to the public.

Burton Proposal

The proposal by John C. Burton was significant because of his former position as chief accountant of the SEC. The proposal was also significant because it was the first to call for the formation of a statutory self-regulatory organization (SRO), a vehicle which would reemerge in later proposals in both the 1970s and the 1980s.

Burton proposed the formation of an organization subject to SEC oversight and analogous to the National Association of Securities Dealers, which regulates trading of securities. The organization would have been governed by a board of directors, half accountants practicing before the SEC and half chosen from the public. Membership in the SRO would have been a condition for practice before the SEC. In return, member firms would have been subject to periodic "quality reviews," conducted not by other accountants but by the staff of the SRO. The SRO additionally would have had responsibility for setting auditing standards and professional ethics, presumably including the proper role of management advisory services. The SRO would have had the ability to investigate complaints and conduct disciplinary proceedings, including the suspension of member firms from SEC practice. In addition, the SEC would have investigated liability claims made against accountants and could have recommended settlements to the appropriate courts.

AICPA Proposal

The AICPA proposal is significant for two reasons. First, it was the Institute's official response to the criticisms in the Metcalf staff study. Second, it was eventually adopted and the others were not.

The AICPA proposed a separate division for firms within the AICPA, having a section for firms in SEC practice (the SEC Practice Section, or SECPS) and a section for all others (the Private Companies Practice Section, or PCPS). Membership in either section is completely voluntary. Members are subject to peer reviews every three years and must make certain data public each year. Each section is governed by an Executive Committee; in addition, the SEC Practice Section is subject to a Public Oversight Board. Each section has the ability to investigate and discipline its members.

Proposals as Responses to External Pressure

These three proposals can be seen as responses to pressure exerted by the Congressional investigations. As evidence of this, consider the motivations expressed in making the proposals. Biegler's motivation in making his proposal has been the subject of speculation. According to Olson, some suspected it was because Biegler felt Price Waterhouse had been singled out for criticism in the staff study [Olson, p. 48]. Olson also comments that:

> Those who were closely acquainted with the firm's top partners . . . were convinced that the firm sincerely believed that the proposed legislation was the best long-run solution and had a good chance of being adopted without unwanted amendments—a view apparently based on the premise that any voluntary regulatory program would prove ineffective. [Olson, p. 48]

Burton's motives in making his SRO proposal appear to revolve around the effect of the threat of more comprehensive regulation on the profession's activities. He comments:

> I think it is very important, from the point of view of the accounting profession and the services which it performs and the function it performs, that there be a period of institutional stability that exists so the accounting profession can be devoting itself to the problems of accounting and auditing, and not to the legal problems of what is its turf, what are its responsibilities, and what rights does it have. [Burton, p. 354]

The AICPA's proposal also appears designed to obviate other regulatory initiatives. Wallace Olson, who was president of the AICPA at the time, concedes:

> As the (Metcalf) hearings continued in May and June, it was clear that the profession could not stand pat, since the risk that both the SEC and members of Congress would conclude that legislative reforms were necessary was too great. [Olson, p. 49]

Note also how each proposal responded to specific issues raised in the Congressional proceedings. For example, Congress expressed concern about representation of the public interest in accounting and auditing standards-setting. Biegler proposed that meetings of the FASB and the Auditing Executive Committee (now the Auditing Standards Board) be opened to the public. The Burton proposal went a step further by giving the public half the seats on the board of directors of his proposed SRO. Under the AICPA proposal, a Public Oversight Board supervises the SEC Practice Section. Congress expressed concern about protection of the public; two of the three proposals responded by suggesting mandatory membership in a regulatory body, and all three proposed external reviews of firms' procedures.

While not every proposal responded to every Congressional concern during the period, a relationship between the proposals and the Congressional agenda is clear. A similar relationship can be found during the period of the 1980s.

EPISODE OF THE 1980s

The accounting profession was again the focus of public attention in the 1980s, following another series of spectacular business failures. On February 22, 1982, Arthur Andersen issued an unqualified opinion on the financial statements of Drysdale Government Securities. Four months later, Drysdale went bankrupt. In January 1987, the U.S. Supreme Court refused to hear Arthur Andersen's appeal of its $17 million fraud and negligence penalty in the Drysdale affair.[2] In March 1982, Peat Marwick Mitchell issued an unqualified opinion on the 1981 financial statements of the Penn Square Bank of Oklahoma. The bank was closed by the Comptroller of the Currency on July 5, 1982, and the closing triggered the largest banking run in history, on the Continental Illinois Bank. On January 25, 1983, Ernst & Whinney issued an unqualified opinion on the financial statements of the United American Bank of Tennessee. A week later, the Federal Deposit Insurance Corporation ordered the bank to recall its financial statements, alleging that they contained false and misleading statements. On February 14, the Tennessee Banking Commissioner closed the bank, and eventually the entire Butcher banking empire, of which it was a part, collapsed. The failure of E.S.M. Government Securities in 1985 resulted in the closing of all state-insured savings and loan associations in Ohio; a partner with then-Alexander Grant and Co., E.S.Ms auditor, admitted accepting payments from E.S.M. in exchange for certifying falsified financial statements.

During the same period, the accounting profession came under Congressional scrutiny again. Beginning in 1985, the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, the subcommittee once chaired by Representative Moss, began holding hearings on the accounting profession [U.S. House, 1985]. Unlike the seventies, there has been no staff study of the profession; Congressional concerns must be discerned from Congressional testimony. However, familiar themes emerge:

- The audit opinion is persistently described in the 1980s as an "early warning system," which is perceived to have failed when firms fail;
- The confounding of rule-making and enforcement, which arises both from the nature of a peer review and from the perceived dominance of the AICPA and the Division of Firms by the Big Eight and other large firms;
- The lack of public participation in the accounting and auditing standards setting process, in the disciplinary process, and the lack of governmental oversight;
- The perceived conflict between management advisory services and the independence of the audit function;
- The perceived conflict between the independence of the auditor and the fact that the auditor is hired by management.

In contrast to the events of the 1970s, the profession's response to Congressional pressure has been more unified and orderly; nevertheless, significant differences among responses are evident. Three new proposals have come forward: a new Price Waterhouse proposal [Price Waterhouse, 1985]; a proposal from the remainder of the Big Eight firms, commonly called the "Big Seven" proposal [AICPA, 1986b]; and the AICPA (or Anderson Committee) proposal [AICPA, 1986a]. In addition, a blue-ribbon panel, the National Commission on Fraudulent Financial Reporting (the "Treadway" commission) has begun a comprehensive study of the problem of management fraud.

Price Waterhouse Proposal

Joseph Connor, chairman of Price Waterhouse, has testified before Congress on a proposal for a statutory self-regulatory organization (SRO).

As in the 1970s, Price Waterhouse appears to be breaking with the rest of the profession, and clearly with the rest of the Big Eight, by calling for greater government oversight of the profession.

Under the Price Waterhouse proposal, an SRO would be created which would be subject to SEC oversight. Membership in the SRO would be mandatory for all firms which audit SEC registrants. The SRO would replace the present Division of Firms, but standards setting in both accounting and auditing would remain with their present private sector bodies, the Auditing Standards Board and the FASB. The SEC would be barred from access to specific client information. Finally, the proposal would expand auditing standards to evaluate management controls and identify situations in a firm's environment which would indicate a higher risk of management fraud.

Big Seven Proposal

Within several months of the introduction of the Price Waterhouse proposal, the managing partners of the other seven firms which comprise the Big Eight submitted a series of recommendations to the AICPA Board of Directors.

Under the Big Seven proposal, the current SEC Practice Section would be retained, and "the SEC should explore the powers it has under current statutory authority to make membership *de facto* obligatory" [AICPA, 1986b, p. 55]. The proposal would also extend SEC jurisdiction over such entities as insurance companies and government securities dealers. The Big Seven proposal states that the auditor should have regular communication with the outside audit committee, or with the entire board of directors if there is no audit committee. The Big Seven would also remove the current restriction on the number of the Big Eight which can be represented on the Auditing Standards Board. Finally, the Big Seven call upon the SEC to endorse the Special Investigations Committee of the SEC Practice Section.

Anderson Committee Proposal

In October 1983, the AICPA appointed a Special Committee on Standards of Professional Conduct, chaired by George D. Anderson. The committee was instructed to "study the relevance and effectiveness of professional standards in today's environment" [AICPA, 1986a, p. 3]. While the committee's report focuses on the Code of Professional Ethics, it includes sections on the role of self-regulation and management advisory services. The Anderson Committee proposal would, like the Big Seven proposal, make membership in the SEC Practice Section mandatory, but in a slightly different way. Under the Anderson proposal, all firms with one or more SEC audit clients would have to join the SEC Practice Section in order to qualify CPAs practicing in those firms for AICPA membership. The Anderson Committee proposal would retain the peer review programs of the SEC Practice Section and the PCPS, and would add a third quality review program, to be administered by the state societies as much as possible. Participation in one of the three peer review programs would be an additional membership requirement for members in public practice. The Anderson Committee also proposes a comprehensive restructuring of the professional code of ethics, under which members should use their own judgment to determine what nonaudit services are consistent with professional conduct.

Treadway Commission

As this paper was being written in early 1987, the Commission's conclusions and recommendations were still tentative. However, several of them would have significant effects on the profession if enacted.

First, the Commission has tentatively recommended that audit committees composed primarily of outside directors be mandated for publicly-held companies. Furthermore, the Commission has tentatively recommended that all publicly-held companies maintain an internal audit function.

The Commission has also tentatively recommended that participation in a "professional quality assurance" program such as the SEC Practice Section be mandatory for all auditors of publicly-held companies. However, the Commission stops short of recommending an SRO as a means of enforcing sanctions against offenders. Rather, the Commission calls upon the SEC to assume primary enforcement of quality standards.

Proposals as Responses to External Pressures

As in the 1970s, the broad elements of these three recent proposals can be viewed as responses to pressures exerted on the profession by the Congress and other outside observers. For example the Price Waterhouse proposal contends:

> Adoption of the statutory SRO model would allow both the public's interests and the interests of the profession to be accommodated. By providing for formal government oversight of an SRO, the public can be assured that its concerns will be addressed by an objective outside entity. . . . Correspondingly, the profession benefits from the enhanced public confidence appropriate to a system of objective outside oversight, while retaining the substance and philosophy of the self-regulatory approach. [Price Waterhouse, 1985, p. 55]

Likewise, the Big Seven proposal states that it is designed "to assure the future relevance, reliability, and credibility of financial information" [AICPA, 1986b]. And while the Anderson committee was formed in 1983, two years before Congressional hearings began, the committee's work should be viewed as a response to the same issues which led to the hearings.

We turn now to an analysis of the issues and events which led to the hearings themselves, in order to assess recurring and perhaps predictable patterns in the impact of external forces on self-regulation.

ANALYSIS OF EVENTS TRIGGERING REGULATORY RESPONSES

As noted in the chronology above, each series of Congressional hearings was preceded by a series of business failures. Comments from members of Congress suggest that these business failures played a large part in triggering the Congressional inquiries. For example, according to Representative Moss, chairman of the House Subcommittee on Oversight and Investigations during the 1970s,

> In all of those situations publicly-owned companies went bankrupt and caused substantial harm to investors with no prior warning from their independent auditors that anything was amiss. Those of us in Congress began to wonder where the auditors were during the period those companies were headed for their falls.

Despite the strong tone of this statement, Congressional interest waned. No new government regulation of the profession was enacted, and the Division for Firms and JEEP were allowed to stand. There are four probable reasons for this turn of events.

First, the AICPA plan had the support, if not the official endorsement, of the SEC. While there were elements of the AICPA plan to which the SEC objected, Harold Williams, then chairman of the Commission, indicated in his testimony before the Moss subcommittee:

> The Commission believes that it is appropriate and desirable that the AICPA be given a full opportunity to institute effective self-regulation before Congress considers the imposition of other forms of regulation [Williams, 1978, p. 363].

Second, the Metcalf and Moss hearings resulted largely from the interest and energies of Metcalf and Moss themselves and their respective staffs. Senator Metcalf died in 1977, and his subcommittee was dissolved. Responsibility for accounting and auditing matters fell to the Subcommittee on Governmental Efficiency and the District of Columbia, part of the Senate Committee on Governmental Affairs. That subcommittee was chaired by Senator Thomas Eagleton; in 1979 he held follow-up hearings on the accounting profession, but no report on the hearings was issued and the matter soon faded from popular view. In the House, Representative Moss decided not to seek reelection. A bill he had introduced to institute an SRO regulating the profession[4] was referred to the House Consumer Protection and Finance Subcommittee, chaired by Representative Eckhardt, where it was never acted upon. With the end of the 95th Congress, Representative Eckhardt assumed the chairmanship of Moss' subcommittee.

Third, even if members of Congress had shown interest in regulating the accounting profession, the appropriate subcommittees had other more pressing political issues, especially the oil crisis. Finally, the late 1970s brought the beginnings of de-regulation, and the 1980s brought a change of administration and Republican control of Congress. Many government agencies were dismantled, and Congress appeared reluctant to establish a costly new bureaucratic structure to replace one functioning solely at private expense.

This pattern of events suggests two competing hypotheses. First, the self-regulatory initiatives taken by the profession satisfied Congressional investigators, thus reducing their drive to impose additional external regulation on the profession. Alternatively, Congressional interest in the profession was overshadowed by interest in other events, including the oil crisis and relations with Iran.

As this paper was being written in early 1987, a similar pattern of events appeared to be taking shape with respect to the most recent Congressional inquiry. Compare the earlier quote from Representative Moss to the following from Representative Dingell, chairman of the Subcommittee on Oversight and Investigations during the most recent hearings:

> It became imperative that Congress investigate the role of the accounting profession, as we saw repeated revelations of illegal conduct of corporate officers, bank failures leading to huge government bailouts, and a series of stock manipulations and corporate takeovers that were apparently accomplished with the aid of accounting gimmicks. In each such case one could not help wondering what had become of the independent auditor. [Dingell, 1986, p. 52]

As before, the recent hearing before the Subcommittee on Oversight and Investigations appeared to be fueled by the interest of a few members of the subcommittee, particularly its chairman. However, following the 1986 Congressional elections, membership on the Subcommittee has changed. Perhaps the change in membership will dampen the Subcommittee's enthusiasm for imposing additional regulation. Further, initiatives were underway within the profession to amend its professional self-regulation. Perhaps these initiatives will alter the public's perception of the need for additional regulation. Finally, the Subcommittee may be called upon to investigate events surrounding the sale of arms to Iran in connection with U.S. citizens held in Lebanon and the possible diversion of funds from the sale to rebels in Latin America. Perhaps Congressional interest in regulating the profession will be diverted by other events.

THE FUTURE COURSE OF PROFESSIONAL REGULATION: ISSUES TO BE INVESTIGATED

To this point, we have suggested that the course of accounting self-regulation thus far has been guided in large part by forces external to the profession, particularly Congressional investigations and that these forces, particularly Congressional investigations, are to some extent predictable. If these statements are true, then the future course of professional regulation in accounting may itself be predictable. However, before such predictions can be made, we must improve our understanding of several basic relationships.

First, what triggers Congressional interest in the profession? We have suggested that business failures play a part, but obviously not all business failures are investigated by Congress. Is it the size of the failure, the number of investors and creditors affected, or perhaps the number of investors and creditors affected in a particular legislative district?

Second, what determines the direction of the profession's responses to public criticism? For example, Price Waterhouse has consistently called for greater government regulation of the profession, while other large firms have called only for strengthening professional self-regulation. To what extent do these responses represent consensus or compromise among conflicting views within the profession?

Third, considering the path of regulation, is there an optimal way to regulate a profession such as accounting? For example, can a voluntary self-regulatory effort such as the Division for Firms satisfactorily enforce its standards? Or is mandatory membership in some government-sanctioned organization the only way to gain control over errant members?

Fourth, how does one evaluate the strengths and weaknesses of existing regulation in accounting? Has the profession "captured" the SEC? Have the large firms "captured" the AICPA and/or the Division for Firms? Have changes to the Code of Professional Ethics, such as the elimination of the bans on advertising and client solicitation, contributed to audit failures? What effect does increased competition have on audit quality? What effect have peer reviews had on audit quality? Has the Division for Firms contributed to conflict within the profession between the interests of smaller firms and those of larger firms?

A fifth question concerns the recurring Congressional inquiries into liability for professional negligence. Coupled with a general crisis in liability insurance, what effect has the Supreme Court's decision in *Hochfelder* had on audit quality? What effect would the removal of limits on liability have on the profession?

Although many other questions about regulation of the profession could be raised, the foregoing list is indicative of the types of questions suggested by the evolutionary view of self-regulation taken in this paper. We believe that this view provides a useful framework for testing whether a predictable "oversight cycle" occurs and how it concerns the progress of CPA self-regulation.

NOTES

1. *Ernst and Ernst v. Hochfelder*, 425 U.S. 185 (1975).
2. *Arthur Andersen & Co. v. Manufacturers Hanover Trust Co.*, 801 F.2d 13 (CA-2, 1986), cert. denied 1/27/87, 00 U.S. 00
3. Moss, John, July 25, 1977 speech, quoted in [Olson, p. 39].
4. H.R. 13175, introduced June 16, 1978 (95th Congress, 2d Session).

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COMMON LAW ACCOUNTING: THE CASE OF GOODWILL

Orace Johnson

ABSTRACT

This study is both conceptual and historical with regard to two institutional systems in the United States for reaching social consensus on accounting standards—the political alternative of statute law passed by Congress, and the judicial alternative of common law adjudicated by the court. Through a strict construction of the United States Constitution, the hypothesis is deduced that common law is more effective and more efficient than statute law for resolving issues of accounting as a language. The null hypothesis is that there is no efficiency difference between the two institutions. From current accounting textbooks a consensus core of 16 elements in accounting for goodwill is uncovered and assumed to be generally accepted current accounting practice. These consensus elements are then traced back to their separate origins under either common law adjudication before 1933 or statute law legislation after 1933. Goodwill accounting thus becomes a metric for

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"measuring" the relative efficiency of common law and statute law. Since 15 of the 16 elements were formed under common law and not reversed under statute law, the hypothesis of no difference between the two institutions is rejected. The alternative hypothesis, *relative* effectiveness and efficiency of common law, is *conditionally* accepted. The conclusion is that more attention should be given (in textbooks, in research, and in the FASB pronouncements) to the common law origins of current accounting standards. We should not ignore the judicial alternative for social control of accounting as a language.

Recent research in jurisprudence and economics of law has refined many legal concepts including property rights, contract, and tort.[1] With attention to both equity and efficiency, the refinements point toward judicial institutions for handling a variety of problems now generally thought best assigned to regulatory agencies.[2] A judicial solution to the institutional problem of power to set accounting standards is not now seen by most people as a practical alternative to a legislative solution.[3] To the best of my knowledge, recent accounting literature has overlooked the common law tradition for reaching consensus on accounting standards.[4] The prevalent view is that "standardized accounting procedures . . . by and large, did not exist prior to the creation of the SEC" (Berk [1981] p. 200).

(One corollary of this prevalent view in this era of statutory law is a reduced understanding and appreciation of common law as being much more than a consensus among judges. A description of these two alternative processes for *social* consensus is presented in Appendix A as background material rather than here in order not to disrupt the main line research argument. This placement is appropriate since proponents of statutory regulation for accounting may tend to misinterpret a first reading of this institutional material as opinionated description rather than neutral citation.)

This paper presents the results of one attempt to discover whether any standardized accounting procedures did exist in the United States prior to 1933. More specifically, the attempt is to discover whether current statutory law standards for goodwill accounting had their origin in common law litigation prior to 1933. While survival itself does imply that the originating process was effective—otherwise there would be no product to survive—survival alone cannot imply all we need to know in order to make a definitive value judgment about process efficiency or about social equity. These issues are especially problematic when both the products and the processes are expressions of human values.

Products of human society (such as accounting standards) and the social processes that produced them (such as common law and statute law) are neither isomorphic nor antithetical. This paper, however, does not address numerous important issues that ought to be investigated, such as questions of philosophical concern (which could alter relative preferences for institutional system designs per se); or questions of environmental change (which could alter relative cost in terms of time and of resources used in common law and in statute law); or questions of wealth and welfare (which could alter preferences for the products, the accounting standards themselves, the substantive laws.)

Since common law and statute law are different processes, the substantive consequences for any subject might vary with the kind of social control. However, this paper neither evaluates the accounting results from an a priori perspective, nor speculates hypothetically upon how likely it might be for statute law to produce the same results as common law, or vice versa.

This paper is limited to *description, origin and change* of generally accepted accounting for goodwill in the context of institutional comparison. I shall not consider separate kinds of efficiency [see Tullock, 1980]. Instead, I shall presume that production efficiency (the process of creating law) and control efficiency (the process of enforcing law) can be subsumed with substantive efficiency (the content of law itself). While acknowledging that a measure of content survival cannot be conclusive, I assume that such a measure might be an appropriate initial test for substantive efficiency.

In concept and scope, this research into the legal case history of goodwill accounting is narrower than that which would result from constitution analysis in general within a context of political theory. But the research is relevant to institutional choice even though I do not consider questions of morality, equity, or jurisprudence which would arise in a full discussion of freedom of speech. The bare conditional logic that guided the investigation reported here is as follows:

IF the Constitution of the United States embodies social wisdom,
IF strict construction of the United States Constitution is correct,
IF common law is more efficient than statute law for matters of speech,
IF speech includes accounting as a language,
IF current goodwill accounting is reflected in textbook consensus, and
IF relative efficiency can be inferred from the historical record,

THEN examination of the origins and changes in elements of accounting for goodwill should lead to rejection of the null hypothesis that there is no difference between the two legal institutions. Furthermore, examination of the historical record should lead to conditional acceptance of the alternative hypothesis that common law is relatively more efficient than statute law for accounting. A tacit presumption in this conditional logic is that whatever may be in violation of the United States Constitution is not socially efficient because the Constitution is the essential fabric of our society, the central focus of social equity.

If substantive precedents for goodwill accounting were not set through private litigation before 1933, then the idea of common law as an effective institution should be rejected. If substantive precedents were set through private litigation before 1933, but if they did not survive under the subsequent statutory regime, then the idea of common law as an efficient institution for setting accounting standards should be rejected.

HYPOTHESIS AND METHOD

The research was conducted in four distinct stages. First, the Constitution was construed strictly and a general expectation was formed. Second, the account title to be used as a research metric, goodwill, was chosen. Third, the textbook consensus about constituent elements in accounting for goodwill was uncovered. Fourth, the legal history was explored with particular attention to common law cases.

The research was unbiased in this critical feature: prior to uncovering textbook consensus on goodwill and prior to examining the court record, I had no factual knowledge of how much current accounting on any topic came from common law and how much came from statute law. A simple null hypothesis, *informed by no evidence and by no theory,* would predict that 50% of GAAP came from each institution. An alternative hypothesis was deduced as the first step in this research.

Concerning the First Stage

The distinction between common law and statute law is particularly important for accounting (Johnson, [1981]). The passage of the Constitution which gives power to the judiciary must be reconciled with two other passages that taken together first confer and then constrict power for the legislature.

Judicial power is established by the Constitution in Article III. Section 2 states in part: "Judicial power *shall extend to all* cases, in Law and Equity, arising under this Constitution" (emphasis added). Congressional power is established in Article I. Section 8 paragraph 3 states in part: "Congress *shall have* Power . . . to regulate commerce with foreign Nations, among the several States, and with the Indian tribes" (emphasis added). Congressional power is then limited by the First Amendment, which states in part: "Congress *shall make no law* . . . abridging the freedom of speech" (emphasis added).

The grammar of the Commerce Clause—"shall have"—is absolute in conferring on Congress the power to regulate commerce of all kinds without condition or exception. The grammar of the First Amendment is equally absolute—"shall make no"—in denying Congress power to regulate speech of all kinds without condition or exception. The grammar of the Judicial clause is equally absolute—"shall extend to all"—in conferring judicial power on the Supreme Court.

Interpretation of these passages (in the context of the whole document, its formation and its history) is critical for accounting. The phrase, "language of business," which is often used in reference to accounting, is more than a mere figure of speech [Davidson, et al. 1974]. Accounting as a language is encompassed by the expression, "commercial speech." Commercial speech is a problem for Constitutional interpretation because it raises the critical question of institutional priority for the power to set accounting standards.

The First Amendment was adopted after the original text went into effect as the fundamental law of the land. This amendment set a limit to Congressional power to regulate. This limit prohibits Congress from passing any statute law which has the purpose of abridging (i.e., regulating) speech. But the Supreme Court retains the power to litigate all speech cases.

Accounting was not mentioned in the Constitution either as specifically delegated to Congress for regulation or as specifically protected from Congressional power. However, two passages in the Bill of Rights are relevant to questions raised by Constitutional silence on accounting. Article IX provides that "The enumeration in the Constitution, of certain rights, shall not be construed to deny or disparage others retained by the people." Article X provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." Therefore, the simple, easy, and strict construction is that *Congress* was not granted and does not now have Constitutional authority to legislate, either directly or indirectly, statutes for uniform regulation of *any* language. The strict correlative interpretation is that public control of speech, including accounting as a language, is a matter for private litigation and court decision.

Concerning the Second Stage

Successful execution of the project required that the account title to be used as a metric should satisfy three criteria: presence, scope, and neutrality. As to presence, in order for a measured institutional comparison to be made, the account title had to be considered a problem under both common law and statute law. As to scope, the title had to be broad enough that it would have a detailed statement of generally accepted accounting principles in the textbooks, and yet be narrow enough that it could be researched within reasonable time and resource constraints. As to neutrality, the account title had to have no evidence or theory that would link it to either legal institution. Intuitively, goodwill seemed to fit all three requirements: neither too broad nor too narrow, likely to have a clear legal trail both before and after 1933, and conceptually independent of both common law and statute law.

This paper might be considered a "case study," since only one account title is used. The weakest sort of case study is one in which various levels of the experimental variable are manipulated by the researcher in a context of weak situational variables. The strongest sort of case study is the polar extreme where, in a context of strong situational variables, the experimental variable cannot be manipulated by the researcher. I believe the research reported here is closer to the strong polar case for two reasons. First, the institution as a quasi-experimental variable is historical and therefore not manipulable. Second, the situational variables (economic, political, and private interests) are likely to have been strong. Future research using account titles other than goodwill as different measurement scales may contradict or reenforce this study. As with all hypotheses, the conclusions presented here are tentative and conditional.

Concerning the Third Stage

I chose to use textbooks as my source of "consensus" for two reasons. First, I was stimulated by Jensen [1982] to wonder about the impact of statutory rule making on accounting education. Second, textbooks are considered to be a source of "substantial authoritative support" for accounting practice where FASB has not pronounced a standard. If FASB has not legislated on all elements of current goodwill accounting, then textbook consensus might be closer to total practice than FASB pronouncements. Under the assumption that a consensus from intermediate textbooks would be a sufficiently accurate statement of generally accepted accounting for goodwill, I did not examine introductory and advanced financial accounting textbooks and specialized textbooks on cost accounting, managerial, systems, auditing, and tax. I saw no reason to believe that the consensus from intermediate textbooks would be changed by the content of textbooks on other related accounting subjects.

Current editions of eleven intermediate financial accounting textbooks were examined for treatment of goodwill.[5] None of the eleven textbooks presented any material on the institutional origin of the elements in goodwill accounting. Since I had no ex ante knowledge about origins, this general omission continued an assurance that the research procedure was unbiased. The textbooks differed greatly in many aspects of their goodwill discussion. Different points were emphasized. Conceptual material was developed differently. Computational material was presented differently. Grammar and style varied. But eleven elements of accounting for goodwill were mentioned in all eleven textbooks. Unanimously, goodwill is considered to be:

1. an asset
2. not tangible
3. not explicitly identifiable
4. not separately transferable
5. not explicitly valued
6. associated with various causal factors
7. estimable by various arithmetic procedures
8. recorded only when purchased at historical cost
9. transferred in conjunction with a whole business
10. quantified as a residual (price paid minus fair market value of separately disposable net assets)
11. amortized over not more than 40 years.

Five other points seem to be part of the goodwill meaning even though not mentioned by all eleven textbooks. Goodwill is:

12. developed over time
13. not recorded as developed internally
14. distinct from an agreement not to compete
15. conceived as the expectation of excess profit, and
16. associated with a major acquisition of either equity or asset.

Some other points were mentioned by only a few textbooks and seem not to be natural elements in a conceptual core meaning of goodwill. For example, it is public policy rather than the nature of goodwill that makes accounting reduction of goodwill not tax deductible. Also, the adjustment procedures in constructing consolidated statements and working capital fund statements, and the equity method of accounting for investments are secondary considerations rather than primary features of goodwill. Finally, textbook omissions, errors of fact, and errors of interpretation are details extraneous to the purpose of this article.

An operational definition of "element" in the complex idea of goodwill cannot be stated precisely enough so that other researchers could read these same textbooks and necessarily infer exactly the same consensus. The distinction between "elements" is not a simple question of conceptual importance, or of verbal space, or of taxonomic generality, or of any single hypothetical attribute. For example, should the single element, "recorded only when purchased at historical cost" (#8) have been treated as two separate elements, "when purchased" and "at historical cost"? Is the element, "not recorded as developed internally" (#13) redundant to "recorded only when purchased" (#8)? Are the two elements, "not explicitly valued" (#5) and "quantified as a residual" (#10) corollaries which should be treated as a single element? How much overlap is there between "not tangible" (#2), "not explicitly identifiable" (#3) and "conceived as the expectation of excess profit" (#15)?

The significant question is whether another reading of these same textbooks, perhaps with unequal weighting assigned to the various elements, would give a significantly different picture of accounting for goodwill and its institutional origins. In my opinion, any difference would be slight and not of the kind to reverse the results.[6]

Concerning the Fourth Stage.

The current consensus might have originated under either common law or statute law. With the backing of Congress and the SEC, a few small groups of professional accounting practitioners, scholars, regulators and legislators might have set all goodwill accounting elements. The current consensus might be an original construction, or it might be a repudiation and reversal of earlier common law. A finding that statute law had wholly repudiated common law would suggest that the common law process was not a viable, practical, effective and efficient institution to set accounting standards. Such a finding would be contrary to the expectation deduced through a strict construction of the Constitution.

On the contrary, the current consensus might be much older than the SEC's statutory authority. Generally accepted accounting for goodwill might have come entirely from common law. It is possible that 50 years of the statutory process have added nothing to our understanding of this "most complex, controversial, and misunderstood" accounting topic. Nothing substantial will have been added by the statutory era if the regulators of accounting have only codified previously existing common law. A finding that current goodwill accounting was derived wholly from common law would suggest that common law is in fact as well as in theory an effective and relatively efficient institution to set accounting standards. Such a finding would be consistent with a strict construction of the Constitution.

Before looking at the historical record, I knew there were several conceivable reasons to explain why nothing might be found. First, goodwill accounting might not have been an issue before the statutory era. Second, if goodwill accounting issues had arisen, they might have been settled out of court and never litigated. Third, if goodwill accounting issues had come to trial, the decisions might not have been appealed to a higher court for a review of the law applied to the cases. (Trial court opinions are not routinely published by legal reporters since they rarely result in new unchallenged legal precedent.) Only if goodwill accounting issues had arisen above the level of trial court, and only if court opinions on appeal had been reported would the common law history of goodwill accounting be clearly traceable. The absence of case records, however, would not prove that generally accepted accounting standards for goodwill had not emerged without litigation prior to 1933. What was actually done as accounting practice before and after 1933 cannot be directly observed. Instead, inferences about practice must be made from formal records such as common law case decisions and legislated statutes. We lack empirical evidence to show whether compliance (as a problem in control efficiency which is not addressed in this research) has increased or decreased since 1933. Finally, this research might become flawed by an incomplete investigation in which I would fail to uncover the actual records of what had happened in the common law development of goodwill accounting.

A clear view of purely private litigation and common law uncontaminated by statute law was needed. Therefore I focused on private disputes where private expectations were judged by courts against the background of evolving business custom. Property law, contract law, and tort law are essentially common law. At the extreme, specific tort action may be unaffected in substance by statute law. So I searched for evidence of goodwill accounting in cases of property, contract and tort action where both plaintiff and defendent were private parties. I began the search by screening citations in Hills [1957]. Then I would read those cases and note earlier citations. From cited case to cited case I searched backward through time. I excluded cases of tax, crime, regulation, probate, and bankruptcy where one party was the government. Since I wanted to stay close to accounting as a language, I also excluded cases involving the legal duty of professional auditors.

More than 1,000 cases with decision and dicta on accounting were screened with these criteria in mind. More than 50 cases were identified with content reflecting current goodwill accounting. Twelve leading cases are summarized in Appendix B. These cases, as well as the prior court precedents cited in them, include a variety of causes and a variety of remedies. The private legal actions were based on tort claims of fraud, misrepresentation, conversion of property, and unfair competition; on breach of contract to buy or sell real estate, other assets, or common stock equity; to operate a business; to form or to terminate a partnership or a corporation; to share profits, to pay interest; to distribute dividends; to refrain from competition, etc. Remedies sought by the plaintiffs included specific contract performance; contract rescission; recovery of sold goods; recovery of purchase price; damages; and injunction. Some cases were decided on the merits of evidence and substantive law. Some cases were decided on legal procedures, such as estoppel, laches, standing to sue, jury instruction error, and evidence admissibility. But even in the cases decided on procedural grounds, the judges in dicta could and did contribute to the nascent consensus. Collectively these cases of private litigation created general purpose accounting for goodwill.

EVIDENCE

As summarized in Table 1, of the 16 elements in goodwill, 15 (or 94 percent) arose under common law through private litigation prior to 1933. This is a clear rejection of the simple null hypothesis that there is no effectiveness difference between common law and statute law where the origins of goodwill accounting are concerned.

None of the consensus points of goodwill came as a statutory reversal of common law precedent. The absence of reversals may be interpreted as a statutory acknowledgement that the common law process was substantively efficient for goodwill accounting.

Continual refinement of accounting for goodwill occurred during the last four decades of common law prior to the statutory era. Six of the leading goodwill cases (50 percent) and six of the consensus elements (38 percent) were decided in the final 40 years of judicial supremacy.

In contrast, during nearly five decades under statute law, 1933–1983, only one of the 16 consensus elements (6 percent) was established. Element #11, that goodwill must be amortized over not more than 40 years, was mandated by the Accounting Principles Board in 1970.

Since the entire population of 16 goodwill elements was examined, no probability inference or confidence interval is appropriate. If the population had been all of the account titles for which discrete component elements could be used in comparing institutional origins, then goodwill would have been a judgmental sample of one from which no statistical inference about the whole population would be warranted. However, the expected alternative hypothesis of common law efficiency (that is, substantive survival) is *conditionally* accepted along with rejection of the null hypothesis.

Thus far the score on institutions to set accounting standards for goodwill is 15 to 1 for a strict interpretation of the Constitution, for judication over legislation, for Courts over Congress, for litigating over lobbying. That score gives an empirical challenge to the prevalent belief that, for reaching consensus on accounting standards, statutory regulation is necessarily more efficient than private litigation. It remains to be seen whether this challenge can be sustained by further research using other account titles to compare consequences of the two institutions.

To use a metaphor, the proposition that "All crows are black" can be refuted by the discovery of a single white crow. If the two categories, black and nonblack, are defined at the 50 percent margin, and if 94 percent of the feathers on one crow are white, then at least we have in goodwill

Table 1. Origin of Current Goodwill Accounting

	COMMON LAW												STATUTE LAW
Year / Element	1620	1810	1858	1859	1860	1867	1893	1897	1908	1916	1920	1930	1970
1	✓												
9	✓												
10	✓							Controlling					
2		✓						Precedent					
5			✓										
3				✓									
14				✓									
7					✓								
6						✓							
4							✓						
16								✓					
15									✓				
8										✓			
12											✓		
13												✓	
11													✓

*See Appendix B for summary and comments on these cases.

one white crow. This finding that common law is the actual origin of most elements in current goodwill accounting clearly refutes the impression that all goodwill accounting came from statutory authority—an impression created by pronouncements and textbooks devoid of history except for reference to statutory authorities.[7]

One exceptional case might be interpreted as anomalous. In McFadden v. Jenkins [1918] the court recognized a possibility that even a firm losing money might have goodwill as an asset. This view is contrary to Hodde v. Hahn [1920] and has not been followed.

Under common law the value of goodwill was a matter of fact to be discovered in each individual case by evidence under adversarial cross examination. This recognition of diversity in fact situations is reflected in many case decisions, such as: Von au v. Magenheimer [1908], where the value of good will was a question of fact, not a question of law; Davenport v. Lines, [1899], where goodwill was not allowed as an asset; Goodnow v. American Writing Paper, [1908], where goodwill did not have to be amortized; Lane v. Barnard, [1918], where goodwill should continue to be carried on the books; and Lane v. Barnard, [1919], where a very rapid writeoff may be appropriate.

Dominant pressure under statute law for uniformity led to the conversion of matters of fact (i.e., life and therefore unamortized values) into law (i.e., time limit of 1 to 40 years). Would Judge Redfeld, in light of his 1854 opinion, think that APB #17 was a hasty freezing or a timely recognition of a change in custom? [Atkinson v. Brooks, p. 578; See Appendix A, p. 22.] The answer would depend on 3 conditions: (1) whether the "basis of such uniformity is convenience [economic efficiency] and justice [legal equity]"; (2) whether by 1970 the 1 to 40 years rule had "become measurably settled by practice"; and (3) whether the rule had acquired "the quality of uniformity and the character of general acceptance" such that it was *already* regarded as a matter of common law.

Was APB #17 merely a formal recognition of custom, or was it a major limitation on practice? The answer would depend on lobbying after 1933, a feature not examined in this research. Briefly stated, ARB #24 [1944] said that amortization was not obligatory; ARB #43 [1953] condemned arbitrary lump-sum writeoff and required an event to indicate goodwill loss; APB #17 [1970] required amortization over not more than 40 years.

It remains to be seen whether education and research at the level of social institutions (in contrast to the level of professional practice and academic theory) will restore to accounting the study of common law. It is one thing to acknowledge the present dominance of statutory legislation. It is quite another thing to be unaware of history and to ignore accounting institutions as a significant factor for the *context of choice* in professional practice.

In light of this study, it is a mistake—in my opinion—for accounting education and research to consider only the one current mode of social control. Since elemental goodwill standards were set before 1933, we know that common law accounting can be effective. Since these standards have survived for half a century into the statutory era, we may not dismiss common law for being substantively inefficient.

It is not enough that occasionally a question is asked rhetorically, with no serious answer expected or given. To ask, "Why is it necessary or desirable to have statutory regulation of accounting?" should lead to the companion question, "What are the criteria by which we can and should judge the relative merits of institutional alternatives?" The criteria used in this study, origin as an indicator of effectiveness and survival as an indicator of efficiency, are not the only possible ones. Others should be explored.

Claims that legislation, the statutory alternative, is "better" for setting standards than the judicial alternative often rest on presumptions of certainty and speed in reacting to new circumstances. Are these claims of certainty and speed confirmed by recent experience with Congress/SEC/FASB? Is the origin and demise of "reserve recognition accounting", for example, a unique instance of statutory speed and uncertainty? What has been the relative frequency of revolutionary reversals in accounting practice under statute law as compared to the frequency of reversals under common law? How many accounting topics are marked by unreversed evolutionary changes under statute law as compared to common law? Is the history of accounting for goodwill a unique instance of certainty? Is goodwill accounting an anomaly?

Even casual acquaintance with accounting problems and the statutory process suggests that we face a great need for historical/empirical research in comparative institutions. It is conceivable that a socially optimal process for reaching consensus on accounting as a form of speech could include some combination of both common law and statute law. But at present, we have no theory of what that optimal combination design would be. [See Calabresi, 1982]. Indeed, except for the strict construction of the United States Constitution which I used in this paper, there seems to be no clear *fundamental* theory that can guide the deduction of hypotheses for testing the effects of alternative *institutions* on accounting language.

Some hope for the future of accounting education and research concerning institutional alternatives can be gained from two recent comments in literature surveys.

"What is needed is a theory of optimal game forms subject to the constraint that the rules do not require a violation of the *Bill of Rights*" (emphasis added) [Demski and Kreps, 1982, p. 136].

"What is the *optimal* structure of accounting institutions?" (emphasis added) [Lev and Ohlson, 1982, p. 251].

Abstract model building of theoretical optima may be necessary. But model building is not a sufficient response to our needs for institutional education and research in accounting. Institutional analysis requires historical evidence as well as a priori reasoning. Thinking about, and getting evidence about, efficiency and/or equity in alternative accounting *institutions* will be much more difficult then studying *market transactions*—especially so when it comes to examining the interaction effects and evaluating the tradeoffs among production, monitoring, and content efficiencies of accounting language alternatives. Hard studies of real (in contrast to imaginary and ideological) alternatives may yet produce a shared paradigm for considering institutional issues in accounting.

APPENDIX A

Institutional Alternatives

Since differences between statute law and common law may not be well understood by accountants, a brief statement about their nature and history is in order.

Contrary to the misleading rhetoric that has been around for at least half a century, the institutional conflict is not between "public sector" and "private sector." Both of the institutional alternatives, statute law and common law, involve both public sector and private sector components [Johnson, 1981, p. 101]. The public component choice is between common law and statute law. The private component choice is between free experimentation and regulatory compliance. The connecting links between public and private components are lobbying under statute law and litigating under common law.

The nature of a production process affects the nature of the product. In the words of one legal scholar, "The basic assumptions entailed by . . . legislative fiat can be and often are quite different from those entailed in . . . law derived [through court adjudication] by reason from prior existing rules, precedents, and principles. Legislation entails concepts of validity, jurisdiction, sovereignty, democracy or general will, and public good. The law which has evolved through the system of the courts is based on concepts of rationality, universality, rights, obligations, action, responsibility, and agency" [Smith, 1983, p. 73].

Statute Law

The expression "statute law" is used here to mean more than laws passed by Congress. Under the Securities and Exchange Commission Act of 1934 Congress delegated explicit power to shape accounting through regulations having the force and effect of law. The SEC first encouraged the accounting profession [SEC, 1938] and then later affirmed that delegation of quasi-legislative authority to a private organization, The Financial Accounting Standards Board [SEC, 1973].

In the most general sense, statute law is the imperative of a sovereign will forced upon subject parties [Merryman, 1969]. Statute law is older than common law, and is traceable to at least ancient Rome. Statute law embodies abstract notions of public good, abstract principles from which private behavior must be deduced. Under threat of criminal penalty by the sovereign, private behavior must conform to unconditional commands.

The first stage of statute law is the private process in which individuals campaign through elections [or through war!] for sympathetic legislators, and then lobby to influence the passage of statutes favoring their private interests. Rhetoric in this first stage always justifies wealth-transferring statutes by alleging "market failure," "need," and "public good." The rhetoric rarely refers to non-market failure or to empirical comparisons of institutions [Kalt, 1981; Wolf, 1979].

The second stage of statute law is the public process in which legislation is passed and the administrative law judge functions as a subordinate bureaucrat serving a regulatory regime [Merryman, 1969]. Minority interests lose to the larger force. Legal duty that favors the majority coalition results in a general policy of wealth redistribution and often places in jeopardy the private rights of minority interests. Statute law trials resemble a simple exercise in logic, a syllogism. The major premise is found in the statute law code. It is assumed to be right and true for otherwise it would not have been created. The minor premise is found in the fact situation. The defendent is presumed guilty, for otherwise he would not have been charged by the regulatory commission. The defendent bears the burden of proving his innocence. In the extreme case, the verdict may be reached by "inquisition," with ideas of "public duty" overshadowing ideas of "private right." When trials under statute law are over, the result is an extension of uniformity in complying with the statute which itself was never on trial by the court (except for rare instances where, as in the United States, a Constitutional question of personal right against government is litigated).

Common Law

The expression "common law" is used here with a meaning wide enough to encompass equity law as well. In England, common law and equity law developed separately in special courts. But under the United States Constitution they were combined into one system. Originally, common law courts looked on "property" as things owned, while equity law courts looked on "property" as behavior claimed of other people. This distinction survives today in accounting balance sheets. The left side, assets, refers to things owned by the entity. The right side, equities, refers to behavior claimed by outsiders against the entity. The consensus core meaning of goodwill reflects both notions of property.

Common law accounting is a pragmatic two-stage system for reaching social consensus on standards. The first stage is private inquiry, experimentation, discovery and choice between competing accounting practices. The second stage is public inquiry through open trial and judgment of the effects on specific parties in light of their expectations. Common law trial is a system of empirical research in which the evidence is presented on record, under oath, and subjected to adversarial cross examination. The dominate questions are: "Who has been or likely will be harmed?", "How much harm was done?" and "Who did the harm?" "What remedy is suitable?" The defendent is presumed innocent until the plaintiff has proved him guilty of specific behavior that was contrary to specific law. Neither individual "need" nor individual "merit" are relevant to the case verdict of who did harm to whom and what remedy is just. Common law cannot contemplate a general policy of wealth redistribution, but only case-specific remedies, including injunction, compensatory and punitive damages.

When a common law trial is over, the judge as impartial researcher announces the conclusions as to both law and fact. The whole dynamic pattern involves looking for consistencies and analogies from case to case. The result is gradual improvement through rejection of generally recognized unfair accounting practices. Reason is thought to be stronger in discovering fallacies or inequities, and weaker in reaching positive truth or equity. Thus the common law process is similar to both Karl Popper's "refutation" philosophy of science and Friedrich Hayek's negative philosophy of social justice [Flanagan, 1979, p. 347].

For 9 centuries the courts in common law countries (first England, and then primarily the United States, Canada, and Australia) have protected two kinds of expectations held by private parties: expectations expressed in their private contracts and expectations expressed in their "social contracts" or customary responsible behavior on the part of a reasonable person exercising due care. When the 13 colonies formed a new and independent nation, they rebelled against the legislative and executive powers of England, against Parliament and King. However, they did not rebel against and did not overthrow their common law heritage. In fact, the United States Constitution gave a more important role to the judiciary because the Founding Fathers thought the Court to be the branch of government least dangerous to freedom [Bikel, 1962].

Under common law, "a sovereign directive was simply not thought of as being as important and significant in the solution of problems as were the people to whom the rules were ultimately to apply and from whose orderly behavior, *unmotivated by legislation or judicial compulsion*, the rules initially came" [Bridewell and Whitten, 1977, p. 97, emphasis added].

The judicial activity in common law is not only a quest for evidence of specific behavior by litigating parties—that is, for the facts of the case—but also a quest for the relevant applicable law of the case. Along with the defendent, the common law is continually on trial [Bridewell and Whitten, 1977, p. 12]. In this larger, dynamic sense, "law" means much more than "statutes." Law is much more than a consensus of judges. Law is the ethics and morality of the locale, or of the industry, or of some other social scope such as accounting.

Custom is continuously evolving. Common law precedents cited by counsel in court arguments are no more than evidence of customary behavior, evidence of what the law is. Common law is a system whereby custom is recognized through, but not created by, the judicial process. Common law is created "in a vast and unpredictable universe of private activity" [Bridewell and Whitten, 1977, p. xiv]. Law is shaped by history, tradition, culture, innovation, and practical considerations. The results of this autonomous behavior are then formally accepted or rejected through the public process of resolving specific conflict between parties in dispute.

In its purest form, common law case decision is a declaration of what the custom would have been anyway without the declaration. However, increasingly over the last century as all aspects of government in the United States became larger and more intrusive, judges have consciously gone beyond the optimal form of their role in common law discovery. Judges now are said to "create" new laws through their interpretative decisions. But this new activist role of the court, in quasi-imitation of statute law, is not of interest here.

The common law system was well described by Justice Redfield in Atkinson v. Brooks [1854]. I paraphrase his original text in three places by deleting his word "commercial" and replacing it with the word "accounting." This paraphrase serves to emphasize one specific instance of the general common law process. The other bracketed material is my own addition.

> The more important question growing out of the case is, perhaps, what is the true [accounting] rule established upon this subject? And it is of vital importance in regard to [accounting] usages, that they should, as far as practicable, be uniform throughout the world. And such is necessarily the ultimate consideration and will inevitably be the final result. It is, therefore, always a question of time as to uniformity in such usages. The basis of such uniformity is convenience and justice combined [i.e.—economic efficiency and legal equity?], and until such rules have become measurably settled by practice, they have to be treated as matters of fact, to be passed upon by juries; and when the rule acquires the quality of uniformity and the character of general acceptance, it is then regarded as a matter of law. It is thus that [accounting] law has grown up. [Atkinson v. Brooks, 1854, p. 578]

Accounting theory under common law may be inferred jointly from factual evidence and legal precedent that continuously accumulate in all jurisdictions. But inferences of theory are never the subject of litigation and never reach the level of a priori truths. Instead, they remain always secondary to practical experience. As Oliver Wendel Holmes said:

> The life of the [common] law has not been logic; it has been experience . . . and it cannot be dealt with as if it contained only axioms and corollaries of a book of mathematics'' [Holmes, 1881, p. 1].

A polar contrast between the two conceptual extremes of statute law and common law is the following: Statute law emphasizes some ideological order or conceptual framework in a process that results from, goes with, and tends to create a society characterized by governmental control and bureaucratically administered wealth transfers. Common law emphasizes justice between private parties in a process that results from, goes with, and tends to create a society characterized by voluntary behavior and contracts for exchange of property.

APPENDIX B

Evolution of Goodwill Accounting

This Appendix presents part of the historical record. It contains summaries of 12 leading court cases which established the precedents that are today incorporated by consensus in intermediate accounting textbooks as generally accepted accounting for goodwill. The case comments are about some of the alternative accounting concepts and procedures that were rejected, explicitly or implicitly, by court decisions and dicta.

Broad v. Jollyfe, 1620, England

The plaintiff, a mercer, was awarded damages for breach of an implied contract. Although the term ''goodwill'' was not used, the context makes unavoidable the concept of goodwill as an asset. The plaintiff had paid three hundred pounds for an entire stock of old textiles. The inventory had a fair market value of no more than one hundred pounds. The two hundred pound difference received by the defendent was in consideration of his voluntary but unwritten promise not to continue his mercer trade in the same shop location. In effect he sold the business assets and goodwill. However, rather than close his shop as promised, the defendent reopened it with new wares, thus depriving the plaintiff of customers expected in his nearby shop.

The alternatives implicitly *rejected* by this decision were: (1) only tangible property can be owned; (2) promises and expectations cannot be sold in conjunction with a transfer of tangible property; (3) the law will not protect property rights of this intangible nature.

Cruttwell v. Lye, 1810, England

The plaintiff, an entrepreneur carrier of wagon trade over a certain route, was denied an injunction against the defendent who, having sold his bankrupt business to the plaintiff, subsequently reentered the carrying trade between the same terminal cities but at different warehouses and over a different route. In refusing to grant the injunction, Lord Chancellor Eldon defined goodwill as "nothing more than the *probability* that the *old* customers will resort to the *old* place." [emphasis added]. The court held that the defendent had not reentered the *same* trade.

The alternatives implicitly *rejected* were: (1) only actualities and not probabilities of this kind may be exchanged under legal enforcement; (2) the vendor of goodwill is totally barred by contract from seeking new customers in a new place of similar business.

Austen v. Boys, 1858, England

In a complicated case of partnership dissolution, the court held that where a trade is established in a particular place, "goodwill" means nothing more than "the sum of money which any person would be willing to give for the chance of being able to keep the trade connected with the place where it has been carried on. Goodwill is something distinct from the profits of a business, although in determining its value, the profits are necessarily taken into account, and it is usually estimated at so many years' purchase upon the amount of those profits." However, the term "goodwill" seems "wholly inapplicable to the business of a solicitor, which has no local existence, but is entirely personal."

The alternatives implicitly *rejected* were: (1) goodwill can be quantified in money terms apart from an arms length purchase; (2) goodwill can be associated with a form of wealth ownership that cannot be exchanged under legal enforcement (i.e., human capital).

Churton v. Douglas, 1859, England

The plaintiff was granted an injunction against his former partner, the defendent who had sold to the plaintiff his interest, including goodwill, in a merchant business. The court said the vendor of goodwill was at liberty to set up precisely the same business next door to the old place.

The injunction barred the vendor from doing business under the old style or firm name. In the court opinion, Vice Chancellor Wood defined goodwill very broadly as "every positive advantage . . . whether connected with the premises in which the business was previously carried on, or with the name of the firm, or with any other matter carrying with it the benefit of the business."

The alternatives explicitly *rejected* were: (1) the sale of goodwill implies per se a contract by the vendor to transfer both positive and negative advantages, the latter being an agreement not to compete; (2) goodwill is associated with only certain tangible assets, such as location.

Mellersh v. Keen, 1860, England

The court held that on principle, in a partnership dissolution, goodwill should be valued, at the hypothetical amount of money it would have produced if sold in an arms-length transaction in the most advantageous manner at the most proper time. In this case, goodwill of a banking partnership was assessed at one years purchase of the average profits for the past three years.

The alternative *rejected* was that goodwill could be accurately valued via a private, bilateral, nonmarket price, negotiated in a manner such that only one partner obtains the benefit. (Or, in other words, the court rejected the idea that goodwill was an asset of the partners rather than an asset of the partnership.)

Bell v. Ellis, 1867, California

In this case of fraud and replevin following a bankruptcy action, the court extended the decision in Cruttwell v. Lye, 1810. Goodwill "is the probability that the business will continue in the future as in the past, adding to the profits of the concern and contributing to the means of meeting its engagements [i.e., debts] as they come in . . . [and] must be taken into accounting in determining" solvency. This opinion also quoted Justice Story's textbook definition of "goodwill" which would come to dominate American jurisprudence. Goodwill is "the advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances, or necessities, or even from ancient partialities or prejudices."

The alternative explicitly *rejected* was a narrow, tangible, net asset position statement for determining solvency and thereby for valuing goodwill.

Metropolitan Bank v. St. Louis Dispatch Co., 1893,
U.S. Supreme Court

The plaintiff was denied his request that the defendent be forced to sell goodwill in order to pay its mortgage. The court said goodwill "is tangible only as an accident, as connected with a going concern or business having locality or name, and is not susceptible of being disposed of independently. As applied to a newspaper, the goodwill usually attaches to its name rather than to the place of publication. The probability of the title continuing to attract custom in the way of circulation and advertising patronage, gives a value which may be protected and disposed of, and constitutes property."

The alternatives explicitly *rejected* are: (1) goodwill is separately disposable; and (2) being separately disposable, sale of goodwill by itself can be forced by the court to satisfy debt claims.

Washburn et al. v. National Wall Paper Co., 1897,
U.S. Second Circuit

The defendent corporation had issued common stock in payment for the goodwill of several acquired businesses, and simultaneously had issued cumulative preferred debentures in payment for the net tangible assets. The plaintiffs were large stock owners of the defendent corporation who sought an injunction against payment of interest expense on the debentures. Determining the value of the goodwill purchased with stock was critical for determining whether payment of interest would, contrary to state statute and to corporate by-laws, impair corporate capital. In dismissing the plaintiff's petition, the court said that goodwill was property actually received by the defendent in exchange for common stock; and that subsequent closing of some establishments did not prove depreciation of goodwill (and thereby capital) when the customers are supplied by other establishments.

The alternatives *rejected* were: (1) goodwill is not property actually transferred; and (2) goodwill is indissolubly connected with a particular locality or specific tangible property rather than with the continuing business.

Von au v. Magenheimer, 1908, New York

Charging fraud, the plaintiff said she was induced to sell her stock to officers of a close corporation, the defendents, after being told that the company had such large losses it would never be able to pay more than a 3 percent divident. As remedy for the injustice, the court awarded damages rather than rescind the contract. In calculating the amount of loss to the plaintiff as a result of the fraudulent sale, the court said that the value of goodwill is a question of fact for the jury to decide. Evidence of company business subsequent to the fraudulent sale was admitted for determining goodwill at the time of sale. The jury found that goodwill was worth six times excess profits, after deducting a normal six percent return on equity from annual earnings.

The alternatives *rejected* were: (1) the value of goodwill is a matter of law rather than of fact; (2) actual balance sheet information is not relevant for comparison and calculation of what goodwill was at an earlier time; and (3) goodwill is valued in relation to normal profits.

Coleman v. Booth, 1916, Missouri

The plaintiff was trustee in bankruptcy of a paper company. The board of directors had by resolution on more than one occasion increased both the amount of "goodwill" asset and the amount of "undivided surplus" equity, thus concealing deficits. They then paid dividends based on the revised balance sheets. The defendent testified that the "undivided surplus account was a flexible account that we charged or credited to, to make trial balances come out every time right." The court did not hold that it was per se fraud to record internally developed goodwill, but "there was absolutely no excuse for . . . [booking goodwill] when the company first commenced doing business, and when it had established no reputation which entitled it to any such asset." Directors individually were found liable to creditors for the amount of illegal dividends.

The alternative *rejected* was that nonpurchased goodwill may be recorded at the time a firm is first organized.

Hodde v. Hahn et al., 1920, Missouri

The receiver of a bankrupt oil corporation sued to recover unpaid stock subscriptions arising from an earlier merger involving goodwill of a mercantile firm received in exchange for stock in the surviving entity. The evidence showed that some accounts receivable existing prior to the merger had after merger been charged to goodwill. According to an expert accountant witness, not only had there been a total loss since the merger, but at the time of bankruptcy assets were less than liabilities. The court said that a company's goodwill "can only be estimated by the results of its business operations from the time it commences until it ceases." If in consequence of general public patronage such declared [goodwill] advantage or benefit turns out to be a disadvantage and a loss, then the goodwill becomes nothing more than a purely imaginary quantity, neither "the substance of things hoped for nor the evidence of things not seen." The court ruled that the stock subscriptions had not been paid because sufficient goodwill had not existed at the time of merger. Original stockholders had to make good the purchase price even though they had sold their shares after merger and before bankruptcy.

The alternatives *rejected* were: (1) subjective assertions about the future are determinate evidence; (2) as a matter of fact a bankrupt firm can have goodwill.

Mills v. Rich, 1930, Michigan

The plaintiff was an employee with a contract for sharing profits and also sharing book value when employment ceased. The plaintiff claimed that he was entitled to be compensated for his share of the firm's goodwill developed during his employment. The court said, "Goodwill is based upon the prospective hypothetical profits to result from voluntarily continued patronage of the buying public. . . . The book value of a business is based upon the actual cost. . . . No goodwill was set up on the books of the company. . . . No claim is made the books were not correct." So the plaintiff's claim was denied.

The alternative *rejected* was that the books of a company must include internally developed goodwill in order to be correct.

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NOTES

1. It is an understatement to say that recent contributions to knowledge through microeconomic analysis of legal concepts are too numerous to mention. Most of the research has been the result of Ronald Coase's classic article, "The Problem of Social Cost" [1960]. Also of classic importance has been Richard Posner's book, *Economic Analysis of Law* [1973, 1977]. For a recent overview of the field see *Hofstra Law Review* [Spring, 1980] which contains the proceedings of the "Symposium on Efficiency as a Legal Concern."

2. Two of the best sources of this vast literature are issues of the *Journal of Law and Economics* [1958 to the present] and the *Journal of Legal Studies* [1974 to the present]. One

of the best single coverages is Posner, *The Economics of Justice* [1981]. For good introductions to the contrasts between statute law and common law see Karlin [1983] and Smith [1983]. The following sources are particularly instructive: Holmes [1881], Pollack [1912] Commons [1923], Clark [1937], Dietze [1973], Chlorus [1978], Calabresi [1982], Rubin [1982], and Elliott [1984].

3. Publications on the law of accounting have generally been only narrative, categorical, and descriptive, such as Hills [1957], Simon [1965], and Courtis [1983]. Studies of accounting for goodwill have tended to identify conceptual issues and to summarize deductive arguments, such as the historical work of Hughes [1982]. I have been able to find not even one example of hypothesis testing of fundamental institution alternatives for accounting.

4. Examples in accounting literature which emphasize the political nature of our present statutory process while omitting the judicial nature of the common law alternative for reaching consensus include the following: Wheat Committee [1972], Horngren [1973], Gerboth [1973], Beaver and Demski [1974], Johnson and Gunn [1974], May and Sundem [1976], Sterling [1977], Watts and Zimmerman [1978 and 1979], and Dopuch and Sunder [1980].

5. My list of eleven intermediate financial accounting textbooks came from the cover of a book which contained the proceedings of a conference on "The Impact of Rule-Making on Intermediate Financial Accounting Textbooks" [Jensen, 1982]. The textbooks were: Chasteen, et al. [1984], Danos and Imhoff [1983], Davidson, et al. (3rd ed.) [1982], Edwards, et al. [1981], Ellis and Thacker [1980], Kieso and Weygandt [1983], Miller, et al. [1982], Mosich and Larson (5th ed.) [1982], Nikolai, et al. [1981], Smith and Skousen (7th ed.) [1981], and Welsch, et al. [1982].

6. After concluding this research using intermediate accounting textbooks as my source of goodwill elements, I examined APB 17, *Intangible Assets* [1970] and FASB *Accounting Standards Current Text* [1985]. APB/FASB do not discuss two goodwill elements which I had gleaned from textbooks: #7, estimable by various arithmetic procedures, and #14, distinct from an agreement not to compete. APB/FASB do discuss four points which are not in my list of 16 elements: negative goodwill, indeterminate life, straight-line amortization, and disposal.

Is "negative goodwill" a contradiction in terms? Is "indeterminate life" sufficiently different from "not explicitly identifiable" (#3) to warrant status as a separate element? Is "disposal" adequately subsumed by "not separately transferable" (#4)? Is "straight-line amortization [unless evidence supports a different pattern]" a distinct part of the core meaning of "goodwill"? The answers to these questions are debateable.

However, the dominant conclusion of this study would not be reversed by the most critical reappraisal of the elements list. If the list were reduced from 16 to 13 to eliminate possible redundancy, and if the additional four points in APB/FASB pronouncements were automatically treated as if they were separate elements originating under statute law since 1933, then the ratio of origination would change from 15:1 to 12:5. The result is still in support of the alternate hypothesis.

7. Direct acknowledgement that common law could be effective and efficient is made nowhere in the original pronouncements of APB or FASB, so far as I have been able to discover. It should not be a surprise that proponents of statutory law ignore common law origins of current standards. The FASB *Accounting Standards Current Text* [1985] does not disclose how much of the pronouncements originated under common law and how much is truly due to the statutory process. "The *Current Trend* does not in any way supersede, change, or otherwise affect the pronouncements from which it is drawn. Although edited by the FASB staff, the abridged text has not been subjected to the FASB's due process procedures used for issuing FASB Statements. The authority of the *Current Text* is derived from the underlying pronouncements, which remain in force." [1985, p. i]. The FASB thus seems willing to cite prior statutory authority (e.g., APB), but it does not seem willing to

cite prior judicial precedents for current standards even where the FASB agrees with the earlier common law. The FASB thus contributes to non-history.

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SEC ACCOUNTING-RELATED ENFORCEMENT ACTIONS 1934–1985: A SUMMARY

Walter K. Kunitake

ABSTRACT

This paper outlines the SEC enforcement activity brought against independent auditors and CPA firms as documented in the 1934–85 Accounting Series Releases and Accounting and Auditing Enforcement Releases under Rules of Practice 2(e). One hundred and sixteen releases documented the investigation of 130 CPAs and 47 CPA firms. Approximately 50 percent of the CPAs either resigned from practice at a Commission hearing or received permanent suspensions; another 37 percent received temporary suspensions of 30 days to 18 months. Other CPAs received censure, agreed to engage in continuing education programs or received no sanction.

Approximately 15 percent of the firms were either permanently suspended or dissolved. About 40 percent received temporary suspensions by accepting

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new SEC audit clients for a stated time; and about 28 percent of the firms that were cited received censure. Since 1973, the SEC has emphasized the firm's role to expand upon the peer review process.

SEC ENFORCEMENT ACTIONS: A SUMMARY

The Securities and Exchange Commission (SEC) remains one of the major monitoring agents of an auditor's performance. It can both bar an auditor from practice thus generating adverse publicity regarding a CPAs professional reputation. An SEC-enforcement action may also be a prelude to judicial action against an auditor.

Empirical research on the enforcement of proper auditing practices by any monitoring agents has been sparse. One such study of disciplinary action was conducted by Loeb [1972] centered on the conduct of a Midwestern state board of accountancy and its state society between 1905 and 1969. Loeb documented few charges of ethical violations against CPAs arising out of either the state society or state board during this period, and he speculated that adequate enforcement was lacking. There have been others who charged that enforcement activities by monitoring agents have been inadequate [Carey, 1965; Armstrong, 1971]. The Metcalf [1976], Moss [1978] and Dingell [1985] committees specifically charged the SEC with inadequate oversight of independent auditors.

The purpose of this paper is to outline the SECs enforcement process of external auditors and to summarize the SEC's enforcement actions affecting CPAs and CPA firms documented in the 307 Accounting Series Releases (ASRs). Also outlined is the first 83 Accounting and Auditing Enforcement Releases (AAERs). Suggestions for future research in SEC enforcement are also provided.

The SEC Enforcement Process

The accounting enforcement activities of the SEC are directed by Rule of Practice 201.2(e), hereafter referred to as Rule 2(e). Rule 2(e) was adopted in 1935 but was challenged in the late 1970s by Touche Ross & Co. to enjoin an administrative proceeding under the SECs Rules of Practice. In his ruling, Judge Timbers opined that Rule 2(e) was valid as a necessary adjunct to the Commission's power to protect the integrity of its administrative procedures and the general public [Touche Ross & Co. v. SEC].

Burton [1975], a former SEC chief accountant, noted that in deciding whether to institute an enforcement action, the Commission considers (1) the seriousness of the professional deficiency, (2) the extent to which the auditor had knowledge of what was happening, and (3) the degree to which the auditor appeared to be an active participant in a scheme to mislead the public through artful or incomplete disclosure or through the creative selection of accounting principles designed to present a picture inconsistent with reality.

Perry [1984] noted that investigations conducted into CPA firm audits of financial statements and records of SEC registrants come from various sources including referrals from the SECs Division of Corporation Finance and the Office of the Chief Accountant. Perry further stated that investigations may also arise from media pieces of magazine and newspaper articles, "tips" from informants, and referrals from government agencies such as the FBI. However, most investigations of alleged audit failures, arise from a firm's failure to meet a financial reporting required by the SEC registrant under the Securities Act of 1933 and the Securities Exchange Act of 1934.

When a CPA or a CPA firm appear to have violated an act administered by the SEC, the Division of Enforcement staff generally conducts an investigation. During this phase, no subpoena is issued and the investigation proceeds with reliance upon the voluntary cooperation of the CPAs. If the staff concludes that it cannot obtain enough information about the alleged violation during such an informal inquiry, it asks the Commission to authorize a formal investigation that allows the staff to issue subpoenas and to compel testimony from witnesses. When it completes its investigation, the enforcement staff shares its findings with the Office of the Chief Accountant. The chief accountant then may make recommendations that differ from those of the enforcement staff, and both sets of recommendations are submitted to the Commission [Burton, 1975].

After the Commission reviews the case, it may (1) institute an administrative proceeding to weigh the imposition of remedial sanctions, (2) initiate a civil injunctive proceedings, (3) refer the matter to the Department of Justice for criminal prosecution, or (4) drop the case without any further action.

The basis for the imposition of sanctions in an administrative proceeding is described in Rule 2(e) of the SECs Rules of Practice:

> The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter:
>
> (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.

An administrative proceeding under Rule 2(e) may bar or suspend an auditor, or a CPA firm from practice before the Commission, but generally it is remedial in nature [Burton, 1975; SEC Rules of Practice, Reg. 202.5]. An injunctive action is one in which the Commission brings civil action against a defendant CPA or the CPA firm for violations of the federal securities laws.

In settlement of an administrative, or injunctive action, CPAs and/or their firms may propose in writing to undertake such voluntary measures as enrolling in continuing education courses or subjecting themselves to peer reviews. The written offer is submitted to the Division of Enforcement where a hearing officer expresses his views on its appropriateness. The offers of settlement are submitted to the Commission along with the recommendations of the enforcement staff. If the Commission decides that the offers of settlement are appropriate, it orders compliance with them (SEC Rules of Practice, Reg. 201.8). This study designates such Commission order acceptances as "settlement undertakings." In some cases against CPAs and the CPA firms, settlement undertakings may occur in addition to receiving a censure or an order of temporary suspension may be issued.

RESULTS

All 307 ASRs and 83 AAERs were reviewed; 116 of the Releases reported investigations of individual CPAs practicing as individual public accountants and of their CPA firms. Of the 116 Releases, 17 covered CPA firms only, 69 involved individual CPAs only, and 30 involved both individual CPAs and their firms. Only 22 of the 116 Releases occurred prior to 1972.

When Rule 2(e) was first adopted, it did not indicate whether the proceedings would be public or nonpublic. However, all proceedings brought under that version of the rule were treated as nonpublic, that is, the proceedings were not open to the public but "findings" of the proceedings were published in the ASRs.

In 1971, the Commission amended Rule 2(e) to provide that:

> All hearings held under this paragraph (e) shall be nonpublic unless the Commission on its own motion or the request of a party otherwise directs. (SEC, 1986)

In 1986, the SEC published a proposal to make public, Rule 2(e) hearings in proceedings against professionals [SEC, 1986].

The incidence of reported investigations involving auditors has increased since 1972. Thirty-nine of the 51 cases in the 1970s occurred in the second half of the decade. In the first 6 years of the 1980s, 43 investigations of auditors and/or their firms already have been reported in the SEC Releases, most of them occurring from 1983 through 1985.

Investigations and Sanctions Against Individual CPAs

SEC documents include investigations of 130 practitioners contained in 99 of the 116 enforcement-related ASRs and AAERs. The first reported investigation against individuals occurred in 1942. The author compiled the alleged audit failures in accordance with the SEC's Rule 2(e) classification. Four were alleged not to possess the requisite qualifications to represent others; 105 were alleged to be lacking in character or integrity or to have engaged in unethical or improper professional conduct; 52 were alleged to have willfully violated, or willfully aided and abetted the violation of a provision of the federal securities laws. The total for these categories sum to 161 rather than 130 since some individual CPAs were alleged to have committed multiple violations.

Of the 130 CPAs, 21 were from the Big Eight firms and 109 from the non-Big Eight firms. For a summary of these investigations see Table 1.

The results of investigations of individual CPAs appear substantive: 86 percent have resulted in temporary or permanent suspensions or in voluntary resignation from practice before the SEC. The lesser penalty, temporary suspension, prohibits CPAs from practicing before the SEC for a period of between 30 days to 18 months. The SECs actions also appear to be remedial as noted in the SEC Rules of Practice. Even CPAs with permanent suspensions were allowed to apply for reinstatement to practice before the Commission after showing exemplary behavior over several years. This option also may apply to those who voluntarily resign from practice before the Commission. The seven who engaged in "settlement undertakings" (as defined by the author earlier) were assigned remedial behavior as compensation for professional misconduct. One of the most common remedial actions applied to individuals was enrollment in continuing education programs.

Censure, a written expression of strong disapproval, was applied against 6 CPAs. The SEC took "no action" against 5 others; in 2 cases the CPAs had already taken appropriate actions internally to remedy any problems they may have had. The majority of the 130 CPAs were partners or managers with principal responsibility for the audit engagement in question.

In most of the injunctive actions the CPAs were alleged to have willfully aided or abetted a violation of the federal securities laws. An injunction prohibits an individual CPA from violating certain federal securities laws in the future, but the SEC may suspend the CPAs' right to practice before the Commission temporarily when such an injunction occurs.

Table 1. SEC Enforcement Against Individual CPAs (1934–1985)

Outcome of Investigations	*Number*	*Percent*
Censure	6	4.62
Temporary suspensions	48	36.92
Permanent suspensions	33	25.38
Resignations of CPAs	31	23.85
Other settlements	7	5.38
No action	5	3.85
Total	130	100%

Note:
The number of referrals of cases by the SEC to the Justice Department for criminal prosecution was not determinable from the ASRs and AAERs.

Investigations and Sanctions Against CPA Firms

Since the SEC was formed in 1934, its Releases show that it has brought only 47 cases against CPA firms under Rule 2(e), the first occurring in 1940. Of the 47 cases, 3 were alleged to lack the requisite qualifications to represent others, 38 were alleged to be lacking in character or integrity or to have engaged in unethical or improper professional conduct and, 11 were alleged to have willfully violated, or willfully aided and abetted the violation of any provision of the federal securities laws. The sum of these allegations again exceeds the 47 cases because certain cases contained multiple charges of violations.

Table 2 summarizes the cases against CPA firms. Each case is represented by an SEC Release, some containing several investigations of a firm—when several separate audit engagements of a firm were under concurrent review. These are treated as single cases because the SEC based its sanctions on the violations in each of the several audit engagements.

Thirty-three or 70 percent of the 47 cases were brought against non-Big eight firms, and in the 1980s, that percentage increased to approximately 78 percent.

Unlike the sanctions against individual, permanent suspensions and resignations were rarely imposed upon firms. Only three firms were permanently suspended, two of which were allowed to apply for reinstatement after submitting to a peer review. One firm could have applied after two years and the other after five years.

Temporary suspensions have been applied to 19, or 40 percent of the firms. Temporary suspensions generally prohibited a firm or office from accepting new SEC audit clients for a stated period ranging from 10 days to 18 months. Fifteen of the cases resulting in temporary suspensions in the 1970s and 1980s have also been involved in settlement undertakings,

Table 2. SEC Enforcement Against CPA Firms (1934–1985)

Outcome of Investigations	*Number*	*Percent*
Censure	13*	27.66
Temporary suspensions	19	40.43
Permanent suspensions	3	6.38
Firms dissolved	4	8.51
Other settlements	4	8.51
Case unresolved	1	2.13
No action	3	6.38
Total	47	100%

Note:
*Sixteen firms received censures but three received temporary suspensions as well. Only the thirteen without temporary suspensions are shown here.

for a total of 30 cases in the 1970s and 1980s involving agreements to undertake corrective action. Beginning in 1973, 27 of these 30 cases involved firms undertaking a first peer review or accelerating or expanding an existing or scheduled peer review. Recently, certain firms have been directed to join the Securities and Exchange Commission Practice Section (SECPS) of the American Institute of CPAs if they wished to continue their practice before the Commission. Considering the emphasis which the SEC places on peer review, SECPS membership which entails a peer review may become a mandatory requirement for firms that practice before the Commission. To date, however, initiatives to establish this requirement have not succeeded.

Sixteen firms received censures, three received temporary suspensions as well. Only three firms received no action rulings.

SUMMARY

This paper describes the SEC's enforcement process related to accountants and their firms and also summarized the SEC's investigations of and sanctions imposed against individual CPAs and firms as documented in the ASRs and AAERs from 1934 through 1985 under its Rule of Practice 2(e). According to the SEC Releases, the number of enforcements against CPAs and firms has increased in the 1970s and 1980s. It was found that a principal number of sanctions imposed were remedial.

Limitations and Suggestions for Future Research

The classification of Rule 2(e) violations are too broad to permit meaningful correlation analysis between audit deficiencies and the imposed sanctions. Additionally, most cases concluded with only alleged violations, which are equivalent to pleas of nolo contendere in court cases. If Rule 2(e) proceedings are made public as was proposed in 1986, and violations are to be made more specific, further research could determine whether sanctions of CPAs are consistently applied.[1] If proceedings were made public, specific classifications of audit violations could be better identified. For example, the classification of violations could follow the ten generally accepted auditing standards or the rules of conduct under the code of ethics.

Peer reviews have been implemented to improve the quality of audits. Since 1973, the SEC has required 27 of the last 38 firms cited in this study to undertake an initial peer review or expand or accelerate an existing one. Further research could attempt to assess the pattern between alleged deficiencies and the effectiveness of specific peer review outcomes. Such findings would assist in determining whether peer reviews should be mandatory for all firms or whether certain limited aspects of peer reviews are more effective in addressing specific deficiencies.

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NOTES

1. Congressional committees [Metcalf, 1976; Moss, 1978; Dingell, 1985] have charged the SEC with an inconsistent pattern of enforcement against CPAs from large and small firms. Shad [1985, p. 552] attributed such pattern to the weaker qualification of CPAs from smaller firms. This study found more CPAs from small firms were investigated by the SEC and proportionately more small firm CPAs received such harsh sanctions as permanent suspension than CPAs from large firms.

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AN ANALYSIS OF ERNST & ERNST v HOCHFELDER: LEGAL AND MARKET EFFECTS A DECADE LATER

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ABSTRACT

Ernst & Ernst v *Hochfelder* was considered a landmark legal decision for the accounting profession. The Supreme Court's interpretation of the level of wrongdoing necessary for filing an action under Section 10b-5 of the Securities Exchange Act of 1934 was critical to the profession due to the number of suits filed against accountants under this rule.

Unfortunately, several important legal and regulatory issues were not addressed by the court in this decision. This paper attempts to (1) summarize the initial controversies surrounding the Hochfelder case, (2) analyze where the controversies stand ten years after the decision, and (3) examine the effects of Hochfelder from both a legal and information market perspective.

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The conclusions reached with regard to points (1) and (2), emphasize that an allegation of simple negligence is no longer adequate to bring an action under 10b-5. It now appears that "scienter" must be proven for a 10b-5 filing. Securities and Exchange Commission (SEC) injunctions against the accountant must also be based on "scienter," although the courts have not been as clear on what is included in the definition for SEC actions.

The potential information effects for the market from the legal discovery process (point 3) have been previously ignored in the accounting and legal literature. This issue is addressed in regard to the damages that could occur to an auditing firms' reputation and credibility regardless of the court's finding.

INTRODUCTION

The accounting profession faces a myriad of rules and regulations implemented by numerous private and public sector regulatory bodies. The Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) exist and receive their power from the profession they govern. The SEC exists and receives its power from an act of Congress, and it acts with legislative authority. The relative importance of many of the rules may be open to question, but it is difficult to refute the argument that those regulations supported by legal authority are of a high priority. This situation places that segment of the accounting profession practicing under SEC jurisdiction in a position where knowledge of both the regulations and the subsequent enforcement of these regulations is critical.

Public investors suffering losses in the purchase or sale of securities by relying on false financial statements have most commonly relied on Rule 10b-5 in pursuing action for damages against the independent auditor [Kellogg, 1984]. Rule 10b-5 was adapted by the SEC under the powers provided by Congress under section 10b of the 1934 Act. The thrust of Rule 10b-5 is to make unlawful "any untrue statement of material fact" or engaging "in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security." A Rule 10b-5 action generally is required to satisfy the standards of materiality, reliance, causation, damage assessment, and scienter. Each of these requirements has a substantial case history and is a present source of debate. As an example, the emerging "fraud on the market" theory provides a new interpretation on the legal requirements of reliance and causation [Fischel, 1982]. Our purpose here will be to focus on the scienter requirement, which is defined as a mental state embracing intent to deceive, manipulate or defraud.

Ernst & Ernst v *Hochfelder* (425 U.S. 185) was heard in 1976 by the U.S. Supreme Court. At the time it was considered a landmark decision for the accounting profession. The ruling permitted members of the profession to express relief and caused critics of the profession to express increased concern. Were the reactions of either group justified at the time and does that justification remain ten years later? This paper will attempt to answer this question by (1) defining the issues addressed in the Hochfelder case, (2) explaining where the controversies surrounding this case currently stand, and (3) providing insights into why legal decisions in similar cases may differ from market conclusions based on audited financial statements.

BACKGROUND

The Hochfelder case arose as a result of audits of First Securities Company, a brokerage firm that was a member of the Midwest Stock Exchange (last audit conducted 12/31/76). The case involved an allegation that Ernst & Ernst, a firm of independent Certified Public Accountants, had breached Rule 10b-5 of the 1934 Act. The plaintiffs argued that Ernst & Ernst was negligent in conducting the audit due to their failure to discover and disclose that First Securities was bankrupt as a result of the embezzlement of funds by its president.

Failure to discover an intra-office mail rule used by the president led to Ernst & Ernst's problems. The "mail rule," which required that mail addressed to the president not be opened by others even in his absence, had allowed the president to perpetuate the embezzlement scheme for approximately 24 years. The scheme involved customers who invested funds for escrow accounts which the president converted to his own use. A suicide note left by the president in 1968 disclosed the scheme. The case first came to trial in 1971, with a verdict for Ernst & Ernst. This decision was reversed on appeal. The Supreme Court reversed the appeals court ruling and found for Ernst & Ernst.

Prior to this case, the degree of blame necessary to support liability under Rule 10b-5 had been subject to dispute [Forseter, 1975]. For example, in *Sargent* v *Genesco, Inc.*, (492 F. 2d 750, 1974, Fifth Circuit) liability was determined by a recklessness standard, whereas in *White* v *Abrams* (495 F. 2d 724, 1974, Ninth Circuit) liability was determined by a flexible duty standard. Determination of wrongdoing was decided in White as being flexible depending on the facts and circumstances of the particular case in question. Prior to Hochfelder it is not apparent that any court required only intent to deceive, or "scienter," to impose 10b-5 [*Washington & Lee Law Review*, Vol. XXXVI, 1979].

The essence of the Hochfelder decision was that an allegation of mere negligence did not state a claim under Rule 10b-5. The Supreme Court held that liability under 10b-5 required an allegation of intent to deceive, manipulate or defraud, which was denoted as "scienter." This ended the debate over whether Rule 10b-5 included negligent misrepresentations in private damage actions. The ruling relieved the accounting profession, which had been the target of numerous 10b-5 actions prior to Hochfelder.

Although controversial issues still remained after the Hochfelder case was decided, different groups made their pro or con feelings known about the ruling. For example, the staff of the Subcommittee on Reports, Accounting and Management of the U.S. Senate Committee on Governmental Affairs [*The Accounting Establishment* 1976] criticized the Hochfelder decision and called for a legislative reversal of the Supreme Court decision. The AICPA disagreed [1977, p. 34] and responded to this subcommittee criticism by emphasizing the two controversies noted earlier: (1) the Court had not determined the extent of fault necessary to sustain a complaint by the SEC; (2) the court had not made clear an operational definition of scienter. In addition, the AICPA issued a plea to those criticizing the findings in Hochfelder by stating,

> The simple issue is this: Is it equitable, is it good policy, to subject an auditor to huge, perhaps even ruinous liabilities, as the consequence of a single negligent act? Is it appropriate—is it fair—to make an accounting firm, made up of literally thousands of professionals, answer for the huge damages that may accrue as the consequence of the negligence of only one or a very few members of the firm?

Emotional appeals aside, the reality of the Hochfelder decision, as determined by the courts, is the main concern of this paper. In addition, this paper addresses a third question previously ignored in the literature, the effects of information disclosed during the legal discovery process. Such information, regardless of a court's decision, may have a negative impact on an auditing firm's reputation.

"SCIENTER" IN PRIVATE ACTIONS SINCE HOCHFELDER

Of course, the Hochfelder case did not provide closure on two significant points of concern to the profession. First, the substantive content of the term "scienter" had been and continues to be the subject of much confusion and debate. Although negligence was ruled out as a basis for Rule 10b-5 liability, the court did not address whether a misrepresentation made with reckless disregard for the truth, but without conscious intent to deceive, would fall under this section. Moreover, the Court did not address the question of whether "scienter" would be required in SEC enforcement actions. The effects of an SEC injunction, particularly against an accounting firm, could be serious, leaving the critical issue of the ultimate liability of an accounting firm unresolved as Lowenfels [1978] argues. The issue concerning the level of wrongdoing necessary to support 10b-5 liability is most easily examined from the perspective of a continuum of actions by the auditor (Figure 1).

At point a we have the "ideal" audit where both the attitude and behavior of the auditor is in accordance with generally accepted auditing standards. The profession has argued that the majority of audits conducted would be classified as "proper audits." Whether this is true or not is open to discussion. If the lack of a lawsuit against the accounting firm over a particular engagement is an indication that a proper audit has been conducted, then the proponents of the "proper audit" argument have a valid point. However, as discussed in a previous study of lawsuits [St. Pierre and Anderson, 1984], there is another issue that should be considered. A negative signal to the users of financial statements may trigger error search, discovery of an alleged error, and a lawsuit. The difference between an alleged proper audit and an alleged problem audit may, therefore, be a function of both the quality of work done and the lack of a "signal" or reason to suspect a potential problem. The "no lawsuit, proper audit" argument may, therefore, be open to question or termed "no signal, no lawsuit."

If the audit is a problem audit, the auditors' actions may be of three basic levels of alleged wrongdoing. It is at this point that the importance of the Hochfelder case becomes apparent. As noted earlier, prior to Hochfelder the subject of dispute was the degree of wrongdoing required to support liability under 10b-5. Since Hochfelder, it has been determined that negligent conduct (point b on Figure 1) is insufficient to impose 10b-5. Point c in Figure 1, reckless behavior, is not as easily dismissed even though Hochfelder ruled that "intent to deceive" was necessary to impose 10b-5. There is a fine line between reckless behavior and intent to deceive and the courts have found it difficult to walk that line.

The common law includes reckless behavior, knowledge of falsity, and

Figure 1

point a	point b	point c	point d	point e
Proper Behavior	Negligent Behavior	Reckless Behavior	Knowledge of Falsity	Intent to Deceive, Manipulate or Defraud

intent to deceive as a form of scienter sufficient to impose liability. Specifically, when a misrepresentation or omission is made by an auditor one of the following five situations is possible:

1. *Proper Behavior:* The auditor may have had an honest belief that the disclosure made was true, with this belief based on solid reasoning and factual analysis, even though it was later found that the disclosure was false.
2. *Negligent Behavior:* The auditor may have honestly believed the disclosure was true, but as a prudent auditor should not have disclosed the item without further factual basis. Concerning omission, failure to disclose a material item was due to auditor negligence in conducting the audit or, if discovered, the auditor negligently failed to realize that the item was material.
3. *Reckless Behavior:* The auditor believed the disclosure was true, but there was no basis for this belief; or the auditor was reckless in either not discovering the item or reckless in not knowing it was material.
4. *Knowledge of Falsity:* The auditor knew the disclosure was false or knew the omitted item was material.
5. *Intent to Deceive:* The auditor knew the disclosure was false and disclosed it to cause financial harm or the auditor failed to disclose the item with an intent to cause financial harm. [*W & L Law Review*, 1979, p. 924].

As we have stated, since Hochfelder, it has been determined by the courts that negligent conduct is insufficient to impose 10b-5. The open question is at what point (in Figure 1) does Rule 10b-5 imply civil liability? The language of the Hochfelder decision has caused some to interpret scienter for 10b-5 damage actions to require "more than knowledge; it requires the pleading and proof of an actual mental intent to deceive, manipulate or defraud," [Liggio, 1976] i.e., the most extreme standard in Figure 1. Others have argued that the Court did not intend to establish a new standard of fraud for 10b-5 cases, but that the traditional meaning of fraud (including knowledge or recklessness) would prevail [Haimoff, 1976]. Scienter could be implied by demonstrating that the accountant had knowledge of the falsity or omission, regardless of the mental state existing at the time. Indeed, the Supreme Court in a footnote to Hochfelder stated that:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act. We need not address here

the question whether, in some circumstances, reckless behavior is sufficient for civil liability under 10(b) and Rule 10b-5.

The Supreme Court's refusal to specifically reject recklessness as a form of fraud has allowed the courts to impose liability on accountants for reckless behavior in conducting audits.

The courts since Hochfelder have followed the common law concept of "scienter" and held that reckless behavior, knowledge, or intent to deceive, will support a private damage action under 10b-5 (*Rolf* v *Blyth, Eastman Dillon & Co.* F.2d.38, 1978; *Wright* v *Heizer Corp.* 560 F.2d236, 1977; *Dupuy* v *Dupuy* 551 F.2d.1005, 1977). The degree of reckless behavior necessary to support a 10b-5 civil suit is, however, still controversial. In a recent case (*Decker* v *Massey-Ferguson Ltd.* 681 F.2d.111, 1982) the Second Circuit Court dismissed a complaint against an accountant defendant stating that "recklessness involves conduct that is highly unreasonable, representing an extreme departure from the standards of ordinary care, but it must approximate an actual intent to aid in the fraud being perpetrated." This opinion suggests a very high standard of recklessness before auditor liability can be imposed.

"SCIENTER" IN SEC ENFORCEMENT ACTIONS

SEC enforcement actions, (unlike private damage actions, which are to compensate investors already harmed by violations of the laws), are brought to protect the investing public from violations of the securities laws. The Supreme Court, in Hochfelder, expressly refused to decide whether "scienter" was necessary in SEC enforcement actions under 10b-5 (425 U.S. 194).

In the late 1970's other courts fluctuated in their rulings concerning the standard of wrongdoing necessary for 10b-5 action in SEC enforcements. Some courts required the SEC to prove only simple negligence (*SEC* v *World Radio Mission, Inc.*, 544 F.2d.535, 1976, First Circuit; *SEC* v *Western Geothermal & Power Corp.*, Fed. SEC L. Rep., CCH par. 96590, 1978) while others held that "scienter" must be shown in SEC actions as well as in private damage actions (*SEC* v *Blatt*, 583 F.2d.1325, 1978, Fifth Circuit; *SEC* v *Shapiro*, 494 F.2d.1301, 1974, Second Circuit; *SEC* v *Manor Nursing Centers, Inc.*, 458 F.2d.1082, 1972, Second Circuit).

Those courts requiring only negligence reasoned that an investor is harmed as much by negligent conduct as by action taken intentionally. In *SEC* v *Shiell*, (Fed SEC. L. REP Par. 96190, 1977) the Court found that Hochfelder did not require "scienter" in SEC injunctive actions on the grounds that requiring the SEC to prove intentional deceit or fraud might seriously inhibit the SEC's ability to protect the public. Healey and Borri argue that this finding was proper, given, from their perspective, what the Hochfelder court intended:

> The Hochfelder decision should not be read to require a showing of scienter in SEC enforcement actions under Rule 10b-5. First, the Hochfelder court was careful to limit its decision to private damage actions. This indicates that the court either did not consider the question of what standard of culpability should apply in enforcement actions or did not intend Hochfelder to resolve this issue. Second, it is generally unnecessary to establish all elements of a suit for monetary damages in a suit for prophylactic relief. A lighter burden in enforcement actions would allow more effective fulfillment of the investor protection policy which underlies the Securities Acts [*Washington & Lee Law Review*, 1978, p. 826].

An argument that contradicts this viewpoint was also evident in the legal literature during this time (see Barden, *Washington & Lee Law Review*, Vol. XXXVIII, p. 929, 1981, and Duncan, *Washington & Lee Law Review*, Vol. XXXIV, p. 912, 1977). The latter viewpoint focused on the potentially severe consequences of an injunction by the SEC. A direct effect of an injunction is to order the defendant to correct any misconduct or refrain from future misconduct. Indirect effects may be greater, however. Failure to comply with an injunctive order, for example, may have various results: civil or criminal contempt; civil liability in private damage actions; disqualification from professional practice before the SEC; forced return of profits; damage to the firm's reputation, excessive costs of defending against the allegations, and the harm of operating under allegations of wrongdoing.

With sound arguments being presented on both sides and various courts finding differently in different cases, the question of level of wrongdoing in enforcement actions continued to be a concern for the profession. The issue was finally addressed by the Supreme Court in *Aaron* v *SEC* (446 U.S. 680, 1980). The Court's decision clearly established that the SEC must prove scienter in enforcement actions under Rule 10b-5. Unfortunately, the Court again was not clear on the degree of wrongdoing (Figure 1) included in their definition of "scienter." Initially the Court used the standard definition focusing on "a mental state embracing intent to deceive, manipulate, or defraud" (p. 686) but later noted that "knowing or intentional misconduct" was sufficient to prove "scienter" (p. 696).

Although the profession may have been initially relieved when the Supreme Court decided the Aaron case, three points should be noted. First, the practical effect of a "scienter" standard may not be as critical as first thought. This standard excludes only those investors harmed by negligent misrepresentations. Other investors should still find protection under SEC enforcement actions. Second, a defendant may still be open to damages under common law for negligence. Finally, a defendant has reason to avoid negligent actions because of the potential harm to its reputation and business interests. This final point will be discussed in light of the "insider" information released in the legal process of discovery and the potential damage to an accounting firm's credibility.

CREDIBILITY DAMAGE VERSUS LEGAL GUILT: INDIRECT EFFECTS

An auditing firm relies heavily on the credibility of its work and its general reputation to function in what is increasingly perceived to be a competitive market. The value of an audit is based on the public's expectations of reliable reporting by the auditor [Watts & Zimmerman, 1986]. What has been missing in the legal literature is a discussion of the potential effects of the information about the conduct of the audit released during a lawsuit. Both the quality and quantity of work completed on a particular engagement are unknown to outside parties. One can, hopefully, assume that a minimum standard has been met on every audit and that proper behavior (Figure 1) is the norm and not the exception. Unfortunately, this is an empirical question which can only be determined after the fact. Until proven otherwise, third parties may assume that accurate reporting has occurred. However, information released during the lawyers' discovery process can reinforce or modify this expectation. Given the fact that the audit process is not observable by third parties, this information source may be critical in forming future expectations about overall audit quality.

The relationship between litigation against the auditor and users' perceptions of audit quality is not definitive. However, there is evidence that the auditor should be motivated to conduct high quality audits and reduce exposure to lawsuits. Dopuch and Simunic [1982] have suggested that one of the firms in the "Big Eight" that encountered litigation problems in the early 1970s, might have seen the result of this action in the loss of clientele suffered by the firm in the over-the-counter market. It would seem plausible that clients and other users of accounting information do obtain information on audit firm reputation and credibility via litigation, and that they may utilize this information in their decisions to hire a new auditor or retain their present auditor. Alchian and Allan [1977] examined the reputation of a supplier of services and stated:

> the more difficult it is to predict the performance of a good at the time of purchase, and the more serious the consequences of deviations from expectations, the more one will rely on the seller—which is intelligent economic behavior. By past and present performance the producer must establish and maintain credibility of future performance. He has an incentive to produce goods of reliable, predictable quality insofar

as his performance will be associated with his name, be distinguished from others, and bring him repeat or new customers.

A critical issue in a suit under 10b-5 against an auditing firm may therefore center on the information disclosed during the discovery stage of the legal proceeding. Discovery, as defined by *Black's Law Dictionary* (1979), concerns the "ascertainment of that which was previously unknown; the disclosure of what was previously hidden; the acquisition of knowledge of given acts or facts." As noted, discovery, in a lawsuit concerning auditors and their work, might include details on the quantity of work completed or the quality of work completed by the auditors. This information is generally unknown to outside parties, although it would appear reasonable that the market for financial information would incorporate an estimate of audit quality in the determination of financial information quality.

Disclosure of information on audit quality as a result of the legal process may affect the estimation of the overall quality of the financial statements by outside parties, either in a positive or negative manner. However, many questions remain unanswered: How are these disclosures processed? What is the effect they have on the evaluation of financial information for a particular client? How do they affect the evaluation of financial information for all clients of the defendant auditing firm? How long do the effects last? For purposes of the discussion here it is sufficient to note that disclosures in a lawsuit provide an additional piece of information for the market to assess the quality of the clients financial information.

The significance of this point can be demonstrated by again examining Figure 1. If an auditing firm is sued under 10b-5, discovery by the lawyers may result in disclosure of otherwise unknown information concerning the quality of the auditor's work. This disclosure could prove harmful even if the courts ruled that neither reckless behavior, knowledge of falsity, nor intent to deceive could be proven based on the facts of the case. The auditor would not be held liable under 10b-5, however, the facts could show negligence on the part of the auditor. Although the audit firm may feel vindicated by this ruling, the finding of negligence may still be damaging to the firms' credibility.

A 10b-5 action offers the possibility for a damaging piece of information to be disclosed (negligence by the auditor) without resulting in a finding against the accountant by the court. Unlike other sections of the Act, 10b-5 allows for the court decision (not guilty due to simple negligence) to differ from the conclusions reached by the market based upon the information content of disclosures made during the proceedings (negligence in the conduct of the audit). Given the limited amount of real information on audit quality, a finding of negligent behavior, although not legally damaging, may cause the information user to discount the value of the audit and question auditor credibility. The greater the frequency of this type of finding, the greater potential damage to a firm's reputation.

The courts have taken this "frequency of occurrence" concept even further. In *SEC* v *Aaron* (605 F.2d.612) the court found that continuation of acts which have deceptive effects establishes "scienter", even though a single negligent act may not cause the court to react in this manner. In a similar manner, the cumulative effect of findings of negligence by an accounting firm in 10b-5 suits may not support liability under this rule, but the damage may still be present in loss of reputation and damaged credibility. It is possible, therefore, that the indirect effects of a 10b-5 filing may be as severe to the profession as the direct effects.

SUMMARY AND CONCLUSIONS

The results of the Supreme Court ruling in *Ernst & Ernst* v *Hochfelder* in 1976 were thought, at the time, to be significant for the accounting profession. Actual effects of a landmark decision such as Hochfelder may differ from perceived effects, however. This paper has attempted to examine concerns and controversies initially discussed when the Court ruled on Hochfelder, and to explain their present status. An allegation of simple negligence is no longer adequate to bring an action under 10b-5. "Scienter" must be proven for a 10b-5 action. It now appears that "scienter" includes either knowledge of the error or reckless behavior by the accountant in private actions. SEC injunctions against the accountant must also be based on "scienter," although the courts have not been as clear on what should be included in this definition for SEC actions.

The evaluation of the 10b-5 situation and the accountant's liability under this regulation must be kept in perspective, however. In a rational market, it is possible that Hochfelder has caused a downward revision of probabilities of success from the perspective of potential plaintiffs. If this is so, a number of suits with a potential for finding only simple negligence may not go to court under 10b-5. However, the ability of the plaintiff to form this judgement is clouded by: (1) difficulty in ascertaining the actual level of wrongdoing by the auditor, and (2) difficulty in ascertaining how the judge would interpret the facts of the case.

Negligent actions by the accountant may still result in legal filings under the common law. The discovery process in a legal filing may still prove detrimental to a firm's credibility regardless of the court's ruling. This latter point reinforces the contention that the indirect effects of regulation may be more significant than the direct results intended. The indirect effects of regulation in the legal environment offers a worthwhile avenue for further research.

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SELF-REGULATION, PUBLIC INTEREST AND THE ACCOUNTING PROFESSION

Ted O'Leary and Richard J. Boland, Jr.

ABSTRACT

This paper begins with a review of some of the major features of the period 1890–1920 as they affected the formation of the accounting profession in the United States. We argue that the development of accountancy was altered by two features of this period: the rise of professionalism and the need to create new forms of trust in economic institutions. We also argue that accounting emerged at this time as a professional form of social regulation. The profession of accounting was imposed on corporations and municipalities as a promise to restore order and provide a new basis for the trust in economic transactions that had been shattered by the rapid industrialization and urbanization of that period.

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These positive, trust-based and inherently regulatory roots of the accounting profession are then contrasted to the way the profession views its relation to economic and professional regulatory processes today. We argue that the profession has, since the turn of the century, altered its self image and its vocabulary of official discourse to dilute its positive, regulatory role and, as a result, to threaten the very basis for its present institutionalized status. The concepts of public interest and self-regulation, as revealed in our present day professional discourse and the Anderson Committee's attempt to restructure the profession's code of ethics and standards of performance, are used as examples to demonstrate how the profession has redefined itself from an active agent of societal regulation into a more passive element in a system that displays market efficiency.

This analysis draws attention to the fact that our understanding of the ethical nature of a profession and its responsibilities are far from immutable, and, in the case of accountancy, have been radically transformed since the turn of the century.

INTRODUCTION

Accountants' responsibility for serving the public interest is fundamental to their status as professionals, but determining what the public interest is has always been problematic. Recent attempts by the profession to strengthen its self-regulation, clarify its mission and restate its standards of professional practice have not resolved that question. Instead, we will argue, the concept of the public interest has become increasingly diverse and confused in a way that threatens to negate the very ideal of professionalism.

As Mautz and Sharaf point out [1961, p. 111], a profession is continually adapting to changes in its social and political environment, and this is certainly true of the accounting profession. We will first trace the way social and political forces played a causal role in shaping the concept of the accounting profession at the beginning of this century. For the first half of this century, although the profession was molded by its social environment, it was little noticed in it. In fact, Edward B. Wilcox observed in 1939 that, "Many people still scarcely suspect the existence of accounting, and when they hear of it, they wonder vaguely what it is." Today, in contrast, the profession is highly visible and subject to strong expectations and intense scrutiny through litigation, congressional committees and the national press.

We argue that whereas the profession was proclaimed as an importantly moral force at the turn of the century, the visibility and scrutiny brought to it today is recasting the idea of the profession into a less actively moral and more economically efficient one. Our point is not to call for a return to the "golden glory" days of the past, since neither the moral nor the economic image of the profession is free from ideological bias and internal inconsistencies. Rather, our point is to raise a critical awareness of the way the profession is shaped and reshaped through dialogue over time, and to call for an open and critical reflection on that dialogue. Not only does the idea of the profession and its responsibilities change over time, but the fundamental terms through which we conduct our dialogue on the profession take on new meanings. We point out how one such change in the key term "public interest" has recently emerged, and its potential consequences for a coherent understanding of the profession and its future role in society.

THE PRODUCTION OF TRUST

Following Zucker [1986], the paper argues that social forces in the late 1800s played a causal role in disrupting the process-based trust that had provided a shared context for conducting economic exchanges. Beginning in the mid-1800s, we start to see the destruction of a trust based on the familiar, established patterns of past exchanges and the shared knowledge of reputations. Industrialization and urbanization dramatically increased the scope and size of organizations that were parties to economic exchanges, as well as the ethnic diversity of individuals brought into increasingly complex exchange relations. This was a period of profound and rapid transformation of the U.S. economy.

Zucker points out that trust is a key factor in achieving efficient economic exchanges, and that although trust is primarily an informal, subjective element in economic exchanges, it should not be considered a mere background factor that emerges independently from economic structures. Rather, she develops a definition of trust that emphasizes its fundamental role in allowing economic or legal transactions to occur, since it is not possible to specify all details even in elaborate contracts. Further, she argues that trust is not exogenous to economic structures, but is actively produced by them in varying degrees. In brief, she argues that the institutional structures of our present economic system have taken the shape they have in order to replace the process-based trust destroyed by the changed social conditions of 1880–1900. Our institutional structures emerged and persisted, she argues, because they produced the trust necessary to enable economic exchange.

Zucker proposes three modes of trust production in economic exchange:

1. Process-based,
2. Characteristic-based,
3. Institutional-based.

Each mode produces trust in the sense that it creates a reciprocal set of background expectations and interpretive frameworks for people to understand how our everyday social world works and how others will behave within it. Each mode also provides a set of rules, values and expectations about how specific kinds of transactions take place in their distinctive context such that the meaning and intentions of the other party to a transaction can be reliably inferred. Zucker draws on Garfinkel [1967] and Schutz [1932] in developing this definition of trust.

Process-based trust production relies on the experience of past transactions with a given party, or reports of past transactions by others familiar with that party. Through the process of engaging in fair, reliable transactions, an individual or firm invests in a reputation specific to them and produces the trust required for future, more involved, exchanges.

Characteristic-based trust production, in contrast, is not produced by the actions or reputation of a specific party. Rather, it is an inferred attribute of a group which shares certain social characteristics and is attributed to any member of that group. Thus, sharing ethnic background, religious practices or economic status can serve as a basis for trust among economic actors in the absence of direct exchange experience or established reputation.

Institutional-based trust is a generalized mode of trust production that goes beyond the specific parties to an exchange or the social characteristic they may share. It is a mode of trust production located in the ways our organizations and markets are structured, and thus has more to do with the institutional environment that makes economic exchange possible than with any particular actor or type of exchange. Zucker points specifically to processes of standardization and formalization, to the emergence of bureaucratic organizations, to the emergence of professionalism and licensing of financial intermediaries, and to increased government regulation as the major mechanisms of institutional-based trust production.

Zucker argues that up until the late 1800s, process-based trust was the major mode of trust production enabling economic exchange. Starting about 1880, however, the dual processes of industrialization and urbanization disrupted the foundations of process-based trust. Zucker documents how both the ethnic diversity of immigrants and the turnover of businesses dramatically increases at this time. She demonstrates profound shifts in types of occupations and ethnic backgrounds of workers, as well as the instability of organizations resulting from both high rates of business failure and sharp increases in new incorporations. The consequence was a profound disruption of the established mode of trust production.

> The old order on which trust was based had been overthrown, but no new order had replaced it. Hence, the major force in the construction of the new social order was protection—from high rates of immigration, from inequitable trade advantage, from spoils and corruption, from undue risk, from business and bank failure. Process-based trust was fundamentally disrupted, and the informal, interpersonal common understandings were undermined. What could replace it? Characteristic-based trust did to some extent; ethnic enclaves were created, and business often formed within these enclaves. However, this was a very limited solution in part because of geographic mobility of the population and in part because of the fragility of the trust thus created. [Zucker, 1986, p. 69]

Zucker proposes that institutional-based trust came to predominate because the conditions of the economy after the disruption created by industrialization and urbanization did not allow for reciprocal process-based trust to reemerge. Zucker identifies three characteristics of the period 1880–1920 that reduced the possibility for process-based trust and provided the conditions for the emergence of institutional-based trust. They were (1) the increased necessity of conducting transactions across an expanding set of group boundaries, including new industrial groupings, new corporate entities and new labor organizations; (2) the increased need to conduct transactions across greater geographic distances; and (3) the increased interdependence among sets of individual transactions such that the risk of failure for any one transaction is dependent on the success of a number of other, widely dispersed transactions that are beyond the control of the parties to an immediate exchange.

We will elaborate on Zucker's general thesis and explore in some detail the way accounting as a professional practice plays an important role in the development of institutional-based trust. Reviewing the historical emergence of accounting as an institutionalized practice reveals important insights into the relationship between the accounting profession and the regulation of enterprise. In particular, it reveals that accounting practice and the profession of accounting were institutionalized as positive, active elements in a regulatory mechanism of trust production. Accounting emerged as an institutionalized practice because it was seen as a potent regulatory device that was needed to recreate trust, and to safeguard the sense of individual freedom threatened by the loss of process-based trust.

PROGRESSIVISM AND THE INSTITUTIONALIZATION OF ACCOUNTING PRACTICE

The dramatic changes in social conditions around 1880 and their implications for restructuring economic institutions discussed by Zucker have been reviewed by Previts [1980, pp. 61–94] and by Previts and Merino [1979, pp. 127–196] as they relate to the emergence of the accounting profession. In contrast to Zucker, Previts and Merino explicitly recognized that these social and institutional changes were wrought in a wider milieu that historians refer to as America's Progressive Period, extending from about 1880 to 1920. As characterized by Previts and Merino:

> Progressivism is best understood as an eclectic term for an attitude that incorporated such elements as pragmatism, moralism, fundamentalism and prohibitionism . . . There were in fact several progressive movements which are often combined and described as "the quest for social justice." [1979, p. 131]

Without denying the pluralism in issues and approaches to which Previts and Merino refer, we would nevertheless draw attention to an important focal point for the political rhetoric of the Progressive Period. Carl Degler identifies this focal point by observing that while Progressivism "was many things—above all it was a response to the challenge of the city and the factory—" [1984, p. 394]. Urbanization and industrialization were establishing novel forms of social organization in America. Society was clotting into apparently powerful groups, with devastating implications for individual opportunity. The concentrations of capital which accompanied industrial integration, the unionization of labor, the domination of city administrations by bosses and their self-serving political machines all seemed to debase the meaning and possibility of action for the individual, unorganized citizen. In that sense, according to Richard Hofstadter, the Progressive Period is a "complaint of the unorganized against the consequences of organization" [1955, pp. 216–7].

The city and the factory challenged an idealized way of life, "the American Dream" according to Degler [1984, p. 394], in which both economic prosperity and a republican polity were based upon the possibility of aggressive independent pursuit of personal betterment by middle-class actors. To restore the American Dream, a rich and complex individuality would have to be reestablished in a corporate and urban social order. That, according to Woodrow Wilson, called for a government and a social structure "devoted to the general interest and not to special interest" [1912; cited in Degler, 1984, p. 402].

But the practical recovery of the republican ideal of individual opportunity, as Woodrow Wilson himself recognized, had to be compatible with economic efficiency in an emergent technological world [Wilson, 1912; reprinted 1961, p. 102]. To turn the argument on the issue of efficiency, however, as author and journalist Walter Lippmann pointed out, was to disqualify politicians as the agents of reform. For neither they, nor indeed lawyers, could express any more than unsubstantiated opinion on what constituted efficiency. To gauge efficiency, Lippmann [1914, pp. 41–2] declared, required the new science of management which Frederick Taylor and others had begun to elaborate. Opinions would have to yield to facts and to "experiments conducted by experts in the new science of administration" [Lippmann, 1914, pp. 41–2].

Lippmann reflected a more general social transition to a faith in science and professionalism as vehicles for accomplishing social reform [Waldo, 1984, p. 19]. Politics, the law and public outrage were coming to be seen as ineffective, unable to reach into the depths of economic organizations to eradicate corruption and to pursue efficiency in a manner which protected the interests of individuals. Professional managers and accountants, however, held the promise to do this. In a sense, these professionals were to become the agents of Progressive reform, utilizing their scientific facts and procedures to:

> enter the factory, the office and the public bureau, to effect a purification where the law could not reach and where the outrage of the public was in danger of being ignored. Morality was to couple with the science, the professionalism and the administrative and calculative practices which would routinely exact and produce it in practice. [Miller and O'Leary, 1986, p. 18]

One instance of this coupling of Progressive moralism with science and professionalism is provided by the Eastern Rate Case of 1910–11. The case has been said to mark the conspicuous point of commencement of America's 'efficiency craze,' etching the proposals of Frederick Taylor into public awareness. In the case, lawyer Louis D. Brandeis, Progressive activist and adviser to Wilson, offered "scientific management" to the court, as the way to uphold the public interest against the vested, partisan interests of capital and labor. Scientific Management, as Samuel Haber [1964, pp. 51–5] has put it, was to be deployed as a disciplinary mechanism to restrain both capital and labor in their own best interests and in that of the public. No longer were the moral imperatives of pursuing good and avoiding evil left to the consciences of individuals. Instead, the good was to be established more concretely with the aid of scientific management tools and procedures. The "goods" of efficiency in production, honesty in effort and justice in reward were to be mediated and established by principles of optimal factory organization as well as by scientific task design and standard production times [Haber, 1964, pp. 51–5; Miller and O'Leary, 1986].

In the context of urban administrations, too, this enveloping of the essentially moral concerns of Progressive thought within a science and professionalism of management and accountancy can be discerned with clarity. According to Robert Wiebe, the expressed policy of the National Municipal League in the period from 1895 to 1915 shows the gradual encroachment of an administrative and calculative orientation as necessary to reform. Reform, as it were, was not a result to be accomplished on a once-for-all basis through legislative enactment, but could only be attained through a continual process of administration and calculation:

> By degrees, the philosophy of urban political reform had moved from simple moral principles guaranteed by the proper *forms* of government to complex procedural principles advanced by the proper *administration* of government. [Wiebe, 1967, p. 149, emphases added]

Leaders of the movement to establish Bureaus of Municipal Research embodied this emergent faith in professionalism. These were to be the institutions of research and training through which a scientific competence would be wedded to morality in the pursuit of the general welfare:

> The Bureau movement was a part of Progressivism, and its leaders [notably W.H. Allen, Henry Bruere and Frederick Cleveland] were leaders of Progressivism. They were tired of the simple moralism of the nineteenth century, although paradoxically they were themselves fired with the moral fervor of humanitarianism and secularized christianity. They were stirred by the revelations of the Muckrakers, but despaired of reform by spontaneous combustion. They were sensitive to the appeals and promises of science, and put a simple trust in discovery of facts as the way of science and as a sufficient mode for solution of human problems. [Waldo, 1984, p. 32]

What the Bureau movement provided, through this intersection of Progressivism and science, was the possibility for the modern professions of municipal administration and treasury to claim a status as upholding fidelity and economy against the corruption and inefficiency of the bosses and their political machines.

The Progressive reform movement and the professionalization of administration and accountancy, then, did not proceed in entirely or even largely separate arenas. The reconciliation of progress and individuality by Progressives required the mediation of a new administrative elite promising to govern technologically driven progress without sacrificing more traditional ideals. Accountancy and administrative options were viable reform strategies because of their association with science. For through science the complex tasks of a more technological world were proclaimed to proceed with that impartiality given by a dedication to the hard, honest facts of situations and processes. The moral defense of the general interest through the presentation of facts unbiased by special interests is seen in an early definition of the professional Public Accountant as proposed by Robert H. Montgomery [1900]:

> A Public Accountant is a man fearless and unprejudiced, with the ability to look at both sides of a question; one who will not allow his honest opinions to be changed by client or adverse party; who dictates and is never dictated to; who places his devotion to his profession above the opportunities of gain by questionable means.

The simple moralisms of an earlier generation seemed necessarily to give way to specialist and expert skills. Honesty, as Dwight Waldo has put it, was no longer enough. Training and competence were also required to "enable a person to keep accounts, design a bridge or manage a bureau" [Waldo, 1984, p. 29]. But the scientific and professional discourse of how to "manage a bureau" or how to account for it was not cast in markedly different language from that of moralistic reformers. The emergent descriptions of professional administration and professional accountancy did not overlap with Progressivism only in personnel, in institutions and in some aim of seeking good over evil. Rather, it is out of the very moralisms of the Progressive movement that the practices, procedures and theories of accounting as a professional discipline came to be formed and established. In their claims to be scientific and professional, administration and accountancy preserved the moral overtones of Progressive language while recasting it in a descriptive, instrumental setting.

THE ACCOUNTING PROFESSION AS A MORAL ENTERPRISE

The term responsibility will serve as an initial illustration of how the science and professionalism of accounting was constituted out of morals. It is clear that, within the Progressive movement, the separation of individuals from responsibility for their actions was one worrying consequence of social organization. And it was a worry that was expressed from a distinctly moral vantage point. That is, one ought to be held responsible for one's actions, as an essential premise of a desirable social order [Wilson, 1910; cited in Ripley, 1927, p. 9]. Yet it was precisely this major premise that was being displaced within large-scale industrial corporations. It was occurring, Woodrow Wilson argued, through a dangerously overelaborated construct of the corporation as a legal person. Senior officials in corporations could break the law with impunity, because the construct had effectively placed them, as individuals, beyond the reach of the law. While wrongs were committed by real, living persons, the law could only procure its retribution from fictional, legal ones. The task which faced the law was "nothing less than to rehabilitate the individual," to restore to law a "direct access again to the individual, to every individual in all his functions" [Wilson, 1910; republished in Ripley, 1927, p. 4].

This escape of senior officials from the moral obligation of responsibility was not, of course, a concern limited to industrial corporations. For the "muckraking" journalists and for Progressivism generally, it formed a central theme in the case of the city and state administrations. Here, the dishonesty and corruption inspired by bosses and their political machines raised the question of how democratic power could be restored to "decent" citizens, how they could have a greater say in policy, and how they could elect "honest" representatives to serve their interests [Steffens, 1904, republished 1957; Hofstadter, 1957, pp. 257–71].

The industrial concentrations were opening up, for the unscrupulous, a new terrain in which to behave dishonestly and irresponsibly. As sociologist E.A. Ross expressed it, whole "new varieties of sin" were taking form within the "mutualism of our time" [Ross, 1907; cited in Degler, 1984, pp. 395–6]. Dense webs of interdependence had arisen in society which hid from sight the individual perpetrator of deeds. For Frederick A. Cleveland, however, it was precisely the moralistic which stood in the way of effective reform. To speak of sin, with an implicit appeal to individual conscience, or of moral responsibility, or to expose corruption and hope that an outraged morality of citizens would end it, these were dreams which would not produce the desired changes in affairs. Muckraking, he argued, could come to have precisely the opposite effect from that which it intended. For while it brought graft and corruption to light, it provided no effective means whereby these could be eliminated: "To the average citizen . . . [the muckraker] does not preach the gospel of hope but of political damnation" [1909, p. 1]. In and of itself, Cleveland believed, muckraking could do no more than to create a feeling of despair that would exhibit itself: "in the social insanity of the anarchist and the apathy or paralysis of the patriot" [1909, p. 1]. Real reform would not proceed through any hand-wringing over graft. It would not proceed through moralistic appeals to responsibility. It would advance, to take the particular context of the cities, only if citizens and their elected representatives could be furnished with the machinery through which to observe and direct the activities of municipal officials towards the public interest. And in an important part, he claimed, the required machinery could be found in the budget [Cleveland, 1909, p. 67].

Cleveland can serve us here to illustrate, within the Progressive period, how it is that the moral categories of reform—specifically, that of responsibility—became embedded within the scientific and professional practices of accountancy and administration. His qualifications to assist in such a task are impeccable. He was Professor of Finance at the newly established College of Administration of New York University. He was a frequent contributor to the literature of accountancy. His paper, "The Scope of the Profession of Accountancy," appeared in the first issue of *Journal of Accountancy* [November, 1905] to which he also contributed several further papers. But Cleveland's interest in professionalized governmental accounting also reflected his part in Progressivism. He was a member of the National Municipal League, the institution that sought to rally citizens to purify the conduct of city administration, and he was a founder and director of the New York Bureau of Municipal Research. This latter association located him in that part of the Progressive movement that sought reform through scientific instruments rather than through "the Man of Good Will" [Hofstadter, 1955, p. 260].

The budget, in Cleveland's view, was an indispensable instrument of reform. It was, he wrote in the *Journal of Accountancy* in 1907:

> . . . an instrument devised to give the direct representatives of the people control over administrative officers. Finding its origin in monarchical government, it has, where not neglected, become one of the most effective limitations of administrative authority. [republished 1909, p. 67]

The budget could limit the authority of officials, directing them to public purposes and away from graft and corruption, in a way that moral exhortations or the *exposé* tactics of muckraking never could. It would do so by taking the construct of responsibility from the domain of conscience and purely moral obligation, and would build in its terms a set of calculative practices. It could participate in a project to purposefully effect that equation in which:

> Administratively, the power *to exact individual responsibility* [from the official] is as great as the power to command the forces which may be utilized for common ends. [Cleveland, 1909, p. 15, emphasis added]

Here was the proposition that the mechanisms of administration and accounting could overcome, in the matter of responsibility of the person, a flaw in both law and moral imperative. For whereas law and moral imperative were ineffective in detecting irresponsible behavior, accounting and budgeting were proposed to persistently and uniformly exact it. Control would replace obligation. And the control to be exercised over officials, through the budget, could be distinctly "positive" in orientation, requiring responsible action in relation to both fidelity and economy. It could be employed to police not only the honesty of officials, but also the efficiency with which they gave effect to public purposes, to measure their professionalism and competence [Cleveland, 1907, pp. 72–5].

With administrative procedures and accounting practices in place to achieve such positive control, Cleveland believed, the limit of social organization permissible within a democracy could be qualitatively extended. That limit need no longer be defined in terms of the old town meeting. If there were collective purposes needing to be attained, then size of city administration would no longer be a barrier, but rather ingenuity in devising administrative and accounting systems:

> The limit of social organization is the limit of human ingenuity to devise systems of inspection and administrative account and statistics, which may provide the means for intelligent official direction and for comprehensive reports to the proprietor, the stockholder, or citizen. With such controlling devices adapted to an institution's controlling needs, the power of cooperation is limited only to the advantages to be gained through combining human activity and the power of the human mind to think, to expand, to invent and to execute. [Cleveland, 1909, p. 15]

The exaction of individual responsibility within social organization was to proceed, for Cleveland, as a scientific and professional matter. In so proceeding, however, none of the moral overtones were lost. To the connotation of responsibility as moral imperative toward an end, in the sense of Wilson's "major premise of all law," was added the further connotation of responsibility as means. As a means, responsibility was generated by accounting practices and administrative procedures that enforced moral imperatives in management practice. The professionalism and science of accountancy was based not just on the calculation and reporting of facts, but also on the promise to convert the ideal of personal responsibility into the deeds of everyday administrative life. To adapt the phrase of historian Samuel Haber, used in the context of Taylorism, the municipal administration, as well as the factory, was to become a "moral gymnasium" [Haber, 1964, p. 17].

BEYOND ECONOMIC REQUIREMENTS FOR TRUST

Whereas Zucker emphasized the trust required for efficient economic exchange, we have argued that there was a much broader set of trust-related issues at work in the development of the accounting profession. Viewed in the broader context of the Progressive Movement, we see that trust in the promise of the democratic system—the republican ideal of effective individual initiative—was also at stake. In addition, the ability to trust that the exercise of municipal and state authority would be in the public interest, as opposed to the interests of a powerful few, was at stake. The moral call to restore these essential forms of trust in industry and government, to re-enfranchise the individual, and to restore responsibility to administration, was answered by the rise of science in management and the profession of accounting. The central theme linking the emergence of the accounting profession to the moral imperative of restoring these lost forms of trust was the accounting profession's adoption of the public interest as its primary reason for being.

> The stress that practitioners placed upon the need to protect the public's interest was an identifiable theme throughout the progressive era. . . . Among the commonest criticism of the profession by outsiders was that accountants considered their discipline to be essentially ethical rather than 'scientific.' [Previts and Merino, 1979, p. 157]

It should be remembered that, in general, a profession is distinguished from an occupation on three main points. First, the professional claims an expertise based on advanced education and training. Second, the professional acts primarily out of a desire to serve the public interest, not out of a desire for financial reward. Third, and in exchange for assuming the first two responsibilities, the professional is granted the right to self-regulation. These three characteristics, especially the right to self-regulation in exchange for a promise to serve the public interest, are widely accepted as the basis for any profession [Larson, 1977, p. 94; Blauch, 1956, pp. 54–57]. What sets the accounting profession apart from most others, however, is the genuine way that it embodied this sense of enacting the public interest during the profession's emergence in America. In the fervor of the progressive era, the accounting profession was an active agent, a medium, through which a trust in the realization of the public interest was created. Trust was to be restored through reforming regulation, and the accounting profession emerged as a vehicle that embodied the necessary reforms in its specialized knowledge and practices.

What intrigues us about the profession and its foundations as a form of regulation and as a moral force promoting the public interest is the way that original noble calling has shifted over time. Previts and Merino note that a shift away from the original vision of the profession begins during the period of "normalcy" that emerged after World War I. They note that the tenor of the times had changed, becoming more favorable to allowing business a free rein:

> Thus, regulatory agencies, which had been established to monitor business and had in the past encouraged audits to protect the public interest, become less interested in corporate control. Business men were left to regulate their own affairs; accountants were now asked to assist management in preparing information on costs, production, and sales to be forwarded to the Commerce Department. The department distributed this information among producers to prevent price competition. [1979, p. 199]

In the final section we review the results of that shift as it is revealed by our modern day discourse on the profession's responsibility to uphold the public interest and its relation to the process of regulation. We will argue that there has been a curious reversal of meaning for key terms, such as responsibility and public interest, as they affect the profession that have allowed it to cloud its original sense of mission, even though claiming to be faithful to it.

A DUAL CONCEPT OF THE PUBLIC INTEREST

In this section we present an example of the noticeable shift that has occurred over the last 80 years away from the original founding image of the American Accounting Profession. This shift is characterized by a loss of a clear sense of the accounting profession as an actively moral enterprise that is essentially regulatory in nature. The original sense of the profession as a promise to seek the public interest is now joined by a second sense of the profession's relation to the public interest. This new, second sense of public interest emphasizes the public's *interest in* accounting, and focuses attention on the professions' responsibilities to recognize and respond to the interest the public has in it.

To exemplify this change of the public interest ideal in the accounting profession, we will trace its use through the seminal work of John Carey [1946], to the current code of professional ethics, and to the restructuring of the code proposed by the *Report of the Special Committee on Standards of Professional Conduct for Certified Public Accountants* (AICPA, 1986), commonly known as the Anderson Committee Report.

Carey puts the profession's obligation to serve the public interest as central to its existence and the focus of its code of ethics:

> Rules of professional conduct have this distinction from other types of rules—they are designed not only to advance the group interest of those who constitute the profession, but also the interests of those who are served by members of the groups—that is, the public. This is not wholly altruistic. It stands to reason that the opportunity of a profession to serve the public will be widened if the public is convinced that members of the profession are required to protect the public interest.
>
> The very existence of the accounting profession depends on public confidence in the determination of certified public accountants to safeguard the public interest. This confidence can be maintained only by evidence of both technical competence and moral obligation. [Carey, 1946, pp. 1–2]

Current AICPA Professional Standards have lost Carey's positive, active call to "protect" and "safeguard the public interest" as a "moral obligation." Nonetheless, they still recognize the public interest as a primary responsibility:

> A distinguishing mark of a professional is his acceptance of responsibility to the public. [ET 51.01]
>
> The ethical Code of the American Institute emphasizes the profession's responsibility to the public, . . . [ET 51.04]

When we look at *The Proposed Code of Ethics of the American Institute of Certified Public Accountants* [AICPA, 1986] contained in the Anderson Committee Report, we see some of the same wording as in the existing code, but some new and curious ways of understanding public interest and the basis of professional self-governance are added. For example, Article IV sounds very similar to the present code in holding that:

> A distinguishing mark of a profession is acceptance of its responsibility to the public. [AICPA, 1986, p. 26]

The body of the report, however, introduces a new use of the phrase "public interest." Instead of "the collective well-being of the community of people and institutions the profession serves," as discussed in Section IV of the proposed code, we see the public interest used to denote that the work of the CPA is *of interest* to the Public:

> *The Public Interest*
>
> The public interest in the quality of performance of CPAs should govern the structure, scope, content, and administration of performance standards. . . .
>
> All who benefit from or depend on the services of CPAs have an interest in the quality of their performance. [AICPA, 1986, p. 11]

Thus, the Anderson Report portrays the "public interest" responsibilities of the accounting profession in two radically different ways. One way more properly recognizes the accountant's professional responsibility to the "collective well-being of the community," though not in the active, positive sense of Carey. The other way introduces a novel interpretation based on the public's *interest in* the accounting profession. In the body of the report, this novel relation to the public interest is proposed as the basis for professional self-regulation:

> The Code notes that because members perform an essential role in society, they have broad responsibilities to those who use their professional services and have a special responsibility for self-governance. [AICPA, 1986, p. 22]

Although the body of the proposed Code carries forward the statements of concern for the public interest from the existing Code, the elaborated report discusses the public interest as if it was merely the recognition that the profession is visible and of interest to the public. Further, in contrast to the accepted notion that professions are granted the right to self-regulation in exchange for actively pursuing the public interest, the Anderson Report proposes that because the public has an *interest in* the profession, the profession has "a special responsibility for self-governance."

This new meaning of the public interest as put forward in the Anderson

Report thus turns self-regulation from a right that is earned by actively upholding the general welfare, into a specialized responsibility that is associated with the broad impact of accounting services. Self-regulation is thus seen as something the profession accepts because of its important role in society instead of something the profession has been granted in exchange for a promise to actively seek societal betterment. This curious new use of public interest in the Anderson Report also affects how the profession proposes to evaluate itself.

Whereas the original sense of the public interest as a responsibility for the general welfare suggests that the profession be evaluated on the outcomes of its services, the new sense of the public interest as an interest in the profession's work suggests that a more internal, process-based evaluation of its services is possible. This is in fact the direction the Anderson Report has taken, proposing that those interested in the profession are interested in seeing it perform its services with "quality." Instead of being evaluated on its achievements in pursuit of the general welfare, the profession proposes to be evaluated based on its intentions to pursue "quality" services:

> Performance standards should give primary emphasis and attention to assuring quality performance and reducing or eliminating substandard performance because the quality of performance affects the general public as well as clients and employers of CPAs. [AICPA, 1986, p. 12]

We are not against quality, but we are concerned about the lack of critical reflection on this shift in use of the ideal of the public interest and its consequences. This new sense of the public interest suggests that the profession be judged in terms of its response to the interests of the market, rather than the consequences of its practice for the general welfare. If the interest of the public in the profession became a basis for judging its performance, what claims to "special knowledge" unavailable to the general public are left to the profession? A heightened concern with the level of public interest in the accounting profession as a basis for judging the performance or recasting the mission of the profession threatens the very basis for its claim to professional status.

How did this shift in the concept of the public interest come about? A body of historical thought on our present period, such as that available for understanding the progressive period, will not exist for some time. More perspective is needed for it to be collected and written. So we cannot give as comprehensive an analysis of the social forces shaping current developments in the profession. However, some generalizations will be offered.

The present time for the profession is marked by a degree of visibility and scrutiny unlike any before. As in the progressive period, efficiency is a key concern, but now the spotlight of efficiency is being cast on the profession itself. Increasingly, the profession is being discussed in terms of a business. Firms engage in marketing, allocate resources, develop new product lines, compete for business and advertise.

In the progressive era, efficiency was also a central concern, but at that time, the accounting profession was seen as a medium that would help establish efficiency in the newly industrialized and urbanized world. It was part of the promise to restore fairness to the functioning of corporations and municipalities, through guaranteeing their efficiency. This was the moral basis that linked science and professionalism to our most cherished republican ideals of individual initiative.

Today, efficiency, along with other images of business, is being applied to the increasingly visible profession. Accounting has thus been brought into and made a part of the market they had previously observed as an outside monitor. As the accounting profession becomes an object of efficiency, to be judged in economic terms of the market, a fundamental conflict for the profession is revealed. This fundamental conflict, we argue, is reflected in the dual sense of the "public interest" proposed by the Anderson Report.

The profession is an active, moral, regulating force as reflected in the original sense of the public interest carried forward from the establishment of the profession. But it is also an economic agent, to be judged in terms of its efficiency in performing according to the interests the public displays in it. To pursue either of these senses of the public interest to the exclusion of the other could well result in the demise of the profession. To single-mindedly pursue its moral mission may be economically devastating in a world of government induced emphasis on competitive pricing and market share. On the other hand, to pursue its mission of economic efficiency and response to the interests of the public undermine the very basis for its claims to be a profession—its specialized knowledge and desire to perform a service apart from considerations of economic reward.

CONCLUSIONS

We have pointed to a transformation in the accounting profession's proclamations of its professional responsibilities. As the profession emerged and became established, that obligation was portrayed as the active regulation of an increasingly corporate social order, policing the public interest in honesty and responsibility against the threat of bureaucratic power. In recent years, this original sense of upholding the public interest has been joined by a second, less actively moral, obligation to recognize and respond to the public's *interest in* the accounting profession's activities.

We do not point to this transformation with an exhortation to accountants to return to the lofty ideal the profession once had, but has gradually changed. Such exhortations, it seems to us, overlook the complex roles which ethical statements can serve in the self-regulation of a profession. They overlook the sense in which ethical statements are utterances specific to the social context within which they are made. Ethical statements are informed by understandings of the political, social, cultural and economic milieu of the time and serve specific purposes within it.

The invitation which we prefer to issue is for a more painstaking historical examination of those conditions which make a particular concept of ethics possible, and which require it to change. Seen in this way, notions of ethics do not represent timeless and immutable meanings, to be pursued in varying ways, but nevertheless constant in essence. In the terms of the philosopher Nietzsche, words that depict ethics are like "pockets," into which various meanings and significances are put for a time, to be later removed and replaced with something else. The meanings of "public interest" and "self-regulation" in accounting dialogue on professional ethics are somewhat plastic, embedded in a changing social context in which their definitions are reshaped and elaborated over time.

We have argued that the social forces of the progressive period shaped the profession and its dialogue in a defense of the public interest. Today, the social forces of increased visibility and economic efficiency appear to be shaping the profession and its dialogue in a defense of its responsibilities to the interest the public displays in the profession. Each of these senses of "the public interest" is related to the ability of the profession to produce trust. Yet the two are clearly in conflict. Success in producing trust in the pursuit of one threatens the possibility for producing trust through the other. This is not a superficial failing on the part of the profession, but is indicative of a contradiction inherent in any profession practicing in the modern world.

The conflict between the profession's interest in producing both fairness and efficiency will not be easily resolved. It can only be met with a commitment to self-reflection on our professional discourse and the terms in which we conduct it. Trust in the profession will best be maintained when that self-reflective discourse is open and critical. In 1961, Mautz and Sharaf criticized the profession for a failure to be sufficiently critical of its standards of performance. Twenty-six years later, the confused and contradictory use of fundamental terms in the Anderson Report suggests that the criticism by Mautz and Sharaf is still applicable today.

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ACCOUNTING REGULATION-BASED EXPERT SYSTEMS

Daniel E. O'Leary

ABSTRACT

Expert systems are being used to solve accounting regulation problems. The tasks performed by these systems include developing financial statements, examining proxy statement information as in EDGAR (Electronic Data Gathering Analysis and Reporting), developing financial ratios from EDGAR and assisting in the computation of the provision for income tax for financial reporting. This paper discusses those systems and some extensions to those systems as well as some of the advantages and limitations of expert systems in accounting regulation.

Expert Systems have been receiving increasing attention from accounting academics and professionals. Recent symposiums and research papers have addressed the relationship between accounting and auditing judgement and expert systems. Some prototype expert systems have been built

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to demonstrate the feasibility of the use of expert systems in accounting [O'Leary, 1987] and some accounting firms have begun to develop expert systems in auditing. However, much less attention has been directed towards regulation-based expert systems.

Accordingly, the purpose of this paper is to provide an understanding of expert systems in general and their interface with accounting regulation in particular. In order to accomplish this purpose, this paper will:

- discuss some of the key elements of expert systems,
- analyze accounting regulation as an area for expert system development,
- review and analyze what has been done in expert systems as they relate to accounting regulation,
- analyze some potential extensions in accounting regulation-based expert systems,
- discuss some of the advantages and limitations of the use of expert systems in regulation.

ARTIFICIAL INTELLIGENCE AND EXPERT SYSTEMS

The term artificial intelligence (AI) is an umbrella term that includes a number of activities: expert systems (ES), pattern recognition by computers, learning and reasoning by computers, natural language use by computers, and other topics. Barr and Feigenbaum [1981], Rich [1983], and Winston [1984] provide comprehensive surveys.

Winston [1984, p. 1] defined AI as "the study of ideas that enable computers to be intelligent." Barr and Feigenbaum [1981, p. 1] have defined AI as "the part of computer science concerned with designing intelligent computer systems, that is, systems that exhibit the characteristics associated with intelligence in human behavior." These definitions indicate that AI is concerned with developing computer systems that perform tasks and do analysis that humans currently use knowledge and reasoning to carry out.

Currently, the most frequently applied branch of AI in accounting is expert systems. ES perform tasks normally done by knowledgeable human experts [Rich, 1983]. Accordingly, ES are developed by programming the computer to make decisions using the knowledge and a representation of the decision-making processes of the expert.

ES Structure

Structurally, ES usually have four major components: database, knowledge base, inference engine, and user interface. The data base contains the data used by the expert system. The data may come from the user or may be part of the system or may be part of a computer database. This is normally the same data that a human expert would use to solve the problem. However, the system may use more or less data to solve the problem. For example, the human expert may use additional equivocal information for ill-defined problems that is not easily incorporated into the system, whereas the expert system may exploit the data processing capabilities of the computer and include unequivocal data that a human would not have time to process.

The knowledge base provides the set of knowledge that the system uses to process the data. Typically, this is the domain-specific knowledge that the expert would use to solve the problem. Knowledge can be represented a number of ways. One of the most frequently used methods is the rule-based approach. Rule-based knowledge representation takes the form of "if. . . (condition) then. . . (consequence/goal)." The rules may or may not include a numeric level of confidence or probability of occurrence. Alternatively, knowledge may be represented as a "frame" to capture the characteristics associated with a given entity. The characteristics define the knowledge about the entity that is of interest in the application. Typically, frames describe a class of objects. The frame generally consists of a collection of "slots" that describe characteristics of the objects. These slots may then be filled with other frames describing other objects, [Rich, 1983].

The inference engine provides the basis for using the knowledge base to process the database. In a rule-based system, the inference engine normally uses either a forward or backward chaining approach (or some combination). Forward chaining reasons toward a goal. Backward chaining reasons backward from the goal to determine if or how the goal can be accomplished. In frame-based systems, the inference engine processes frames. The information within the frames then guides the choice of the next frame. Other approaches may be used depending on the knowledge representation and the problem solving approach used in the system.

The user interface provides the communication between the user and the system. Generally, the interface is user friendly, particularly in those situations where data is generated by the user. The user interface may include an analysis of the reasoning of the system in developing its decisions.

AI Languages and ES Shells

Developing ES requires a means to communicate with the computer. This means is usually provided by procedural languages, artificial intelligence languages and/or ES shells.

Procedural languages, such as BASIC, allow the user to define a sequenced set of operations to solve a specific problem. Some ES and some ES shells have been developed using procedural languages. Fortran, Pascal and most recently C are among the most frequently used procedural languages in the development of ES or ES shells. Two primary generic AI languages are in use: List Programing or LISP [Winston and Horn, 1984], and Programming in Logic or PROLOG [Clocksin and Mellish, 1984]. The primary AI programming applications that have been developed in the United States have used LISP, whereas the Japanese have chosen PROLOG for their fifth generation project [Feigenbaum and McCorduck, 1983].

AI languages differ from procedural languages. Procedural languages are dependent on the order of the statements, whereas AI languages may not have that constraint. This allows the development of a knowledge base independent from the rest of the system and facilitates changing that knowledge base in response to environmental changes. Second, in contrast to other computer languages that are designed to process numeric information, AI languages process symbolic information.

ES shells can simplify the development of an expert system by providing many user friendly features [Turbin, 1985]. The inference engine can be specified and does not need to be developed. The knowledge base is easy to specify to the computer. The ES shells also may allow the user to access existing databases, such as dBase II, procedural languages, and AI languages. Recently, many shells have been criticized for being computationally slow and for providing little beyond some versions of AI languages. In addition, the shells are still computer software and, accordingly, nonprogrammers still find it difficult to use the ES shells to develop an expert system.

Understanding and Learning by ES

The notion of "understanding" by ES generally is dependent on the particular context. For example, in a discussion of a program, SAM, that is intended to model a human story understander, Schank [1978, p. 133], notes that "by 'understand' we mean that SAM can create a linked causal chain of conceptualizations that represent what took place in each story."

Learning by ES refers to the acquisition of new knowledge by the ES. In virtually all the business and accounting systems developed to date this means that the knowledge base of the expert system is updated manually or via interactive transfer of expertise. The systems do not have the capability to learn by themselves.

Purpose of the System

ES can be used in a number of ways: an educational mode, an advisory mode, and a replacement mode [O'Leary, 1986].

AI/ES are being used to model educational functions that previously would not have been placed in a computer model. STEAMER [Williams et al., 1981] is an example of a simulation program that uses concepts from AI to serve as a tutor; training students in the principles of propulsion engineering.

Most ES developed to date are designed to function in an advisory manner. These systems make a recommendation. A human expert reviews the decision and the logic behind the decision, before the decision is implemented.

There are some systems designed to replace the decision maker. Glover et al. [1984] designed a system that they indicated should be called a "managerial robot" because it was designed to replace the manager. The system was designed to schedule employees in a decision-making environment of weekly fluctuations. However, systems designed to replace the decision maker do not have to be implemented in that manner but instead can be used in an advisory manner.

Knowledge and Decision Characteristics

There are a number of characteristics of successful expert systems. First, the knowledge is in short supply [Fox, 1984], not readily accessible, or an expensive resource. This ensures that the system that is developed will be a benefit to the company. Second, the knowledge is not easily acquired, otherwise, there would not be a need for the ES. Third, the decision should require short reaction time or the processing of a substantial amount of information. Fourth, McDermott (1984) adds that the decision should be a high value decision. Fifth, the knowledge required for the decision is structured and limited. These last two characteristics contribute to the likelihood of a high cost-benefit ratio.

ACCOUNTING REGULATION AS AN AREA FOR EXPERT SYSTEM DEVELOPMENT

Accounting regulation is beginning to draw interest as a domain for ES development. This section defines accounting regulation-based systems and relates those systems to the knowledge and decision characteristics of the previous section.

Definition

An accounting regulation-based expert system is an expert system that incorporates accounting regulation knowledge into the system or allows the user to respond to changes in accounting regulation; the set of expert systems driven by accounting regulation. The focus of regulation in this paper excludes taxation, except to the extent that such methods involve financial statement issues.

Knowledge and Decision Characteristics

The knowledge and decision characteristics of successful ES suggest that accounting regulation is an environment that can benefit from the application of ES. First, the number of accountants with a high degree of technical knowledge about accounting regulation is limited. Second, such knowledge is not easily acquired and is expensive to maintain. Third, there is a substantial body of regulation knowledge that is not easily accessed. Fourth, regulation has a substantial impact on the "accounting behavior" of firms. Thus, there is a high value associated with regulation. Fifth, some of the knowledge of accounting regulation is structured. For example, there are rules on disclosure of financial information. In addition, some knowledge in accounting regulation is only loosely coupled with other knowledge.

ACCOUNTING REGULATION-BASED EXPERT SYSTEMS

There have been at least five prototype expert systems that have been developed in accounting regulation. These systems reflect a number of design approaches and types of accounting regulation knowledge.

ELOISE

Two systems have been developed to interface with the Securities and Exchange Commission's (SEC) Electronic Data Gathering Analysis and Retrieval (EDGAR) project: ELOISE, and FSA. The EDGAR database places the actual filings of companies in a computer format [e.g., Goodman and Jayne, 1986].

ELOISE [Arthur Andersen, 1985a] stands for *E*nglish *L*anguage *O*riented *I*ndexing *S*ystem for *E*DGAR. ELOISE is a prototype expert system designed to analyze the proxy statements in EDGAR, in order to study antitakeover provisions. The system was designed using LISP.

ELOISE is based on Fast Reading Understanding and Memory Program or FRUMP [DeJong, 1979], an AI program that is designed to read and "understand" news stories. These systems are designed to identify a concept based on the identification of some key building words associated with those concepts. After a concept has been identified, the system can predict the content of the material. The system does an iterative matching between the predictions and the actual content to "understand" the material. These systems also use semantic information to determine where to look for the desired concepts. A sample of ELOISE-supported analysis is given in Exhibit 1.

ELOISE uses two kinds of knowledge: SEC knowledge and English language knowledge. ELOISE contains specific vocabulary found in proxy statements. ELOISE uses two aspects of the anti-takeover provisions:

- changes in by-laws to accommodate the acquisition or disposition of securities, and
- changes in by-laws to require a supermajority vote for mergers.

In addition, ELOISE uses knowledge about English grammar, sentence structure and possible meanings of the words.

ELOISE was developed as a stand-alone prototype application. At this point in time, ELOISE does not actually use the EDGAR database, but instead uses unaltered excerpts (provided by the developers to the system in American Standard Code Information Interchange (ASCII) from actual SEC proxy documents.

ELOISE is regarded as a regulation-based system because it was commissioned by the SEC, it is designed to interface with EDGAR and because it is designed to analyze proxy statements in order to study antitakeover provisions, an issue of importance in regulation.

FSA

FSA stands for *F*inancial *S*tatement *A*nalyzer. FSA (Arthur Andersen, 1985b) is a prototype expert system designed to develop financial ratios by locating, interpreting and analyzing financial information contained in nonstandardized financial statements. FSA was programmed using LISP.

Exhibit 1. ELOISE-Supported Document Retrieval

Concept: Amendment to the company's by-laws dealing with the authorization of securities.

Component Name	*Component Concept*
Base Concept:	Document Revision
Type of Document:	By-Laws
Action:	Change in Number
Effect of Action:	Increase
Target of Action:	Common Stock

Source: Arthur Andersen (1985a, p. 13)

FSA has a knowledge of ratios, financial report captions and footnotes. The system is designed for three ratios: quick ratio, debt-to-equity ratio and the times fixed charges earned ratio. Since the search for information for the components of these ratios is contained in the captions and the footnotes, the system must have appropriate knowledge to access that information.

Unlike ELOISE, FSA does not use the techniques employed in FRUMP. This is because the semantic structure of the captions and footnotes is irregular. Instead, a vocabulary of certain key words is used to identify where the information required for the ratios is located.

As in ELOISE, the EDGAR database is not used. Instead, the system uses database representations of the financial statement documents. The user interface in FSA is very friendly, with the system designed to be an analyst's workbench. The system is flexible and the analyst has substantial control over what the system does.

FSA is designed for the services industry. However, the knowledge required for other industries can be built into the system.

FSA is an accounting regulation system because it was commissioned by the SEC and it was designed to interface with the EDGAR database. Although there are other financial analysis ES [Blocher and Scalf, 1986], those systems are not included here as regulation systems, since general financial statement analysis is done in many areas of accounting and finance and is not always related to regulation.

FINSTA

FINSTA (O'Leary and Munakata, 1986) is a prototype expert system designed to take "natural language" input—an unordered set of accounting titles and dollar amounts and develop a financial statement (balance sheet). The system is designed to consolidate some of the accounts with other accounts, and to formulate, structure and label the statement according to accounting regulation requirements. FINSTA was programmed using PROLOG.

FINSTA uses a frame-based form of knowledge representation to structure the basic characteristics of accounting concepts. Concepts are differentiated by the time dimension and the liquidity dimension, each of which is necessary to develop the balance sheet. The system recognizes a number of concepts, including cash, prepaids, receivables, fixed assets and others. Certain accounting titles (vocabulary) were attributed to each of these concepts. For example, the system would find that "Net Electric Plant in Service" has a plant asset concept and "Cash" has a cash concept of a short term asset and the most liquid short term asset.

The system determines which concept to invoke based on an analysis of the account titles. FINSTA analyzes the words in the account titles in order to identify the concept associated with that title.

In addition, FINSTA incorporates other disclosure requirements. For example, rules such as the need to disclose expenses that are one percent or more of sales can be included in such ES.

The inference engine [as above] in FINSTA is the execution of a sequence of PROLOG procedures. The data base is included in the program. The user interface is limited to the output of the system: the original accounts and the financial statement.

FINSTA is designed for the electric power industry. However, the knowledge from industry guides in other industries can be built into the system. FINSTA is included as an accounting regulation-based expert system because it includes rules of regulation for financial statement presentation.

ExperTAX

ExperTAX was developed by Coopers and Lybrand [Shpilberg and Graham, 1986] and [Shpilberg et al., 1986] to assist their audit staff in analyzing and computing the income tax accrual for financial reporting purposes. ExperTAX was developed in LISP and runs on IBM and IBM compatible personal computers.

Tax accrual is an audit task that requires specialized training. Accounting firms have developed questionnaires and checklists to facilitate the gathering of the necessary information. These questionnaires are usually completed by staff accountants in the field and analyzed by audit and tax management in order to identify tax planning issues and opportunities. However, practical realities limit the efficiency of the process. Questionnaires are perceived as long and complicated documents. Some of the issues on the questionnaire require tax expertise while others require audit expertise. Analysis of the forms can be a long and complex task that may not meet the timeliness required by the situation.

ExperTAX was developed to mitigate these problems. ExperTAX improves the process by reducing the elapsed time from start to finish, maintaining the quality of the output and reducing time demands on personnel. The system incorporates over 1,000 rules and several hundred frames. There are two types of frames in the knowledge base, question frames and issue frames. The frame types differ in the number and type of attributes and the procedures and facts associated with them.

The inference engine for the rules is forward chaining. A frame "manager" program is used to execute the two different types of frames.

The user interface is operated through a system of nested menus that allows the user to control the process. The user friendly system employs multiple windows to communicate with the user on multiple levels, and includes information identifying the section being analyzed, the questions being asked and the explanation of system requests of the user.

EDAAS

EDAAS (*E*xpert *D*isclosure *A*nalysis and *A*voidance *S*ystem) is an expert system in use at the Environmental Protection Agency (EPA). EDAAS [Feinstein and Seims, 1985] is designed to advise on the disclosure of confidential business information (CBI). Although the system does not employ accounting information or make judgements that directly affect accounting information, it is included here as an example of an expert system in use by a regulatory agency. The system was developed using Fortran because of the availability of programmers and portability of the software.

Chemical manufacturers, importers and processors submit detailed information to the EPA on thousands of chemical substances in commerce. The EPA has instituted security procedures to prevent the direct release of that information. However, if there is a request for information that is not sensitive then EPA tries to honor the request unless the information can be combined with other nonsensitive information that "too closely" estimates sensitive data protected under Federal nondisclosure law. This indirect disclosure could be used to estimate corporate strategies or research and development plans.

The process of determining whether the information is sensitive can require substantial manpower. Because of the Agency's limited resources, the well-understood nature of the tests of the information and the rule-based structure of the procedures, an expert system was built.

EDAAS contains two separate knowledge bases, each represented different ways. One of the knowledge bases uses rules to represent the specific law concerning information release. Another knowledge base contains known relationships between "pieces" of company-related CBI and non-CBI data.

EDAAS includes about 60,000 chemicals in the database and has thirty categories of chemical data. For each class of chemical and category of data there are approximately eleven rules. This is equivalent to about 198,000 rules.

EXTENSIONS

In addition to some extensions of the above systems, there are at least two other areas for potential application of expert systems in accounting regulation: modeling the law and regulations, and interfacing with EDGAR.

Extensions of ELOISE, FSA and FINSTA

Both ELOISE and FSA can be extended to interface with the EDGAR database [Arthur Andersen, 1985a,b]. This could be accomplished by the use of a translation module that would allow those two systems to access EDGAR.

All three of these systems can be extended by providing additional knowledge. For example, FSA could be extended to other ratios [Arthur Andersen, 1985b]. All three systems could benefit from an increased vocabulary.

The FSA system could be provided with a memory that would allow it to only compute the ratios one time for each company and then store the results. The stored results would then be used to provide the information in later requests.

Each of the systems could be expanded beyond their current domains. For example, FSA and FINSTA could be expanded beyond their single industry orientation and ELOISE could be expanded to other concepts besides anti-takeover provisions in the proxies.

Modeling Law and Regulations

Accounting regulation involves a substantial body of law and regulations. It has been demonstrated [Waterman and Peterson, 1981], that rule-based expert systems can be used to model various aspects of the law. Similarly, many regulations have a rule-based structure. Accordingly, to the extent that accounting regulation has such a structure, those problems may be amenable to the development of ES.

This could be beneficial because the complexities of the law can make it difficult to understand and because the frequent changes in the law can make it difficult to keep up with these changes. A computer program that fostered a use and understanding of the laws and regulations could make it easier for the user.

Interface with EDGAR

The purposes of EDGAR, as delineated in Goodman and Jayne [1986, p. 1], provide a basis for examining some of the other potential capabilities of expert systems. These purposes were to:

- provide investors, securities analysts and the public with access to corporate disclosure documents on computer screens,
- allow companies to make required filings via direct transmission, diskette or magnetic tape, and

- enable commission staff to process and analyze filings more efficiently at computer work stations.

FSA was aimed at aiding in the first purpose. However, FSA could be expanded beyond the development of financial ratios to include an analysis of the meaning of those financial ratios. This type of a system likely would focus on a particular industry, much as human experts (financial analysts, for example), focus on particular industries. In addition, the system also would likely be aimed at meeting the needs of a particular group of users.

Once the filings have been developed an expert system could be developed to translate the firm's filings into a format that meets the SEC's requirements.

The third purpose could also benefit from an ES approach. An expert system could be developed for the commission staff as an aid in analyzing the filings for accuracy and completeness.

ADVANTAGES AND LIMITATIONS OF ACCOUNTING REGULATION-BASED EXPERT SYSTEMS

Accounting Regulation-based Expert Systems

A recent national survey [Fried, 1986] cited a number of benefits of ES: improved decisions by nonexperts, more consistent decisions, reduced response time, reduced cost, and improved training. From the perspective of accounting regulation, these benefits suggest a number of implications.

The first benefit suggests a quasi-replacement mode of use for ES wherein experts could spend their time on more complex problems while nonexperts use ES to process the more routine decisions.

The second benefit indicates that by using the expert system, for example, the analysis of the filings may be done in a more consistent manner. The third benefit suggests that by using ES both the firm's filing and the SEC's analysis of the filings could be done in a more timely manner.

The fourth benefit arises because after an expert system has been built, it can be replicated without substantial additional cost (other than computer time and knowledge base updating). This is in contrast to human experts who require salaries, benefits, working space, etc.

Finally ES can be used to provide educational benefits. Using principles of AI and ES new systems can be used to provide education in areas that have been ignored previously in computer-aided education.

However, there also are some general limitations of ES [Messier and Hansen, 1983] and [McDermott, 1984]:

- a substantial effort is required to build an expert system,
- the development process requires an expert to spend time developing and debugging the systems,
- the size of the knowledge base is limited by current technology,
- the systems do not learn from their experience, and
- the systems do not have a general knowledge to fall back on if the specific knowledge is insufficient.

The regulation environment also limits the feasibility of the current generation of expert systems. Accounting regulation is in a state of constant change due to actions by rule-making bodies. This may induce obsolescence and/or lead to rapid changes in the knowledge base except at the most primitive levels.

In addition, although accounting regulation has a large body of formal rules that claim to define the domain, these rules are often contradictory, ambiguous and incomplete. In addition, the rules often employ complex and ill-defined concepts. This indicates the importance of chosing the right problems for the ES. If a decision-making problem includes many of these characteristics then it may be better to avoid it or to use a unique approach.

Human experts use many kinds of reasoning processes. The knowledge on which their decisions are based may require the judicious use of common sense, rather than domain-specific knowledge. However, ES do not easily incorporate common sense, which would require too broad a range of knowledge. Those problems for which common sense is used should likely be avoided in favor of those problems that are high in domain-specific knowledge.

CONCLUSION

This paper has introduced fundamental ES concepts and investigated the use of ES in accounting regulation. The paper has examined some actual ES and possible extensions to those systems. In addition, the paper has summarized some of the advantages and limitations of using ES in accounting regulation-based problems.

Two implemented and three prototype accounting regulation-based ES were discussed. These systems demonstrate the feasibility of using ES to model problems of concern in accounting regulation. These ES also demonstrate the range of accounting regulation problems that can be addressed using ES.

ES strengths are in the performance of structured activities with well defined problem domains. They can be used by decision makers to perform some of the "day-to-day" tasks, while humans focus on more complex problems. Because of the nature of accounting regulation and ES, it appears that accounting regulation can benefit from the application of ES.

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THE EXPECTATIONS GAP:

AN ADDED DIMENSION—THE CASE OF GOVERNMENTAL AUDITING

Richard E. Brown

ABSTRACT

In March 1986, the U.S. General Accounting Office (GAO) released a study, *CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards*, the last in a series of such reviews spanning nearly two decades, all quite critical of the governmental audit work conducted by the accounting profession. The latest GAO report is different from many of its predecessors in two important respects: first, by using widely accepted sampling techniques which include large and small CPA firms, in many regions of the nation; the current study counters earlier charges by the profession that the GAO's previous reports and critical findings were "unrepresentative"; second, the report, definitive in nature, comes at a time when the accounting profession has been criticized for commercial sector audit deficiencies.

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The paper addresses three main issues:

- the validity of the GAO's findings and their degree of acceptance by the accounting profession;
- responses to the GAO-alleged deficiencies and attempts by the profession to correct them;
- the implications of the above for self-regulation of the accounting profession.

The author concludes that the case made regarding substandard governmental audit work by CPAs in the current GAO report, and in earlier GAO reviews, is difficult to refute and is agreed to by key representatives of the profession. The response to date by the profession, while commendable in many respects, has been slow in developing, partial, and still uncertain in outcome. Finally, while it is by no means certain that regulation of the accounting profession is really designed to be *self-regulation,* as is so often assumed, the continuation in the current regulatory mode of the profession's peer regulation with government oversight very much depends upon the profession's willingness and ability to take decisive and publicized disciplinary actions against recalcitrant members who do not comply with professional standards for governmental audits.

An article in *The Wall Street Journal* in August 1986 neatly summarized the ongoing debate over regulation of the accounting profession. The article first quotes one party to the debate: Representative John Dingell asserts that "the accounting profession's self-regulatory system operates in secrecy and has not disciplined a single firm involved in well-known audit failures." An opposing view is also presented: speaking for the profession, Peter Scanlon, Chairman of Coopers & Lybrand, is quoted to the effect that "the entire process is not intended to be punitive but preventive. I'm not for hanging people from a lamp post. It's destructive." An academic viewpoint is added by John Burton, Columbia University's Dean of Business, who comments: "Self-regulation of accountants cannot work without scalps of offenders who fail to adhere to professional standards hanging on the belts of the regulators" [Berton, 1986a].

The article in *The Wall Street Journal* is important for several reasons. First, it illustrates the public nature of the debate over regulation of the accounting profession. Further, the article deals exclusively with "audit failures" in the commercial sector, ignoring comparable problems in public sector audit work. Finally, the article takes as an assumption what may actually be a crucial issue in the debate—that those who rely upon the accounting (audit) function for crucial investment, spending, and accountability decisions must depend upon a system which has self-regulation as an essential feature.[1]

For nearly two decades the accounting profession has been under attack for what has been popularly termed "substandard audit work" of federally-assisted programs. This criticism recently came to a head in the form of a new report on this topic by the U.S. General Accounting Office (GAO).[2] Key questions raised by this report include the following:

- What is the extent, nature, and accuracy of charges relating to "substandard audit work" in the public sector?
- How timely and effective was the accounting profession's response?
- What are some of the implications of these charges and the manner in which the profession has responded, to the concept of "self-regulation?"[3]

THE GAO'S 1986 STUDY

The March 19, 1986 GAO study, titled *CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards*, was prepared in response to a request from Representative Jack Brooks, Chairman of the Legislation and National Security Subcommittee of the House Committee on Government Operations [U.S. GAO]. The importance of the study is indicated in a few statistics. First, the federal government administers more than $100 billion annually in domestic assistance programs through 50 state and more than 80,000 local governments.[4] Second, the report estimates that the federal government pays the public accounting profession $100 to $200 million annually in fees to audit and report on the multitude of federal programs. This represents fees in the range of from 0.1-0.2% of the federal grant monies.

The report examines the issue of the GAO's standard for "audit quality" in some detail, and indicates the guidance provided to CPAs for governmental audit work by both the American Institute of Certified Public Accountants (AICPA) and the GAO. In an appendix to the report, a summary is provided of the GAO standards presented in "The Yellow Book," the *Standards For Audit of Governmental Organizations, Programs, Activities, and Functions (1981 Revision)*. In commenting on differences between the AICPA and GAO standards the report discusses an issue which becomes central to the audit findings. It states:

> In the area of financial statement audits, these standards have one significant difference. . . GAGAS [generally accepted *government* auditing standards] require, in addition to an opinion on financial statements, a statement on internal control and a statement on compliance with laws and regulations. [U.S. GAO, p. 12]

The report stresses, however, that the difference in the two sets of standards is in *reporting* requirements and not in the nature or extent of audit *fieldwork*, which in both cases is designed to evaluate or test internal controls or compliance with relevant statutes or regulations. The GAO report also emphasizes that the CPA conducting an audit of a grant program would be expected to—indeed bound to—know and follow GAGAS. Finally, the report recognizes both the professional judgment required by the CPA in applying the audit standards to the specific audit engagement, *and* the professional judgment required by the GAO auditors in reviewing CPA compliance with those same standards.

GAO Method

Problems in governmental audits identified in some earlier GAO audits had been criticized as being unrepresentative of the profession as a whole. In this report the GAO was especially careful in the selection of both its review techniques and sample and with the detail in which it described those procedures in the report.

The inquiry consisted of reviewing random samples of CPA audits received in fiscal year 1984 by 7 federal inspectors general (IGs) and the Department of Treasury's Office of Revenue Sharing in 6 major regions of the nation. In total these agencies administer about 95 percent of all domestic federal assistance. Excluded from the total number of audit reports received were audits in which the IGs had already reviewed the CPAs' working papers and, in many cases, corrected them. The universe was estimated at 6,400 audits. Samples were drawn of audits in each of the 6 regions, and then stratified to ensure that large and small firms were about equally represented, and that about 75 percent of the sample were grant audits and 25 percent were single, or entity-wide audits. The total number of audits ultimately evaluated by the GAO auditors was 120.

The GAO auditors performed much of their work at CPA firm offices. Audit reports and the supporting working papers were examined. Tentative findings were discussed with the CPA firm personnel who conducted the audit. Because of the role of professional judgment, the GAO made heavy use of more experienced personnel [U.S. GAO, pp. 16–17]. A list of the audits selected, the CPA firm conducting the work, the firm's location, and the period covered by the audit are included as an appendix to the GAO report. While the GAO report avoids associating firm names with specific problems identified in the report, one can move from a handful of specific illustrative problems described in the report directly to the appendix to identify some firm names. At least one national newspaper took the time to do this matching and to phone the firms identified to discuss the GAO's criticisms [Berton 1986b].

Report Findings

The GAO found that 34 percent, or 2,208 of the 6,420 audits received by the 8 agencies, did not comply with the relevant audit standards. Twenty percent, or 1,317 of the audits, had severe standards violations, meaning that the CPA either failed to perform a majority of required work or could not produce sufficient evidence to support the audit work that was supposedly completed.

The sampling methods selected by the GAO also permitted the auditors to reach some conclusions with regard to firm size. In essence the report substantiates the "conventional wisdom" in this area—smaller CPA firms had a greater likelihood than larger firms of performing unsatisfactory governmental audits, as shown below:

Unsatisfactory Audits by Size of CPA Firm

	Large firms	*Medium firms*	*Small firms*	*Total*
Unsatisfactory audits	8	8	22	38
Audits in the sample	55	31	34	120

Source: [U.S. GAO, p. 21]

The GAO auditors organized their findings into three major areas relating to audit standards. In sum, they found:

- *Fieldwork standards.* For several audits the CPAs acknowledged that they did not complete all required audit work. For others there was a lack of evidence to substantiate that the audit work was ever done.
- *Reporting standards.* Of the 38 audits in the sample that did not comply with audit standards, seven did not comply with the reporting standards on legal compliance. Thirteen reports did not comply with reporting standards on internal control. In several instances either the required statement was not included at all, or the statement was unsatisfactory. In nine audits the CPA reported to have performed a study and evaluation of internal control when, in fact, only a preliminary review was made.
- *General standards.* Largely because of the problems cited above, the GAO determined that the CPAs involved in the 38 audits had violated the due professional care standard.

The GAO report included several "examples of unsatisfactory audits" to illustrate the nature of the problems found. One of the examples included in the report follows:

> In Colorado, a CPA firm audited a city's federal revenue sharing funds of $1 million for the year ending December 31, 1983. The CPA firm reported that it performed its audit and that it reviewed compliance with the Revenue Sharing Act and regulations issued by the Office of Revenue Sharing, U.S. Department of the Treasury. The CPA firm reported that, based on its review, it found no instances of noncompliance. The CPA firm, however, performed virtually no review of compliance for the year ending December 31, 1983. In discussions with us, the CPA firm partner responsible for the audit said he performed tests of compliance in 1977, but had not performed tests since then because there had been no changes in the city's accounting system or key officials. [U.S. GAO, p. 28]

THE PROFESSION'S RESPONSE

Of the 120 audits in the GAO sample, 21 were judged to have significantly deviated from audit standards. These instances were referred to the respective state boards of accountancy for review and disciplinary action. For the 17 audits that contained less severe deviations from the standards, the GAO referred these to the AICPA and the relevant federal IGs.

These actions, coupled with the publicity surrounding the GAO report itself, might have been sufficient to gain the attention of the accounting profession, but there were also a series of other factors involved. First, the GAO report served to support the allegations of "audit failure" made by Congressional leaders such as Representatives Brooks and Dingell. In addition, the GAO report was not the first time such a study was issued on the inadequacies of governmental audit work by CPAs. In a series of reports over two decades the GAO had pointed out such deficiencies. The AICPA itself had identified similar concerns in a study begun in 1979 and published in 1984 [U.S. GAO, pp. 10–11; p. 30]. Finally, the 1986 GAO report—along with a report covering the first phase of the study released in December 1985 and focusing on the role played by the IGs in reviewing CPA work—also included recommendations in three areas: education, enforcement, and audit fees.

In the area of education the report stated that the profession should consider:

- broadening requirements for continuing professional education to include a specified level of governmental accounting and auditing for CPAs performing governmental audits;
- requiring governmental audits to be included in peer reviews;

- placing greater emphasis on governmental accounting and auditing in the uniform CPA examination;
- including governmental audits in CPA firms' internal reviews of their audit quality;
- seeking an expansion of college curricula to include greater attention to the nature and performance of governmental accounting and auditing.

The GAO also recommended:

- strengthening the profession's enforcement program;
- including more periodic reviews of governmental audit work;
- identifying instances of substandard work;
- taking appropriate disciplinary action as needed.

Additionally, the 1986 report contained a recommendation that the "Director, Office of Management and Budget, establish, consistent with the Single Audit Act, more definitive criteria for prohibiting the cost of substandard audits to be charged to federally assisted programs" [U.S. GAO, Chapter 3 and p. 41]. It appears that this latter issue was initially raised for the GAO's consideration at a November 1985 hearing by the Chairman of the Legislation and National Security Subcommittee of the House Committee on Government Operations.

Congressional Hearing

The GAO report was reviewed and discussed at a March 19, 1986 meeting of the Legislation and National Security Subcommittee of the House Committee on Government Operations. Four of the Subcommittee's 10 members were present, including Chairman Jack Brooks [AICPA 1986a, p. 3]. The Chairman opened the meeting with a brief statement which asserted that "decisive corrective actions are needed to dramatically improve the quality of these audits" [U.S. House of Representatives, 1986a]. The GAO report was summarized for the subcommittee members in attendance by Charles Bowsher, Comptroller General, who was accompanied by the representatives of the audit division responsible for the report and by staff members of GAO's audit quality task force [U.S. House of Representatives, 1986a].

AICPA Response

The AICPA was represented by Herman Lowe, Chairman of the Board of Directors, who spoke on behalf of the AICPA. He was accompanied by the AICPA President, an AICPA Vice President, and the Chairman of the AICPA Task Force on Quality of Audits of Governmental Units [U.S. House of Representatives, 1986a].

Lowe began his testimony by commenting that he had "not had an opportunity to study the findings and recommendations the GAO has presented." However, perhaps in large measure reacting to earlier GAO studies, Lowe outlined what he considered the essential problems and a program to improve audit quality; the program was the result of deliberations by the AICPA task force on audit quality, composed of representatives of large and small CPA firms, state auditors, and a federal inspector general. Indeed, this task force had been appointed in large measure to address the GAO's concerns [AICPA b].

Addressing the area of education, Mr. Lowe stated that "audits of federal grant recipients have unique requirements that have no parallel in conventional audits of financial statements. . . . No state board, federal agency, or professional body mandates education in [compliance testing and reporting]." Concerning the engagement of auditors, Lowe commented that the government "procurement process often focuses too much on the fee and not enough on quality." In the evaluation area, he felt that steps must be taken to move beyond the detection of audit problems into a program with the prime objective of preventing such problems. Relating to the enforcement of standards, Lowe used his strongest words:

> There is a need for effective enforcement to deal with the CPA who will not, or possibly cannot, comply with relevant standards. These CPAs—we believe they are few in number—who turn their backs on the requirements of their profession and thereby ignore the public interest . . . need to be promptly punished. And the government needs to know that it is being done. [U.S. House of Representatives, 1986a, pp. 5–6]

Finally, relating to the exchange of information, Lowe stressed the importance of having CPAs in the national and regional intergovernmental audit forums in order to exchange ideas with federal, state, and local auditors.

Lowe's assessment of the setting which contributed to substandard audit work seemed accurate; his list of actions taken to date and promised for the future was also persuasive. To help correct deficiencies in the education area, the AICPA had published a revision of its audit guide, *Audits of State and Local Government*, in February 1986. Also, according to Lowe, the AICPA had organized, sponsored, and participated in numerous training programs and conferences throughout the United States. These sessions, often carried out through the state societies, would continue in the years ahead.

To aid in evaluating audit quality, the AICPA had modified its peer review standards to ensure that such reviews would include at least one audit conducted pursuant to the Single Audit Act of 1984. While membership in the AICPA peer review program is voluntary, almost 1,600 firms (which include about one-half the individual members in public practice) were involved in the program. Lowe also underscored the AICPA's interest in obtaining from the GAO and IGs the audit engagements which, in their view, merit further inquiry or a disciplinary hearing.

Lowe's list of proposed actions was even more specific. He stated that at a February 1986 meeting the AICPA's Board decided to recommend to the federal government that CPAs should not be allowed to audit federal assistance programs unless they:

- complete appropriate continuing professional education courses;
- agree to have the AICPA report the status and disposition of any investigation triggered by an IG;
- participate in an approved peer review program.

A second recommendation pertaining to confidentiality was addressed in more detail by Lowe. He stated that "the Institute believes it is reasonable to require . . . CPAs to waive their traditional right to confidentiality. The most effective and timely way to achieve this end is through the audit contract."

Lowe also summarized some important statistics relating to the Institute's peer view program. As of February 15, 1986, 2,381 peer reviews had been completed and accepted since the late 1970s. Over 11 percent (269 reports) were modified or adverse due to some important deficiency; this information is kept in a public file. Actions were taken in the case of 270 firms; these actions are also in a public file. While the actions detailed by Lowe, including accelerated peer reviews and revisits by the peer reviewer, do not constitute very strong action, he seemed to be stressing the importance of the public nature of the actions, rather than the actions themselves [U.S. House of Representatives, 1986a, pp. 10–14]. A key question is whether placing such records in an open file has the same impact as making actions publicly known through a more formal reporting mechanism.

NASBA Response

The National Association of State Boards of Accountancy (NASBA) was represented by Thomas Iino, NASBA President, who served as spokesperson, and by the immediate past president, NASBA's Executive Director, and a member and former chairman of Florida's Board. Mr.

Iino's testimony did not respond specifically to the GAO report findings or recommendations. Instead, his statement outlined the role and operations of NASBA and state boards. Traditionally, he stated, most state boards had relied on a complaint-based system of enforcement and discipline. But, he added, relatively few complaints are received by state boards of accountancy. Recognizing this, according to Iino, in the mid-1970s the boards began an approach called the "positive enforcement program," which emphasizes the seeking out of complaints and substandard work. In general, he stated, the program has uncovered the same problems identified in the GAO report.

Iino discussed the publication in 1978 of "broad guidelines" for the positive enforcement program, which were substantially revised and expanded in 1984 into a 100-page manual. NASBA is now at work developing a set of guidelines for a recommended model program for all states. This model program will require that all firms undergo a quality review acceptable to the state board as a condition to the renewal of their permits to practice public accounting. The program is designed to identify substandard work and impose, as needed, a range of corrective and disciplinary measures. The possibilities include supervised education and training, limitations on practice scope, fines, and suspension or revocation of licenses. Mr. Iino's testimony did not, however, specify how public sector audit work would be included in this review program, nor was much said about the public sector expertise of quality review teams. Also, no statistics were offered to the subcommittee on disciplinary actions [U.S. House of Representatives, 1986a].

The Profession's Actions—Post-Hearing Period

It is likely that the testimony rendered on March 19, 1986 by the AICPA and NASBA representatives constituted a good faith effort based upon deliberations which addressed long recognized problems.[5] Thus, the hearing was "productive" for it provided congressional and GAO critics with a forum for addressing the structural and institutional process of public sector audits. However an examination of the actions by the profession since the issuance of the GAO report and the conclusion of the hearings provide further awareness of the profession's ability to meet the expectations of Congress.

In general, the professional organizations have done an excellent job of informing members of the problems. In the June 1986 issue of the AICPA's *Journal of Accountancy*, the membership was made aware in some detail of the GAO's charges and the March Congressional hearings [Washington Update, 1986]. The November 1986 issue of the Institute's journal carried a news feature on the topic, essentially reporting on the AICPA's National Governmental Accounting and Auditing Update Conference, held in Washington, D.C. This article, and the conference, repeated the GAO and congressional concerns, and the AICPA's general response to them. Congressman Frank Horton, a member of Brooks Subcommittee, was a speaker at the conference [''News Feature'' 1986a].

The April 1986 issue of *The State Board Report* offered NASBA members a full account of the GAO report and the hearings [National Association b]. At NASBA's Annual Meeting, attended by representatives of 47 state boards, the quality of governmental audit work was a key item on the agenda [''News Feature,'' 1986b].

As important as all the above are to informing the profession of the problem and discussing possible solutions, perhaps the most significant specific action during this period was NASBA's efforts to create an information system to collect and report on disciplinary actions taken by state boards. Until this time no such system existed. As stated in the October 1986 report on the Brooks Subcommittee hearings:

> Earlier this year, NASBA initiated efforts to develop and maintain comprehensive information on disciplinary actions taken by the various state boards of accountancy. These efforts will be made in cooperation with the Clearinghouse on Licensure, Enforcement and Regulation (CLEAR)—an organization affiliated with the Council of State Governments. On a quarterly basis, NASBA will collect data on disciplinary actions taken by the state boards and send them to CLEAR for computer processing. CLEAR will then provide NASBA a quarterly report on all disciplinary actions taken by the boards. . . . This report will be distributed to all state boards of accountancy and we hope will be made available in the future to others with a legitimate interest in such information. [U.S. House of Representatives, 1986b, p. 22]

In an effort to improve the referral process, NASBA has appointed a Special Committee on Relations with Governmental Agencies. The committee's role is to serve as a coordinating body to facilitate and expedite the process of handling the referrals that will be forthcoming from the GAO's investigation and subsequently from the Inspectors General [U.S. House of Representatives, 1986b, p. 22].

With regard to the GAO's recommendations dealing with education, NASBA has more recently joined with the AICPA and gone on record to suggest that the federal government has the right to establish any continuing or other education requirements it wishes in the procurement process. NASBA also supported the notion of including governmental work in the peer review process [National Association 1986a, p. 11].

Finally, while no specific numbers were available, there seemed to be some indication that progress was being made in the more serious disciplinary cases. At NASBA's 1986 Annual Meeting a GAO representative is quoted as stating: "The state boards seem to be doing an excellent job so far. We don't have any final results, just interim indications, but if it continues as it is, it looks like our report to Jack Brooks will be very bright" ["News Feature" 1986b, p. 159].

THE RECORD

So far this paper has been principally devoted to considering the GAO's 1986 analysis of governmental audit work performed by CPAs, and to the profession's more immediate response to that report. However, the main purpose of this paper is to assess the implications of these events for the regulation of the accounting profession. The issues raised at the outset of the article remain its principal focus:

- the extent, nature, and accuracy of allegations regarding substandard governmental audit work;
- the timeliness, nature, and specificity of the profession's response;
- the implications of the above to the manner in which the profession is regulated.

The balance of the paper addresses these issues.

Assessment

A review of the record suggests that CPAs have done too much governmental audit work that does not meet professional standards. Earlier GAO studies document this view and the most recent GAO report, using widely accepted technical methods, confirms it. A study by the AICPA further supports the concerns. Finally, the leadership of the profession has indicated at congressional hearings that there is substance to the basic thrust of the GAO report.

A great deal of money is spent annually on fees for governmental audit work, and the GAO report documents that in a substantial number of cases, ranging from 20 to 34 percent, depending on how one views the severity of the problems, the benefit can be questioned. If we accept the mid-point of the GAO's estimated annual fees for audits of federally-assisted programs, the figure is $150 million. It may be argued, therefore, that in cases involving between $30 and $51 million of the audit fees, the taxpayers did not get what they paid for. In one exchange at the Congressional hearings Congressman Brooks asked:

> Does the serious lack of documentation in some of these audits raise doubt as to whether the required . . . work was done at all?

The GAO responded:

> There is no question that many times when it is not documented, . . . the work has, in fact, not been done. [U.S. House of Representatives, 1986b, p. 6]

It is important not only to consider this implication, but also to recall some of the principal reasons for the audits in the first place. If fundamental concerns over internal control systems and compliance with program requirements are not adequately addressed and tested during the audit function, substantial portions of the $100 billion in federal expenditures—not to mention possible state and local dollars added to the federal dollars—may have been unaccounted for and misused. Beyond this vital concern is the even more crucial question as to whether a program is needed at all. If, for example, compliance with eligibility requirements was not adequately checked by auditors, how are policy-makers and managers to know whether the program is meeting the basic purposes for which it was designed? In short, the government program may not be needed at all, or may need major modifications if it is to succeed.[6]

In late 1980, as a prelude to the current period, the AICPA and GAO jointly sponsored a colloquium in Cherry Hill, New Jersey. The meeting's focus, however, was adroitly turned not on substandard audit work but on the more general issue of improving relationships and the specific issue of improved contracting procedures. For the most part, any strong references to substandard work were in speeches by federal officials; panel discussions dealt with other less contentious topics. A federal official who attended the meeting made this comment about Cherry Hill:

> It zeroed in on the problems of training and procurement. . . . The discussion of substandard work was left to the last day of the colloquium and never got heavy coverage. [Cronin, 1986, p. 61]

At the Cherry Hill sessions the AICPA President made the following comment:

> The extent of substandard performance is not precisely known. Poor audits receive unfavorable publicity, but the thousands of good audits performed annually receive no attention. This is how it should be because the client expects, pays for, and should get a quality audit. I am sure we will hear a number of examples of substandard work during this meeting. I hope that they are the exceptions and not the norm. Since human failure is the ultimate cause of poor performance within a profession, we cannot eliminate the problem completely; but we can constantly strive to reduce the number of cases. [AICPA 1986c, p. 11]

At that same conference the Chairman of the AICPA Auditing Standards Board took issue with "the appropriateness of the sampling techniques used by the GAO to identify examples of deficient work. There is a high probability that we do not share a common understanding of exactly what is implied by the profession's generally accepted auditing standards," and that such "differences of opinion . . . may well be a significant contributing factor to the government's lack of satisfaction with current CPA performance" [AICPA 1986c, p. 70].

In short, it appeared that several leaders of the profession in 1980 still remained unconvinced of the widespread nature of contract governmental audit deficiencies. 1986 should be considered a benchmark year in the resolution of this issue, since the profession now seems to have acknowledged that the problems warrant careful attention. One measure of the profession's seriousness about regulating itself could be its response over the past several months to the recommendations contained in the most recent GAO report, and in the report of the Brooks Subcommittee. A summary of these recommendations, along with the responses thus far of the AICPA and NASBA is contained in Exhibit I.

It appears that the AICPA is showing increased readiness to address the issues of continuing professional education for governmental auditing, the basic education of the accountant-auditor as reflected in the college curriculum and CPA exam. It has been clearly established that most accounting students do not study governmental accounting. Even if they did, it would not be much help since most courses and texts deal very little with such matters as internal control and program compliance in the governmental environment. Some do not deal at all with the newer concept of performance auditing used widely in the public sector—performance auditing also embraces many of the compliance techniques so much at issue in the current GAO reports. Furthermore, the basic auditing course does not devote much attention to *governmental* auditing. About 10 percent of theory and practice sections of the uniform CPA exam currently deal with nonprofit accounting. The kinds of issues raised in the GAO report are rarely included on professional examinations, and much of the college course and exam is devoted to "other nonprofits," such as hospitals and universities.[8]

The AICPA is not ready to mandate participation in its own peer review programs. This would be handled by having the federal government somehow ensure that a requirement to undergo peer review would be placed in the basic audit contract or other legal document. The same would occur with regard to the requirement for more CPE work in governmental accounting and auditing—such requirements would be placed in the basic audit contract or mandated by the federal government.

The key to strengthening enforcement efforts, in the AICPA's view, is straight-forward: ensuring first that CPAs participate in the peer review program and that governmental audits are included in the review and, second, that those performing governmental audit work agree contractually to waive confidentiality with regard to investigations of claims of substandard work. The AICPA appears to have been fairly consistent in its view on this issue. At the 1980 Cherry Hill colloquium a former Chairman of the AICPA's Professional Ethics Executive Committee stated:

> The rules on confidentiality surrounding these issues have been extremely stringent in the past. . . . One of the primary goals of this review program is a better educated group of practitioners as well as government representatives. It would be very difficult to reap the educational benefits of the program if the Ethics committee continues to be constrained in terms of its ability to discuss individual cases. Accordingly, the Ethics committee approached the Board of Directors once again, this time for permission to initiate an amendment to the Institute's confidentiality rules which would permit discussion of the results of individual review cases with government representatives. Formally such amendment requires the ratification of the various state societies of the Institute. The Board of Directors approved amending the rules and the exposure of the proposed rule changes to the state societies for . . . approval. [AICPA 1980c, pp. 74–75]

This position was again advanced by the AICPA as part of Mr. Lowe's 1986 testimony. It is important to realize that such a disclaimer of confidentiality on the part of CPA firms is a far cry from a formal public announcement of the results of disciplinary actions.

NASBA's response has been largely within the more general framework of promoting its model positive enforcement program. It is not clear, however, whether the benefits of such a program would encompass governmental audit work. Through this vehicle NASBA would seek to have state boards of accountancy deny renewal of practice permits to those who do not submit to quality reviews. This proposal would require deliberation and action in each of the 50 states, a lengthy and uncertain process. NASBA has also responded by establishing an information system on disciplinary actions. Again, however, disciplinary action per se is left to each state board, and little has been said about the ultimate public disclosure of the data collected. Finally, like the AICPA, NASBA takes the view that the federal government can require more CPE if it wishes, as well as peer reviews for those engaged in governmental audit work.

The Accounting Profession and the Model Regulatory System

Although progress is being made, the response of the profession to date has been slow, cautious, and less than complete. To put the profession's response in perspective, it is important to examine expectations for a regulatory system which oversees the conduct of professionals.

Exhibit I.

GAO Recommendation	*Subcommittee Recommendation*	*AICPA Response*	*NASBA Response*
Education:			
• Broaden CPE requirements to include governmental.	• GAO and IGs should take actions to assure CPAs are trained in governmental auditing. GAO should revise GAGAS to include a standard which requires CPAs doing federal work to complete CPE courses.	• Board has recommended to federal government that contracts should specify that CPAs must complete appropriate CPE work.	• Same position as AICPA—federal government can require.
• Seek expansion of governmental in college curricula.		• In general agreement.	• No comment.
• Include more governmental in CPA exam.		• Intention to increase coverage on CPA exam from 20 to 25 percent.	• No comment.
Enforcement:			
• Include governmental audits in peer reviews.	• GAO should revise GAGAS to require CPAs doing federal work to undergo peer reviews.	• Peer review standards revised: peer reviews should include governmental audits; Board has recommended to federal government that contracts should specify CPAs must participate in peer review program.	• Federal government can require CPAs to undergo peer review.

• Include governmental in firms' internal reviews.		• No comment.	• No comment.
• Establish positive enforcement programs to review CPAs.	• AICPA and state boards should more aggressively sanction CPAs and make results public.	• See above comments on peer review program. Board has recommended to federal government that contracting CPAs must agree to have AICPA report status and disposition of investigations. CPAs must waive traditional confidentiality.	• NASBA moving to model state positive enforcement program—necessarily on state by state basis. Model requires all firms to undergo acceptable quality review to renew permit to practice.
• Identify and refer those performing substandard work to state boards of accountancy, IGs, program managers, and AICPA.	• IGs should strengthen their reviews and be more aggressive in referring problem cases to AICPA and state boards.		
• Discipline violators.	• IGs should include this information in their reports to Congress.	• Statistics cited on disciplinary measures.	• Also establishing an information collection system to record disciplinary actions of state boards.
Fees:			
• Prohibit cost of substandard work from being charged to federal grant.	• No recommendation.	• No comment.	• No comment.

Such a regulatory system, whether self-administered or not, should contain several key elements:

- well-understood organizational elements with responsibilities delineated among parties;
- standards of professional work and conduct arrived at through a consensus-building structure;
- education, training, and testing developed to reinforce the standards and enhance a professional's ability to achieve them;
- oversight activities which both seek out and acknowledge complaints, which include positive steps to test for compliance with professional standards, and which rehabilitate and/or discipline members in a manner that is fair, certain, objective, and a matter of public record.

Role Confusion

When measured against the above-listed criteria for an oversight process of governmental audits, the existing system is far from complete. These deficiencies, however, are not due to the "self-regulatory" nature of the system, but to other factors. First, there may be too many parties in the regulatory scheme whose responsibility and authority are unclear. The AICPA, state societies, NASBA, and state boards all play important roles. One GAO official stated:

> If we found a CPA doing substandard audit work, we would refer the CPA to the Ethics Division of the AICPA. We would never refer a CPA to a state board of accountancy. I never understood the policy for that. [Cronin, pp. 59–60]

However, in its most recent report on this issue the GAO referred the most serious infractions to the respective state boards and the less serious violations to the AICPA. In his testimony before the Brooks Subcommittee the NASBA President commented:

> NASBA should not be confused with the voluntary professional accounting societies such as the AICPA or the various state societies. NASBA is a federation of state licensing agencies. . . . The licensing of public accounting practitioners, and to a significant degree the regulation of public accountancy, are matters governed by state laws and state governmental agencies. . . . It is important to emphasize that state boards of accountancy are governmental agencies with the authority to issue and revoke licenses. [U.S. House of Representatives, 1986a, pp. 3–5]

Many CPAs, of course, do not belong to the Institute and, while the Institute may take disciplinary action against the CPA, there is no assurance the relevant state board will do the same. This role confusion in the regulation of accountants adds to the perception that many of those who perform substandard work "slip through these cracks" of the enforcement system. If stronger, more objective enforcement is to be achieved, the process, composition, and activities of state boards must be considered. Is the state board role a *self-regulation* process? Is it not instead a *state government* regulatory process? But if accountants are the majority of the state board, does that mean a lack of public interest or concern? One source, published jointly by the AICPA and NASBA, reported that of the 370 members of boards of accountancy nationwide, only 67 (or about 18 percent) were neither licensed CPAs nor public accountants [AICPA, 1983, pp. 104–5]. And although the Cherry Hill conference was to deal, at least in part, with substandard work, NASBA did not play a leading role in it. The GAO and AICPA were co-sponsors of that conference. Indeed, a review of the colloquium report does not disclose the name of a single participant who identified himself as representing NASBA or a state board. One issue, quite simply, is "who in fact performs the process of regulation," and not "how well is it done?"

It would appear that the AICPA and the state societies, while performing a commendable job on behalf of the professionals they represent, may—by virtue of their visibility and prominence—actually be undermining the crucial role of NASBA and the state boards. The AICPA, with a staff of nearly 600 individuals in New York (its headquarters) and Washington, D.C., has far more personnel resources than NASBA, with a total of 14 staff members in New York, most of whom are clerical. The AICPA has an annual budget of about $70 million, while NASBA has a budget of approximately $1 million.[9]

The confusion surrounding the enforcement process was highlighted in the draft report of the Task Force on the Quality of Audits of Governmental Units. The Task Force concluded:

> The task force believes that the complexity and slowness of the referral process *is* not the only reason it has not been widely used for governmental audits. It also appears that most potential users do not understand how the process works and thus how to use it effectively. . . . Once a simpler, more timely system is in place, a program to explain its functioning and limitations should be undertaken. [AICPA, 1983, p. 82]

This confusion was further manifested at NASBA's 1986 Annual Meeting. When asked by a board member how the quality review work of the two groups might work, the AICPA President responded that that problem had not been dealt with directly. Perhaps, he stated, it might evolve as the CPA exam has—state boards would place reliance on the AICPA's quality assurance program. "Our leadership and NASBA's," he stated, "has to talk about how the programs could best be integrated" ["News

Feature," 1986b, p. 160]. This exchange raises a number of important questions, not the least of which is: Who, after all, is in charge of regulation of the accounting profession?

Audit Standards

While discussions about generally accepted accounting standards occupy much time for accountants and auditors, the problems associated with standards are often simply the result of the sheer *abundance* of standards. Governmental audit work is different than that performed for the commercial sector, and the "added" standards established by the GAO have created some difficulties.

Education and Training

The third aspect of the regulatory system deals with education and professional testing. Until quite recently many CPA firms avoided governmental audit work and to no great surprise, accounting students in turn did not elect courses in nonprofit accounting. Students found alternatives for "getting by" the few questions on the CPA exam. As mentioned earlier the situation is changing, though only slowly. Perhaps the most one can conclude in this area is that the accounting curriculum will ultimately respond to the demands of the market place and professional examinations. Also, as we have seen, the profession is finally showing a willingness to respond in the areas of examinations and CPE requirements.

Enforcement

The final important element in the regulatory model deals with enforcement of professional standards. After the standards have been clearly articulated, and after a reasonable effort has been made to provide adequate education, training, and testing of a profession's members, there should be a mechanism in place that will:

- check compliance with relevant standards;
- review instances of noncompliance in an objective manner;
- discipline members, as necessary, in an appropriate and noticeable fashion;
- assist in rehabilitating members who are deficient.

As with the first element in the model (organizational structure and responsibility), accounting's regulatory process does not fare well in this area. Indeed, the role confusion described above may be a major contributor to problems in the enforcement area.

The record to date is not very encouraging. The Comptroller General stated at a hearing that "one of the great problems of the accounting profession over the years has been that its disciplinary procedures . . . have not been very good" [U.S. House of Representatives, 1986b, p. 13] While the AICPA's peer review process initiated in the late 1970s is a step in the right direction, there has been little coverage of governmental work, and many firms do not participate in the program at all. NASBA's positive enforcement program is also relatively new—only 14 states have adopted the program thus far.

The statistics on disciplinary actions do not present convincing evidence. NASBA is only now beginning to collect such data, leaving an interested party to inquire about data on a state-by-state basis. Moreover, NASBA can not guarantee that all states will participate in the program. The AICPA's historical record in this area, while somewhat easier to scrutinize, is not much stronger. For example, between February and September 1980 the IGs submitted 199 cases to the AICPA, of which the Institute investigated 106 (the number of AICPA members). Four cases were referred to the AICPA Trial Board; one firm was expelled from the Institute, while the remaining 3 were "admonished" and required to attend CPE classes. Twenty-three firms were issued administrative reprimands (of which 21 were required to take CPE courses) and "constructive comment" letters went to 64 firms; only 15 firms had no action taken [U.S. House of Representatives, 1986b, p. 15]. It should be noted that within the framework of the accounting regulatory process, the AICPA may deny membership to a CPA, but it is the state board which governs the CPAs right to practice.

The profession's reluctance to take strong measures against members is a difficult problem. At the hearings of the Brooks Subcommittee, the NASBA President was quoted as stating that the strongest sanctions are very rarely imposed in cases involving substandard work:

> In the present legal environment, it is extremely difficult to revoke or suspend an individual's license when dishonesty or fraud are not in evidence. Attempts to do so are frequently overturned by the courts on appeal. And because most instances of substandard work stem from ignorance rather than malice, rehabilitative sanctions are more frequently imposed. [U.S. House of Representatives, 1986b, p. 14]

At NASBA's 1986 Annual Meeting a member and former chairman of Oregon's State Board commented on NASBA's model positive enforcement program. He stated, in effect, that discipline is not the program's primary focus; education is.

> To make the program work, the majority of practitioners must feel that the program will be fair, be effectively administered, and will respect confidential information. ["News Feature" 1986b, pp. 160–161]

Finally, there is the matter of the public record. The regulatory model espoused by public officials seems to place heavy reliance on the need to make the results of disciplinary measures widely known. The record on this matter is filled with comments substantiating this view, but it is very neatly summarized in the Brooks Subcommittee report:

> The committee wholeheartedly agrees with the Inspectors General. . . . It wishes to underscore the need for the AICPA and the state board to make all disciplinary actions against CPAs a matter of *public* record—simply sharing such information with the IGs is not enough. Public disclosure is necessary for at least two reasons. First, it will serve as a strong deterrent against substandard work by other CPAs. Second, it will provide recipients procuring audit services with information needed to select a firm capable of producing a quality product. [U.S. House of Representatives, 1986b, p. 16]

It may well be, as the opening to this article suggests, that "scalps of offenders . . . on the belts of regulators" are needed if this system is to be accepted, and if the current regulatory scheme is to endure.

In sum, accounting's self-regulatory model may not really be a *direct* self-regulatory one, but rather an *indirect* one via state boards of accountancy made up largely of accountants. The model is confusing due to the mixing of roles, with many looking to the prestigious AICPA and its state societies for assistance in enforcement—assistance which they cannot directly provide. However, these professional bodies, the AICPA and state societies, have the primary role in training, educational testing, and standard-setting. The success of these latter activities is as important as enforcement in the regulatory model, but many of those outside the profession appear to be most concerned (and frustrated) with the enforcement element of the model.

CONCLUDING OBSERVATIONS

In the process of examining the issue of the quality of governmental audit work by CPAs and its implications for regulation of the accounting profession, it would be improper not to underscore the complexity and difficulty of auditing in the public sector. Some CPA firms, or portions of them, continue to avoid governmental accounting work per se because of these factors. Federal, state, and local audit groups often do not agree on basic issues. If they do, the Office of Management and Budget and/or the Congress may see the issue differently. Members of the CPA community may have very different interests or, at least, very different views of the same interests: large and small CPA firms will view issues in quite different ways; different offices within one large firm may disagree.

The AICPA must represent all CPAs, regardless of size or location.

The AICPA and state societies fill very different roles than NASBA and the state boards—or at least they should fill very different roles. NASBA is heavily dependent upon action and support by its member states and state boards, all with their own views and political environments. Furthermore, in our efforts to create and maintain a vigorous enforcement program, due process for those under investigation must be a central concern. None of this, of course, addresses the issue of the special nature of governmental audit work, which is difficult and demanding and is, in the final analysis, very different from commercial audit work [Brown, 1982].

In this arena of dispersed, diffused, and competing authority and power, the governmental audit work must compete within the CPA firm for time, attention, and resources along with commercial auditing, which is traditionally perceived as more attractive—if not more lucrative. One reason governmental audit work may be gaining in popularity among CPA firms is the belief—real or perceived—that it does not carry the element of risk associated with commercial clients. It is unlikely that a governmental "audit failure" will result in a massive lawsuit. The pressures of the market place may suggest to CPAs that cutting audit costs by cutting important audit work makes sense if there are no consequences associated with such action.[10]

Despite all the ambiguities and complexities, taxpayers' dollars are used to purchase this work, and they and their elected representatives will not accept indefinitely problems of the current magnitude. The record of the profession in the matter of addressing substandard CPA work on governmental audits is mixed and raises serious concerns about regulation of the profession. Turf questions between the AICPA and NASBA must be resolved—in peer review and in enforcement—and both parties, especially the state boards of accountancy, must be more aggressive and public in their enforcement role. It may be helpful if more qualified individuals from the community and government, including non-CPAs and non-accountants, were brought into the process. This would not only add new insights to the accountants' perspectives—it would enhance the credibility of the profession's attempts at self-regulation.

Government, for its part, can be expected to keep the heat on, while getting its own house in order. Some have argued that if CPAs cannot or will not do governmental audit work properly, other professionals will be given a chance to do so—a not unreasonable viewpoint.[11] Writing specific language into audit contracts (or through audit standards, federal regulations, or directives) regarding continuing education, course work and experience, peer review, and release of confidentiality, is also a possible approach. Procurement officials must become more courageous—they should become more discriminating, reject low bidders on occasion, and reward those who do the work well. Also, government officials should use files on CPA performance, and press for more public disclosure on "audit failures." And lastly, regarding audit fees, there has been little reaction to the GAO recommendation that the cost of substandard audit work should not be charged to the federal program grant. This silence is interesting, and probably important. The choice would not be whether the federal grant is charged or whether someone else picks up the tab—if the audit work is not done according to contract, no one should pay for it. The procurement officer would surely not do so if it were *his* own business and money.

Given the record to date and the realities and pressures of the marketplace, it may be unlikely that continued improvements will be made without continued prompting by the GAO and Congress. In the absence of such prodding, the regulation of any profession takes on a flavor reminiscent of the old Pogo cartoon: "We have met the enemy and it is us." Accountants sit on boards of accountancy and are asked to discipline their friends and colleagues. Governmental accountants may aspire to retire from government to lucrative positions in public accounting. Many attend the same professional conferences or social functions. And the taxpayers pay the bill for most of it. To expect completely effective peer regulation within the framework of governmental oversight in such an environment may be a bit unrealistic. Still, to paraphrase the commercial, we've come a long way . . . but we still have a long way to go.

ACKNOWLEDGMENT

In preparing this article the author received considerable information and excellent cooperation from both the American Institute of CPAs and the National Association of State Boards of Accountancy. While these organizations are unlikely to agree with all of the author's view of events, this assistance is appreciated and acknowledged.

NOTES

1. For other fairly current articles indicating the nature and extent of this publicity see, for example, Lee Berton, "Small CPA Firms' Liability Rates Soar: Plight Tied to Malpractice Suits Against Big Eight," *The Wall Street Journal*, November 19, 1985; and Richard Koenig, "ESM's Former Auditor Pleads Guilty to Felony Charges, Will Help In Probe," *The Wall Street Journal*, December 18, 1985.

2. For background information on the U.S. General Accounting Office, see: Richard E. Brown, *The GAO: Untapped Source of Congressional Power* (Knoxville: The University of Tennessee Press, 1970); Joseph Pois, *Watchdog On the Potomac: A Study of the Comptroller General of the United States* (Washington, D.C.: University Press of America, Inc., 1979); and Frederick C. Mosher, *The GAO: The Quest for Accountability in American Government* (Boulder: Westview Press, 1979).

3. This article does not attempt to analyze the more basic issue of the *need* for *any kind* of regulation of the accounting profession. It assumes that the need for such regulation exists. In the public sector the need for regulation has been analyzed and answered affirmatively in a number of "sunset" audit reports conducted by or for state auditors. In these reports the auditors were asked to assess the need for and success of various regulatory bodies, including the state boards of accountancy. See, for example, the work done in the State of Kansas, the Legislative Division of Post Audit, *Sunset Audit Report: Board of Accountancy and the Accountancy Advisory Council*, September 1980. For a more general discussion of sunset auditing see Glenn E. Deck, "Sunset Auditing," *The Internal Auditor*, December 1980. Some references on the broader issue of regulation of the accounting profession are included in John C. Burton, "A Critical Look at Professionalism and the Scope of Services," *The Journal of Accountancy*, April 1980.

4. While a staggering amount of dollars in absolute terms, the $100 billion figure is actually less than 10 percent of an annual federal budget which now exceeds a trillion dollars.

5. It must be remembered again that the March 1986 GAO report was but the most recent in a series of such reports. Congressional hearings had been held before the Brooks Subcommittee in November 1985 on the GAO report dealing with the role of the IGs in quality reviews. The March 1986 issue of the AICPA's *Journal of Accountancy* contains a report on the AICPA-NASBA National Conference, held in January 1986. At that conference many of the issues involved in the past and forthcoming GAO reports were discussed, along with the upcoming hearings of the Brooks Subcommittee.

6. The importance of auditing for compliance with legislative and program intent are the focus of the volume by Richard E. Brown, et al., *Auditing Performance In Government* (N.Y.: John Wiley, 1982).

7. Recommendations are summarized from the GAO report and the report of the Brooks Subcommittee, and the AICPA Audit Quality Task Force Report (specific citations shown under references).

8. For a discussion of governmental accounting in the curriculum see, for example: John H. Engstom and Mortimer A. Dittenhofer, "Accounting In the Public Administration Curriculum," *The Government Accountants Journal*, Summer 1986, Vol. XXXV, Number 2; and John H. Engstom, "Public Sector Accounting Education," paper presented to the business meeting of the Government and Nonprofit Section of the American Accounting Association, August 16, 1984.

9. This information was gathered during a visit to NASBA offices in New York on January 22, 1987, and by a phone call to the AICPA Washington, D.C. offices on January 26, 1987.

10. An August 18, 1986 issue of *Fortune*, using SEC data, stated that between 1980 and 1985 the Big Eight firms paid out over $175 million in settlements and judgments over disputed audits.

11. Representative Brooks has repeatedly issued this warning. See, for example, his statement at the March hearing on the GAO audit. This point was discussed at some length by John Lordan, then with the Office of Management and Budget, at the Cherry Hill Colloquium. Also, The Association of Government Accountants has considered a certification in governmental accounting and auditing on several occasions over the past several years. See, for example, Jack Moore, "Certification Revisited," *The Government Accountants Journal*, Fall 1986, Vol. XXXV, No. 3, pp. 44–47.

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PERSPECTIVES

OPINION LEADER

HISTORICAL PERSPECTIVE

LEGAL PERSPECTIVE

REFERENCE GLOSSARY

BOOK REVIEWS

Opinion Leader

THE SEC AND THE PROFESSION:

AN EXERCISE IN BALANCE

Robert J. Sack

What I would like to do is to give you my perspective on the role of the SEC in the regulation of the accounting profession. Please understand my stress on that qualifying phrase "my perspective." The standard disclaimer I am obligated to give you as a matter of SEC policy absolves the Commission and all my friends on the staff of the SEC from any responsibility for the views I may express here. But I want to go beyond that disclaimer: for the moment I would like to step out of my role in the Enforcement Division at the SEC and share with you my personal perspectives on this matter.

The perspective I want to share with you has been shaped by my understanding of the historical development of the SEC, and my understanding and observations of the development of the profession during my 25 years at work. What I want to bring you today is one individual's composite observation on the role of the SEC in the regulation of the profession.

Research in Accounting Regulation, Volume 1, pages 167–175.

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From time to time I have had the opportunity to learn something about the history of the establishment of the SEC. I have been deeply impressed by the work of the deliberating Congressional committee in 1933 as they considered the form of the obviously required securities legislation. It is my understanding that the committee was considering the fair play-caveat emptor plan, which we now call "full disclosure," and they were deliberating on various proposals for implementation of that full disclosure process. They heard proposals for the establishment of a federal chart of accounts and a federal audit corps. After all, what better way to assure fair play in the markets than to require uniform accounting and reporting by every company, and to assure adherence to those requirements by a governmental audit.

However, the committee also heard testimony about the problems which had developed because of the rigid accounting requirements which had previously been established by federal legislation for railroads. The committee members heard testimony explaining that in that situation, the mandated chart of accounts had the disadvantage of being stultifying while not providing any discernible advantages to railroad reporting. Also, the committee heard testimony that the government would find it difficult to obtain sufficient numbers of qualified people to staff the proposed federal audit corps and that without those qualified people in the requisite numbers, the proposed full disclosure program would founder.

Based on those Congressional hearings, the securities laws were written broadly, without detailed accounting provisions. Instead, the Securities and Exchange Commission was established with the obligation to promulgate regulations prescribing the form of the balance sheets and income statements that were required to be filed according to the laws. The newly-established Commission did establish the form of the financial statements required, but decided against promulgating detailed accounting rules. Instead, according to one Commissioner, a "governmental agency should frame rules to govern the exercise of professional functions only when the need for such rules has been shown to be of real public importance. Mere preference of the administrative agency for one form or one method is not sufficient reason for taking the formulation of principles and practices out of the hands of the members of a profession, and where the profession gives evidence of its capacity and willingness to develop and apply proper methods without evasion or undue delay, it should be encouraged to take on the responsibility." That citation, from then Commissioner Mathews in 1937 (cited in the Third Edition of Rappaport) expresses a philosophy which has been followed, by and large, to the present day.

But the Commission has not been reluctant to exercise its standards-setting authority when necessary. In the 1939 Interstate Hosiery Mills matter (again cited by Rappaport), the Commission commented on the expert testimony of practicing CPAs and said that "the Commission must in the end weigh the value of all expert testimony against its own judgment of what is sound accounting practice."

ASR 4, issued in 1938, perhaps captures both points of view. It says that financial statements would be presumed to be misleading if they were prepared using accounting principles that had no "substantial authoritative support." But it also concluded: "In cases where there is a difference of opinion between the Commission and the registrant as to the proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves [that question was the basic issue addressed in the ASR] only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other official releases of the Commission, including the published opinions of its chief accountant."

I am of the opinion that AAER, read in context, makes it clear that the Commission intended that the authorities in the profession would have the opportunity to establish GAAP—but the Commission and its Chief Accountant would have a significant say, perhaps the final word, in that process.

The experience of the Commission and the profession since 1938 has confirmed the wisdom of that original decision. The profession has been able to muster substantial resources for efforts to set standards of accounting principles, with 40 full-time technical staff people presently employed with the FASB. And of course that standard-setting effort by the FASB is just the most visible part of the overall effort by the profession. The Board relies heavily on the input of its task forces, staffed by experts from practice and industry. Would those resources be so freely available to the Commission? Perhaps. Are they readily available through the private sector to the FASB? Obviously.

In my judgment the question of who should set the standards is more than a simple resource question. The determination of accounting standards is subject to significant conflicting pressures, and it seems that as the stakes have risen, so have the pressures. Every student of the profession recognizes the forces that came to play in the investment-credit debate, the poolings-purchase debate, and the debate over oil and gas accounting. But in the future I believe that accounting historians will note with great interest our current discussion over pension accounting, accounting for greenmail, and accounting for financial instruments. The Commission was wise (perhaps even prescient) in 1938 in their decision to require a resolution of those conflicting pressures within the private sector. That structure forces the private sector to resolve its own conflicts, and minimizes the special interest pressure which might otherwise be brought to bear directly against the Commission. The combination of a primary responsibility focused on the private sector with an oversight responsibility exercised by the Commission has proven to be both conceptually and practically sound.

The Commission's authority over the auditing side of the full disclosure program is also supervisory—perhaps more directly so than with regard to accounting. The securities laws say simply that financial statements filed with the Commission must be certified by an independent public or independent certified public accountant. The licensing of public accountants and certified public accountants has, from the beginning, been a function of the states and nothing in the securities laws changed that function. However, it would be illogical to say that the SEC is responsible for the health and welfare of the full disclosure process, but also argue that the SEC should not have an oversight authority over the auditing of the full disclosure financial statements.

Any discussion about the Commission's expressed and implied authority over auditors and auditing standards must begin with a perspective on two very important cases. In *Touche Ross & Co.* v. *SEC* (609 F.2d 570 (1979)) a member of the Big Eight challenged the Commission's authority to discipline CPA firms, arguing that the right of discipline was restricted to the licensing agency and was therefore beyond the authority of the Federal Government and the SEC. The Commission in turn argued that it was entitled to (and in fact obligated to) protect its interests in the full disclosure process, and to do so it was entitled to (and obligated to) discipline any who abused that process. The 2nd Circuit Court held that the Commission did have the authority to establish rules to regulate its own processes and that under those rules it had the authority to discipline accountants who practiced before it. Specifically, the Court said: "Rule 2(e) thus represents an attempt by the SEC essentially to protect the integrity of its own processes. If incompetent or unethical accountants should be permitted to certify financial statements, the reliability of the disclosure process would be impaired."

Another case which bears on this matter is the *SEC v. Arthur Young & Co.*, (590 F.2d 785 (1979)). In that case the Commission sought to enjoin a number of individuals connected with Jack Burke, an oil and gas venture promoter, and the CPAs who had been associated with Burke's activities. In particular the Commission sought to enjoin the CPAs for their failure to find the fraud in which Burke and his associates had been engaged. The Court heard Commission attorneys argue that the auditors "should have done 'more' to reveal to investors the conduct of Burke," but the Court ruled against the Commission. The Court concluded that "on the facts of this case, AY discharged its professional obligations by complying with GAAS in good faith. The trial court's findings, which are not clearly erroneous, established beyond dispute that AY and its auditors conformed to this standard." The Court refused to allow the SEC to hold the auditors to a posteffective standard of performance, rather than to the norm of practice at the time.

I believe, the message from those two cases is this: to protect its processes and to discharge its obligations under the Securities Laws, the Commission has the right and the duty to discipline accountants who practice before it. The standard to be used in measuring the performance of a practicing accountant is the standard of the practicing profession, Generally Accepted Auditing Standards. Strictly speaking, Generally Accepted Auditing Standards are those 10 broad guidelines promulgated many years ago by the AICPA. But in addition, GAAS includes those implementation-directed statements now published by the Auditing Standards Board which form the codified Statements on Auditing Standards. The Commission's Chief Accountant monitors the work of the Auditing Standards Board and comments on the Board's agenda and on specific statements. The Chief Accountant is in a good position to influence the development of those individual statements, simply because of the authority of his position. (The development of SAS 16 is an interesting example of the exercise of that persuasive ability.)

But there is more to GAAS than just the pronouncements from the AICPA and its Boards and Committees. GAAS comprehends auditing-directed articles and texts—*Montgomery's* being a good example—and of course good practice. I believe that GAAS also includes the lessons which can—and should—be learned from the statements about good and bad auditing practices, as outlined in the enforcement releases published by the Commission, detailing actions against practicing accountants. Those releases address the implementation of one or more of the 10 Standards as applied to the facts of a specific case.

That understanding of Generally Accepted Auditing Standards—the 10 Standards themselves, the Statements from the AICPA's auditing arm, good writings and good practice, and the SEC's case-by-case enforcement actions—is in my view entirely consistent with the court's use of "generally accepted auditing standards" in the Arthur Young matter.

Therefore, as with GAAP, a system has been established whereby the private sector practitioners have the first responsibility for the development of GAAS, subject to comment and oversight by the SEC and its Chief Accountant. That division of responsibility serves everyone well because it puts the primary burden on the practitioners who have the resources and the detailed experience to discharge that job; but it puts an oversight responsibility on the Commission so that a wider focus can be brought to bear.

In essence my perspective on the role of the SEC and the regulation of the profession is simply this: the Commission has the ultimate authority and responsibility to establish both accounting principles and auditing standards, but has wisely allowed the front line practitioners to exercise the front line effort in both areas. That arrangement has served the public well, in large part because each side of the balance between front line effort and oversight supervision has done its job well. The profession *has* stepped up to its responsibilities and established the appropriate practice standards, although sometimes those forward steps have been only as a result of pressure from the Commission. In my view, it is vitally important for all that the balance be maintained.

Let me turn now to several specific issues, more directly from my experience in the Enforcement Division, which raise some concerns about that balance.

In the area of accounting principles I am concerned that we are seeing some erosion from the edge of the practice, specifically in the area of revenue recognition. We have had a rash of revenue recognition cases which suggest that CFOs and CPAs are finding it more and more difficult to determine when a sale is a sale. When a Company was involved in heavy industry it was relatively easy to determine when a product was sold—a ton of steel was clearly sold when it was dropped in the customer's yard. But it has become much more difficult to determine the appropriate time for revenue recognition for the sale of services or intangibles. Consider the practical problem of measuring the completion of the earnings process for a sale of semi-customized computer software. Also the notion of "bill and hold" sales has somehow taken root, even though those transactions by definition raise serious concerns about the passage of risk. And finally, "sales" to tax shelter entities raise very serious concerns for practitioners because the buyer is often not interested in the product per se, and so the normal armslength negotiation for price, terms, and delivery may be lacking. See, for example, Accounting and Auditing Enforcement Releases 58, 59, 100, and 108.

In each of those revenue recognition enforcement actions the SEC has relied on APB Statement 4 as its GAAP authority. That venerable pronouncement, with its interesting discussion of the earnings process and its pragmatic reliance on collectability, is an adequate authority for prosecution of those cases. But, given our experience for the last several years, its seems to me that the profession would do well to develop implementation guidelines on revenue recognition for the kinds of revenue transactions we see today. I believe that new implementation standards are required regarding revenue recognition in order to restore the balance between the SEC's enforcement activity and the professional standard-setting activity.

Similarly, I have been concerned over the number of times the SEC has been involved in discussions with registrants and their auditors debating the form and substance of a major transaction. There have been several enforcement cases on this theme (see AAER 48, and 101) and there have been a number of cases where the Chief Accountant has been forced to step in and express his view as to the substance of a transaction (see the restatement implemented in 1984 by Financial Corporation of America).

I would not argue for further standard-setting efforts to deal with substance and form, either in general or for specific situations, because that act in itself would erode the professionalism of accounting. We cannot be proud of the fact that the FASB found itself forced to issue SFAS 68. In my view the practicing profession should have taken a strong stand against the development of liberal accounting for research and development arrangements, so that no standard-setting effort would have been required. I believe that to restore the balance in this area, individual practicing professionals and the major firms must simply apply the transcendent notion of substance over form against each new accounting gimmick they see. We need no new rules here, we simply need stronger professional practice.

In the auditing area the profession has been quite active, and the Commission's pressure has advanced standards and practice—although it is also true that Congressional interest has had some influence on that process. Consider for example the issue of finding client fraud.

The Commission has brought a number of enforcement actions against accountants for the failure to find fraud, beginning with the McKesson and Robbins case in 1940. And there have been a number of similar SEC enforcement actions, all holding the auditor to the standard of "healthy skepticism." More recently, the Commission settled a case against a partner in a major CPA firm alleging that the partner failed to exercise adequate skepticism in the face of substantial red flags. The Commission's release stated, "Here the auditors had in their possession conflicting information on a material assertion. Rather than adequately extending their auditing procedures to ascertain the true nature of the questionable transactions, the auditors reconciled material irregularities on the basis of implausible representations." That case (AAER 109A) is an important, comprehensive statement of the Commission's views on the auditor's responsibility for finding fraud.

In public statements the profession has been reluctant to acknowledge significant responsibility for finding client fraud. We have heard that there has been an "expectation gap." That public posture is clearly influenced by the profession's legal advisers, not without reason. The 1977 Statement on the subject (SAS 16) charges the auditor with the responsibility to plan the engagement to look for fraud that might be material to the financial statements, and in particular to be sensitive to the possibility of management fraud where the warning signals put the auditor on notice of the possibility of fraud. But that same Statement also includes defensive words which articulate the limitations inherent in the audit process.

I have been concerned that the legally defensive words in the profession's written statements could confuse some in practice and minimize their sensitivity to the possibility of client fraud. Auditors who lived through the 1960s and remember US Financial, Penn Central, Westec, and National Student Marketing will surely retain a fraud sensitivity. But it is possible that those who have joined the profession since that time may not share that perspective. As a result of the interaction of the SEC's Chief Accountant and the Auditing Standards Board, and as a result of Congressional interest in a number of current financial disasters, the profession is now rethinking SAS 16. You can be sure that the Chief Accountant's Office will be watching that new drafting process with interest.

The Commission has been involved in a dialogue with the profession on another auditing matter which is a relatively new development. As you may be aware, the AICPA SEC Practice Section requirements specify that every SEC engagement must be subject to a Concurring Partner Review. The concept was introduced when the Practice Section was formed, but the details of how a Concurring Partner Review was to be conducted were left quite open. The Chief Accountant's Office has pressured the Practice Section to be more specific about the requirements of the Concurring Partner Review and to insist specifically that the concurring partner go beyond conversation and a simple reading of the financial statements—and get into the audit workpapers.

The Enforcement Division has brought several cases against CPA firms where one part of the action had to do with the Concurring Partner Review. In one case the Commission expressed concern that the firm's policy of switching responsibilities between the engagement partner and the concurring review partner negated the independent challenge required of the Concurring Partner Review. And in another case, the Commission alleged that the engagement team and the firm permitted the Concurring Partner Review to be delayed, and ultimately performed after the report was issued, thereby negating the impact of that review. (See AAER 62 and 78.)

Together, those enforcement actions and pressure from the Chief Accountant's Office have changed audit practice: in September, 1985 the SEC Practice Section revised its requirements to require more specific duties of the concurring reviewer. And, you can be sure that there will be continued pressure to assure that the idea of an independent challenge by a concurring partner is effectively implemented in practice.

I believe that our enforcement actions against registrants and public accounting firms, and the participation of the Chief Accountant's Office in both auditing and accounting standard setting, demonstrate that the SEC has every intention of fulfilling its responsibilities under the Securities Laws and maintaining its part of the balance between the regulators and the profession. I believe it is most important that the profession step up to its responsibilities and maintain its share of the balance, in order to keep this 50-year-old relationship on an even keel.

I am not arguing for more regulation, I am arguing for more self-regulation. The profession has the vehicle to regulate accounting standards; we simply need to make sure that the vehicle works efficiently and effectively. The profession has the vehicle to regulate auditing standards; again, the burden on the profession is simply to make sure that the vehicle works effectively and responsively. There is a third leg to the self-regulation stool, that of disciplining professionals. At the moment, that aspect of the regulatory scheme has been left to the SEC because the profession has not found a way to deal with self discipline effectively. Again, I'd argue that the profession must move to establish a balance in the area of discipline and to undertake a more effective, more visible self-disciplinary program. I believe I can make a strong case that the profession would be better off with more regulation by its peers, and less regulation by lawyers in a legal process. I believe I could make that case convincingly based on my experience in the Enforcement Division, but that is a subject for another day.

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Historical Perspective

INFORMING STOCKHOLDERS: A JOB FOR PUBLIC ACCOUNTANTS IN PREFERENCE TO THE FEDERAL TRADE COMMISSION

Alexander S. Banks

(This letter originally appeared in the *New York Herald Tribune*, November 4, 1925 and was reprinted in the Certified Public Accountant, January 1926. Banks was a former President of the American Society of CPAs which was later merged into the American Institute of CPAs.)

Professor W.Z. Ripley of Harvard University suggested last week at the annual meeting of the Academy of Political Science an enlargement of the scope of the Federal Trade Commission to protect the millions of investors who, he said, were helpless at the present time.

The army of investors in securities of corporations has been growing

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at an enormous rate during the last few years. Rarely do any of the investors take any interest in the management of their companies; instead they leave the management in the hands of a controlling group, generally the representatives of the larger individual stockholders.

Professor Ripley calls attention to what he terms the dangerous tendency in corporation affairs resulting from the wide diffusion of ownership and the lack of or inability of the mass of this ownership to supervise the affairs of their companies. His remedy is for more publicity of accounts as a check upon otherwise unrestrained control. His idea is to have the Federal Trade Commission examine the accounts and exercise supervision that is so lacking at present on the part of stockholders. I can say on behalf of myself and other accountants that publicity of accounts is generally an effective means of supervision on the part of stockholders and the public. It is one thing, however, to require publicity of accounts and another to teach stockholders to use this information. I have known hundreds of investors, large and small, and rarely have I seen one who reads more than the short transmittal letter forwarding the corporation's report to him. As long as the stockholder receives his expected dividends he cheerfully assumes that things are managed properly, just as in governmental affairs, as long as there are no public scandals or criminal mismanagement, the citizen feels that the government is running smoothly.

Great Britain, which has a longer history of experience with corporations than we, has reached the conclusion that the best method for the stockholders to exercise supervision over the affairs of their companies is to require the companies to appoint a disinterested auditor responsible, not to the officers or directors, but to the stockholders. It is his duty to see that the accounts of the company are correctly stated and explained to the stockholders. This is certainly a better method, in my opinion, than burdening a Federal commission with the supervision of the hundreds of thousands of corporations in the country. There should be a requirement, in my opinion, that every corporation having more than 10 stockholders furnish, at least annually, a financial report to the stockholders, and this report should be certified as correct by a responsible auditor. This proposal has been made repeatedly for many years. There was a time when the objection was raised that there were too few trained auditors in the country. Now, however, there are approximately 9,000 public accountants whose fitness has been certified to by the various states and who are authorized to practice as certified public accountants. In certifying to accounts of companies, CPAs are only in a minor sense acting for the officers of the company who employ them. They feel a moral responsibility to the stockholders and the general public by whom their certified reports are read, even if not acted upon. This responsibility which the certified public accountants have assumed as a matter of ethical duty should be made a matter of legal responsibility.

The writer does not agree with the oft-repeated suggestion that financial reports of companies be standardized. It may be all very well for some corporations to furnish the general public with very detailed analyses of their transactions. In the case of most companies, too much detailed information may do great harm by furnishing competitors with confidential information. If a Federal commission were to supervise the acts of our hundreds of thousands of companies in various lines of business, great injustice might be done to many of them if detailed information of their affairs were given to the general public—which, of course, includes competitors.

How to give full information to those who are entitled to it, and at the same time withhold details from those not entitled to it, is a problem which we accountants have been pondering for years.

No Federal commission would, in my opinion, be able to judge in each particular case what information should, and what information should not, be made public. After all, too much information furnished for the benefit of particular stockholders may actually do them more harm than good, because the information they obtain will also be obtained by present or prospective competitors of their company. One suggestion I might offer to meet this difficulty is for the auditor of the company to present his report in person after the annual meeting of stockholders. Interested stockholders could ask for more details than were furnished, and the auditor could then either furnish this information to all the stockholders assembled or, if that is making the information too public, he might furnish it in confidence to the one stockholder who is interested. If the management objects to his furnishing the requested information to anyone, the reason for withholding it could be stated at the meeting, and the stockholders could then judge whether or not to overrule the decision of the management. This, in my opinion, would certainly be a better remedy, as far as protection of corporate stockholders is concerned, than to have overworked and underpaid government officials assume the stupendous task of supervising our hundreds of thousands of corporations.

Legal Perspective

SEC ENFORCEMENT OF INSIDER TRADING LAWS

David W. Burchmore

I. SHAD's CRUSADE

The recent spectacular developments in the case involving arbitrager Ivan Boesky are only the latest in an escalating series of actions taken by the Securities and Exchange Commission (SEC) to curb the practice of insider trading in the past few years. The SEC's campaign against insider trading can largely be attributed to a personal crusade by its former Chairman, John R. Shad. Between 1966 and 1980, the SEC had brought only 35 insider trading cases—an average of some two-and a half per year. But when Shad left his position as Vice Chairman of E.F. Hutton to head the SEC in mid-1981, he promised to make insider trading a top priority of his administration and "to come down with hobnail boots to give some shocking examples to inhibit the activity." In 1982, 20 cases were filed, and 24 the following year. By the end of 1985, a total of 77 cases had been

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brought—a number equal to all the insider trading cases in the SEC's entire history prior to 1982. Enforcement activity was stepped up even further in the fall of 1985 because of the increasing occurrence of stock price run-ups preceding buyouts, mergers, and takeovers. Insider trading litigation now comprises 10–15% of the SEC's case load, and more than 30 actions were filed during 1986.

According to former SEC Enforcement Director John M. Fedders, the SEC "initiated the insider trading program to raise the level of risk and to increase the public consciousness." More recently, SEC Commissioner Grundfest has declared that its actions show the SEC is not only "willing to go to the heart of Wall Street," but that it "will do cardiac surgery whenever the evidence so warrants." Indeed, many observers think that the SEC is following the "big bang" approach to enforcement, bringing large, spectacular cases against prominent traders and officials in order to derive the greatest impact from its efforts.

In the course of doing so, the SEC has not only increased the number of cases, but has also pressed hard to expand the scope of the prohibition against insider trading. The SEC wants not only to deter the practice, but to reshape the contours of the law. The greatest obstacle to achieving the latter goal is not Wall Street, but the Supreme Court. The problem is that Congress has never passed a law which explicitly prohibits insider trading, or even defines it. The Securities Exchange Act of 1934 merely prohibits the use of "any manipulative or deceptive device or contrivance," and the SEC's own Rule 10b-5, promulgated thereunder, simply makes it unlawful to engage in any practice that "would operate as a fraud or deceit upon any person" in connection with a stock trade. It was not until 1961 that the SEC announced, in the *Cady, Roberts* case, that failure to disclose material, nonpublic information before trading was one form of impermissible "fraud or deceit."

But the true wellhead of insider trading litigation was a decision handed down by the Second Circuit in 1968. In *Texas Gulf Sulphur,* the appeals court enunciated the rule that "anyone in possession of material inside information must either disclose it to the investing public or must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed." Of course, this was judge-made law, and subject to refinement by the Supreme Court. The rule of *Texas Gulf Sulphur* was subsequently restricted by two major decisions. First, in the *Chiarella* case of 1980, the Supreme Court held that a financial printer who traded on the basis of inside information gleaned from documents in his shop was not guilty, because he did not owe a duty either to the shareholders of the companies involved or to the investing public in general, and was not bound to disclose the information he had learned. Then, in the *Dirks* case of 1983, the Supreme Court held that a financial analyst who passed information to his friends concerning the Equity Funding scandal had committed no actionable violation, because the insider (or tipper) who originally gave the information to Dirks (the tippee) had derived no personal benefit from doing so. Dirks and the others could not be held liable in the absence of some breach of fiduciary duty by the insider/tipper from whom their information came.

The one bright spot for the SEC in these cases was the suggestion in Chief Justice Burger's dissent in *Chiarella* that the printer should have been liable, even without any fiduciary duty to the corporations involved, simply because he had "misappropriated" information from his employer—information which was not his to use, regardless of its source. The majority did not decide whether this "misappropriation" theory would work, because it had not been raised at the trial or considered by the jury. However, three other Justices (Brennan, Blackmun, and Marshall) agreed in principle.

A brief comment in Justice Powell's majority opinion in the *Dirks* case, suggesting that Dirks was blameless because he did not "misappropriate or illegally obtain" the Equity Funding information, gave further hope to the SEC and indicated that a majority of five votes might be ready to approve the "misappropriation" theory when it was properly presented to the Court. However, now that Burger, the chief proponent of the misappropriation theory, is gone and Scalia, a conservative jurist and a strict constructionist of the law, has joined the Court, the future is less certain. On December 15, 1986, the Court agreed to review the case involving R. Foster Winans, in which the Second Circuit upheld a *Wall Street Journal* reporter's conviction on the grounds that he had "misappropriated" information from the *Journal's* upcoming "Heard on the Street" column and passed it on to his friends. In a dissenting opinion, one member of the three-judge panel argued that the ruling extended the sweep of the insider trading laws "beyond all reasonable bounds," and that the publication schedule of the *Journal* column "simply is not the special securities-related knowledge implicated in the misappropriation theory." What the new Supreme Court does with this case will be fascinating because, if affirmed, it would mean that the law can be violated by one who is not an insider of the corporation and who trades or tips on the basis of information that is arguably not material to the company involved.

In the meanwhile, SEC Enforcement Director Gary Lynch insists that the SEC's enforcement program has not been seriously impaired by the *Dirks* and *Chiarella* decisions. Indeed, the SEC has had some notable successes, such as the case involving former Deputy Secretary of Defense Paul Thayer wherein the SEC argued that even though he did not trade on the basis of inside information, or receive monetary payment therefore, he derived a personal benefit from giving the information to a woman with whom he had a "close personal relationship."

A substantial boost was given to the SEC's enforcement efforts in 1984 when Congress passed the Insider Trading Sanctions Act. Although the Act still did not furnish a definition of insider trading, it did provide for a civil penalty of up to three times the profits derived from the trade, in addition to disgorgement of the profits themselves. The Act also increased the maximum criminal sanction for any willful violation of the Exchange Act from $10,000 to $100,000, on top of the maximum jail term of five years. The SEC has subsequently indicated that it will seek ITSA sanctions in all cases involving post-1984 facts, and it sought the triple damage penalty in more than a dozen cases during 1985.

In the wake of the Boesky scandal, several Congressmen have promised to hold further hearings on insider trading, and the wide publicity given to the Boesky affair may provide the final impetus needed to pass legislation specifically defining and outlawing the practice. The SEC continues to oppose such a law on the grounds that the currently vague prohibitions against fraud allow it to do a more effective job of deterring "the infinite variety of devices by which undue advantage may be taken of investors and others." Nevertheless, critics of the SEC wonder why insider trading should remain simply whatever the SEC chooses to say it is. They point to the paradox of the Boesky case itself: even as the SEC prepared to fine Boesky for his violations, it allowed one of his funds to sell $440 million worth of stock before the news of his case was made public. By almost any logic, Boesky's sell-off with advance knowledge of his situation would seem as improper as his earlier trades. Yet, under current law, he did not "misappropriate" any information and, apparently, the SEC decided that the fact of his impending prosecution was not material to the value of stocks he sold.

II. DETECTION OF INSIDER TRADING

Both the SEC and the various exchanges have in recent years increased their efforts and dramatically improved their ability to detect insider trading when it occurs. The exchanges have spent millions of dollars on sophisticated computer equipment designed to spot unusual trading patterns and to identify the participants. In testimony before Congress last year, New York Stock Exchange Chairman John Phelan noted that the exchange had budgeted over $8 million for market surveillance in 1986, with more than $3 million of that dedicated to automating its audit and surveillance systems.

The NYSE has three different systems for monitoring trades. Stock

Watch monitors trading as it happens and alerts the exchange to unusual trading activity. ISIS, the Intermarket Surveillance Information System, is a database that stores months of trading data along with flexible programs that analysts can use to search for suspicious trading patterns. Finally, ASM, the Automated Search and Match system, is a database comprised of publicly available information on close to 500,000 business executives and over 75,000 companies and subsidiaries. Out of the 15 million trades in 1985, the NYSE analysts reviewed about 6,000 unusual price or volume variations. About 10 percent of those looked suspicious, and a total of 65 were finally referred to the SEC for investigation.

The American Stock Exchange also has state-of-the-art computer systems and databases for monitoring securities and options trading. It was the AMEX surveillance department that first alerted the SEC to a series of unusual trades preceding the publication of the *Wall Street Journal* column "Heard on the Street," and thus initiated the investigation leading to the conviction of Journal reporter R. Foster Winans. The NASD, too, maintains audit trails of trading in over the counter stocks.

The exchanges are thus important sources of information for the SEC, but the Commission has also built up its own surveillance technology. Within its headquarters in Washington is the infamous "ticker room," containing video terminals linked to the various exchanges and to the SEC's own mainframe computer which fills nearly half a floor. According to a former general counsel of the SEC, now in private practice, the SEC wants the room to remain "shrouded with mystery. They want to create an aura that big brother is in there and can find you." It was in the ticker room that the SEC first noticed unusual patterns in several stocks linked to former Deputy Secretary of Defense Paul Thayer, which they followed up by checking on trades made by some of his friends. The SEC's computer is programmed to show, among other things, how many shares a particular brokerage firm has sold, the price, and the percentage of market volume the sales represented. In addition, since 1973, the SEC has been collecting microfiche copies of nearly every stock transaction on the American and New York Stock Exchanges. The files are listed chronologically by date and company. Thus, the SEC can track every buyer and seller of a given stock on a given date for the past 14 years.

Key to the surveillance programs at both the SEC and the exchanges are the warning parameters programmed into the computers' memories. Based on a stock's previous performance, the computers will flag any unusual swing in price. If such moves occur prior to significant corporate announcements (such as a pending merger or lawsuit), insider trading may be suspected and the SEC will go into action. First, it calls the exchange to see which brokers executed the trades. If only one or two were involved, the Commission calls their compliance departments to find out who the customers were, where they work, what their net worth is, and whether they have any connections with the company whose stock was traded. The brokers are required by Section 17 of the Exchange Act to answer these inquiries, and they invariably comply. The SEC may then call the customer and, after giving certain warnings, ask for a voluntary explanation. If the responses are not credible, the SEC can proceed with a formal investigation, including the issuance of subpoenas to compel sworn testimony.

According to the head of the SEC Surveillance Department, customers rarely admit that they based their transactions on non-public information. In a recent address to the National Investor Relations Institute, SEC Commissioner Grundfest cautioned those who claim to be trading on the basis of innocently overheard inside information that any "casual encounter" story is fundamentally implausible. He compared such claims to claims by children that the "dog ate my homework," and asked how many people would really invest a substantial portion of their net worth in highly volatile stocks or options based on something overheard from two total strangers. "If you are going to claim 'the dog ate my homework,' it is probably a good idea to at least own a dog" and many defendants the SEC encounters with this story do not. The one notable exception would be Oklahoma University football coach Barry Switzer, who successfully persuaded a jury that he had not been tipped, but had simply overheard certain information while sitting near the former president of Texas International Corporation and his son in the stands at a track meet. But this is the only insider trading case the SEC has lost in recent years. Apparently, Switzer had the dog.

As the *Levine* and *Boesky* cases have demonstrated, the SEC is also beginning to employ the kind of surveillance techniques that one would associate with other criminal investigations—wiretapping, bugging, tracing of telephone records, and the use of plea bargaining to elicit information about co-conspirators. Various news sources report that the SEC caught Boesky by combing through Levine's telephone records. News reports on the Boesky affair indicate that Boesky not only had his phone tapped, but was personally wired for sound. In cutting a deal with the SEC, Boesky agreed to point the finger at other highly placed stock traders in return for a smaller fine and the promise of a shorter jail sentence.

Perhaps the most bizarre twist of all is the suggestion made early last year by SEC Chairman Shad that the Commission might begin using money disgorged in insider trading cases to pay rewards or "bounties" to informants for tips about the misuse of inside information. Tips have always been an important source of leads for the SEC—witness the *Levine* case itself, which reportedly began when the New York office of Merrill Lynch received an anonymous letter from Caracas stating that two of its brokers there were trading too successfully in takeover stocks. After tracing the orders to the Bahamian branch of a Swiss bank, Merrill Lynch alerted the SEC. However, the deliberate use of paid informants begins to make the Commission look more like the FBI than the SEC.

It is important to realize that the SEC has the option to refer insider trading cases to the Justice Department for criminal prosecution. Both the SEC and the U.S. Attorney's Office indicated at the ABA convention last year that they are much more likely to initiate a criminal action if they see perjury or obstruction. SEC Commissioner Grundfest predicts that criminal referrals will become more frequent, and with good reason. "Violations of the securities laws are not crimes of passion. It is not a hot summer night in the Bronx and somebody decides, 'My god, I'm gonna go out there and do a 10b-5.' That's not the way it works. . . . People see opportunities to make money as a result of what is basically a fraud, a theft, a taking without permission. . . . There's no social gain in that kind of behavior in the marketplace."

SEC Enforcement Director Gary Lynch emphasized at the PLI Securities Enforcement Institute last year that people are "hanging themselves weekly, if not daily" by coming into investigations with a story. Lying to the SEC can add perjury and obstruction of justice charges to the insider trading count, and it can also help the SEC to make its civil case. If someone is found to have destroyed documents, it adds to the argument that he acted with the requisite intent to deceive, manipulate or defraud (scienter).

In order to avoid an investigation and prevent violations, certain precautionary measures are becoming routine. Many experts agree that public corporations and firms that serve corporate finance needs should adopt codes of conduct to bar trading on material, nonpublic information. A number of companies have also taken the approach of requiring that all insider trades in company stock be cleared through their general counsel's office. Firms providing legal and financial services should have a "full scale" written policy that is periodically updated and circulated. Broker/dealers have a duty to supervise their sales people as well. In the last two years, the SEC has brought numerous cases against firms and their managers for the failure to supervise.

III. INTERNATIONAL ENFORCEMENT PROBLEMS

Detecting a possible instance of insider trading may not lead to the identity of the responsible person if the trading was conducted through a foreign intermediary and information on the persons involved is shielded by the banking and business secrecy laws of the relevant country. This may not be a problem in countries such as Canada, where insider trading is a crime and where the Toronto and Montreal Exchanges both monitor and regulate trading by means which allow for cooperation with the United States. But an increase in trading through countries such as Switzerland has hindered the SEC's investigations.

The Commission in recent years has pursued various means for overcoming foreign blocking laws and is making slow but steady progress towards its goal. Since 1977, the United States and Switzerland have had a Treaty for Mutual Assistance in Criminal Matters that would permit access to Swiss banking records in certain cases—but only if the crime being investigated was also an offense under Swiss law. At present, Switzerland has a general prohibition against intentional fraud, but no law specifically aimed against insider trading as it is defined in the United States. This makes it exceedingly difficult to use the Treaty to pierce the Swiss secrecy laws. It took the SEC three years—from 1982 to 1985—to get information on several persons who traded through Switzerland prior to the Santa Fe International takeover by Kuwait Petroleum in 1981. However, the Swiss government has drafted a law against insider trading which is expected to be passed in 1987. Once that happens, the Mutual Assistance Treaty will be a more potent weapon for the SEC.

In the interim, the United States and Switzerland signed in 1982 a Memorandum of Understanding and the SEC entered into a private agreement with the Swiss Banker's Association whereby an informal Commission of Inquiry will review requests for information and give it to the SEC unless it appears that the customer either was not involved in the transaction or was not an insider. The first case actually prepared with the aid of information obtained through the MOU was filed by the SEC last August. The complaint alleged that a Lazard Freres financial analyst who worked on the RCA-GE merger tipped (among others) his father-in-law, who then bought 100,000 shares of RCA stock through a Swiss bank.

The Swiss Memorandum of Understanding was one of the principal achievements of former SEC Enforcement Director Fedders. Shortly after succeeding Fedders in April of 1985, Gary Lynch stated that obtaining further international enforcement agreements would be one of his top priorities. Since then, several advances have been made:

- In late 1985 talks were held with French authorities regarding their blocking laws;
- On September 9, 1985 the SEC received a letter from the Ontario Securities Commission stating that Canada's new blocking statute would not prevent cooperation in securities law enforcement;
- On May 23, 1986 the SEC and Japan's Securities Bureau signed a joint memorandum on procedures to facilitate requests for surveillance and investigative information on a case by case basis;

- On July 3, 1986 the United States and Great Britain executed a Mutual Assistance Treaty concerning the Cayman Islands, which refers explicitly to "insider trading" and "fraudulent securities practices" as activities to be investigated and prosecuted;
- On September 23, 1986 the United States and Great Britain signed a Memorandum of Understanding to improve the exchange of information between the SEC and the British Department of Trade (a mutual assistance treaty is to be negotiated in 1987);
- On December 10–12, 1986 securities regulators from the U.S., U.K., Canada, West Germany, Switzerland, France, Japan, Hong Kong, and Australia met in England to discuss ways of improving the exchange of information among regulatory agencies, and a series of bilateral agreements on insider dealing may ultimately be negotiated.

Reference Glossary

A SELECTED GLOSSARY OF SECURITIES OFFERING AND SEC ACCOUNTING TERMS

J.W. Martin

The study of the Securities and Exchange Commission has been impaired by esoteric terminology. Over several years of following SEC accounting developments, the author has collected many definitions of the terms that relate to the SEC or security offerings. The list below includes over 200 brief definitions that should prove useful to SEC researchers.

The glossary is intended as a quick reference source. Common accounting terms have been excluded because students can easily refer to the many excellent reference sources that discuss these terms. While the definitions are not exhaustive, they should prove useful, especially to students, by allowing one to quickly grasp the essence of the term. Toward this end, legalistic phrases have been avoided, where possible, in the hope of clarifying the word.

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ABORTED OFFERING. A securities offering that is cancelled or postponed for a period exceeding 90 days.

ACCELERATION. A practice whereby the SEC allows a registration statement to become effective immediately after a pricing amendment is filed, and therein forego the normal 20-day waiting period. Acceleration is granted at the end of the normal registration process after all deficiencies have been corrected and the registration statement is complete except for the pricing amendment. When the pricing amendment is filed, a new 20-day waiting period would commence unless the SEC grants the registrant's request for acceleration.

ACCOUNTING AND AUDITING ENFORCEMENT RELEASES (AAERs). Releases by the SEC that describe enforcement actions taken against accountants and auditors by the Commission. Some AAERs are relatively lengthy, describing the facts of the case, conclusions, and offers of settlement. Other AAERs, such as orders vacating temporary suspension of the right to practice before the SEC, may be very brief.

ACCOUNTING SERIES RELEASES (ASRs). Pronouncements issued by the SEC before April, 1982, which served one of several purposes: first, an ASR could amend an existing SEC regulation; second, an ASR could announce disciplinary action against an accounting firm; third, an ASR could describe policies to be followed by the SEC. ASRs have been superseded by Financial Reporting Releases (FRRs) and Accounting and Auditing Enforcement Releases (AAERs). FRR #1, issued on April 15, 1982, is a recorded compilation of the ASRs that the SEC wanted to keep in effect.

AFFILIATE. A person that controls, is controlled by, or is under common control with another specified person. See PERSON.

AGENT FOR SERVICE. An individual who is designated by the registrant to receive communications from the SEC. The agent for service is named in the registration statement.

AGREEMENT AMONG UNDERWRITERS (AAU). A contract among those underwriters who will attempt to market an issue of securities and assume the related risks. Among other things, the AAU gives the lead underwriter the authority to execute the underwriting agreement, negotiate the offering price, control advertising, make appropriate regulatory filings, and trade in the securities for the underwriters. The AAU should not be confused with the underwriting agreement.

ALL OR NOTHING UNDERWRITING. An agreement to distribute a securities issue wherein the underwriting syndicate agrees to sell all of the securities, or return all funds received to investors. As securities are sold, the funds are often placed in escrow until the final outcome is determined. The purpose of the agreement is to protect investors in the event the company does not collect enough funds to attain its objectives.

ALONGSIDE-THE-OFFER PURCHASE. A purchase of securities in which a party making a tender offer also buys securities of the target company on an exchange or in a private transaction. Such purchases are illegal since securities acquired in this manner would not be subject to the terms of the tender offer. See TENDER OFFER.

AMOUNT. A measurement characteristic of securities referring to the principal amount of debt securities, the number of shares of stock, or the number of units of other kinds of securities.

ASSESSABLE STOCK. Stock that can be resold by the issuer if the holder of the stock fails to pay any assessment levied thereon.

ASSOCIATE. An organization of which a person is an officer or partner, or is the beneficial owner of at least 10 percent of any class of equity securities.

A trust or estate in which a person serves as trustee or in a similar capacity, or has a substantial beneficial interest.

A relative or spouse of a person, or a relative of such spouse, who shares the person's home, or who is a director or officer of the registrant, or any of its parents or subsidiaries.

ASSOCIATION. A relationship between two persons (see PERSON) where one:

is controlling, controlled by, or under common control with the other, or

has, in common with the other, an official, such as an officer or director, who performs similar functions, or

shares in the profits of the other, or has a financial interest in the business of the other.

BACK DOOR LISTING. A method by which an unlisted company becomes listed on an exchange by purchasing or merging with a listed firm.

BACKLOG. Customer orders that a company has not filled, but which are expected to be filled in the future. Regulation S-K requires disclosure of a firm's sales backlog; however, the auditor generally would not give comfort to underwriters on information of this nature. See REGULATION S-K.

BEST EFFORTS UNDERWRITING. An agreement to distribute a security issue wherein the underwriters specify only that they will use their best efforts to market the securities. An underwriting syndicate often requires this type of agreement when dealing with small, unproven companies.

BLANKET PREFERRED STOCK. Preferred stock whose voting rights or other preferences may be fixed by the board of directors without a vote of existing common shareholders. Before allowing a public offering to become effective, state security examiners may require an undertaking (see UNDERTAKING) by an issuer that no blanket preferred stock will be issued during the registration period without the approval of common shareholders. Of course, such undertakings would be limited to situations where the preferred stock would have greater voting rights (in proportion to the number of shares of each class outstanding) than the common shares.

BLUE SKY LAWS. State securities laws that control the registration and sale of securities within a state. While blue sky laws generally are patterned after the federal securities laws, some state laws, unlike federal laws, seek to prohibit the sale of securities that are considered highly speculative.

BLUE SKY MEMORANDUM. A document submitted to various state security commissioners that accompanies blue sky filings. The preliminary memorandum lists those states where a preliminary prospectus may be circulated before the registration becomes effective, or where offers to sell may be made prior to the effectiveness date. The final blue sky memorandum is distributed when the registration becomes effective, and lists the states where the securities can be sold and the number of shares that can be sold in each state.

BRING-DOWN LETTER. A second comfort letter usually issued at the closing date of a registration. A "bring-down" letter normally states that nothing has changed since the issuance of the initial letter (the first letter is often issued on the date the underwriting agreement is signed). See COMFORT LETTER.

BRING-UP PROSPECTUS. A prospectus that has been updated. If a prospectus is still being used nine months after its effective date, the information contained therein can be no more than sixteen months old. By updating the information, a company brings the document up to date; hence the term, bring-up prospectus. See PROSPECTUS.

BROKER. An individual who buys and sells securities for the accounts of other people.

BUSINESS COMBINATION. A transaction in which an acquiring company issues stock for the stock of another company, and, after the acquisition, has control of the acquired company.

CAPITALIZATION TABLE. A table included in a registration statement that reflects various classes and amounts of long-term debt, preferred stock, and common stock. The table is presented in comparative form and depicts the registrant's capital structure as of a specific point in time and compares it to the pro forma capital structure which would exist if the proposed security issue were made.

CAPSULE INFORMATION. Financial information contained in a registration statement that covers the latest interim period for which data is available. Capsule information generally consists of net sales, net income, and earnings per share data, and is often presented in a paragraph following the notes to the Summary of Operations.

CHARTER. An instrument affecting the creation of an unicorporated or incorporated person (see PERSON), such as articles of incorporation or a declaration of trust.

CHEAP STOCK. Shares that are issued to selected individuals, such as promoters, officers, or directors of the issuer, before (generally within the year immediately preceding an initial public offering) or at the same time as an initial public offering, at a price that is less than the public offering price.

CHUMMING. An abusive option-trading practice that results from multiple option listings. Brokers may direct small orders from public customers to the exchange it considers to be the primary market. The SEC attempts to prevent chumming by arranging for the publication of reports on proprietary option transactions by floor members.

CHURNING. A practice in which broker-dealers buy and quickly sell a particular stock for a customer's account for the purpose of increasing their commissions. Churning also might be used to create a price rise in a firm's stock. This is accomplished by setting up a dummy account in a particular company's stock and then initiating in and out transactions (buying and selling at the same time). The appearance of great activity in the stock might instigate a price rise.

CLASS OF SECURITIES. A group of securities that possesses similar characteristics and which conveys similar risks and rewards to the owner.

CLOSED-END INVESTMENT COMPANY. A corporation whose principal profit-making activity is investing in the securities of other corporations. A closed-end investment company has a fixed number of securities outstanding and will not redeem those shares that have been previously issued to shareholders. If shareholders wish to sell their shares, they must do so on the open market.

CLOSING DATE. The date on which the company issuing the securities delivers them to the underwriters in exchange for the proceeds of the offering.

COMFORT LETTER. A letter in which the accountant provides negative assurance to aid underwriters in carrying out their responsibilities under the 1933 Act. Comfort letters are not required by the SEC and, therefore, are not filed with the Commission. The comfort letter is sent to the registrant's underwriters and is generally dated at or shortly before the closing date. While the underwriting agreement usually calls for a comfort letter and specifies the items for which comfort is sought, the underwriters generally desire comfort on financial and accounting data that is not covered by the independent accountant's report. See BRING-DOWN LETTER.

COMMISSION. The remuneration received by an individual who sells securities for his or her own account or for the account of others.

COMPLETING AMENDMENT. See PRICING AMENDMENT.

COMPLIANCE NOTES. Footnotes that must be included in financial statements that are submitted to the SEC in order to make the statements conform to SEC requirements. Compliance notes must be added to financial statements whenever SEC disclosure requirements exceed GAAP requirements.

CONFORMED COPY. The copy of the registration statement or other SEC report which contains typed or printed signatures, as opposed to handwritten signatures.

CONSENT DECREE. A negotiated settlement of an SEC proceeding against an accounting firm whereby the accountants consent to the disciplinary action, but neither deny nor admit to the Commission's accusations.

CONSENT LETTER. A statement by an expert such as an accountant consenting to the use of his or her name in the registration statement. In addition, accountants consent to the use of their reports on the registrant's financial statements. The consent should be dated and signed manually.

CONTROL. The ability to direct the business policies of a company, as through the ownership of voting securities.

COOLING-OFF PERIOD. See WAITING PERIOD.

CORRECTING AMENDMENT. An amendment which a company makes to its registration statement for the purpose of rectifying a deficiency; a correcting amendment is usually filed in response to a deficiency letter from the SEC. See DEFICIENCY LETTER.

COVERAGE RATIO. A ratio of earnings to fixed charges when debt securities are being registered. If preferred stock is being registered, the coverage ratio is the ratio of earnings to combined fixed charges and preferred stock dividends. See FIXED CHARGES.

CROSS-REFERENCE SHEET. A page in a registration statement, similar to a table of contents, that denotes the location of the various items required by the particular form.

CURSORY REVIEW. A brief review of a registration statement by the SEC whereby no written or oral comments would be provided to the registrant. Generally, a cursory review is utilized in situations where the registrant's expertise in filing registration statements is well known.

DEALER. An individual who buys and sells securities for his or her own account.

DEFERRED OFFERING. See SHELF REGISTRATION.

DEFICIENCY LETTER. A letter from the SEC which informs a registrant of defects in a registration statement.

DEFINITIVE PROXY STATEMENT. A proxy statement in its final form which is distributed to stockholders. See PROXY STATEMENT.

DELAYING AMENDMENT. A trivial amendment which a company makes to its registration statement for the purpose of preventing the statement from becoming effective. Registration statements automatically become effective within 20 days of filing unless a delaying amendment is filed (or a stop order is issued). The delaying amendment starts a new 20-day period and gives the SEC time to review the statement.

DELISTING. A process in which a listed security is removed from a securities exchange.

DIRECTOR. A director of a corporation or any person performing similar functions for any organization.

DISCLOSE OR ABSTAIN RULE. A general requirement that an insider possessing inside information must either disclose the information, or refrain from trading the related security.

DUTCH AUCTION. A security buyback program where security holders designate a price for the security. The company buying the shares then reviews the offers and selects a price. A "Dutch auction" is sometimes used in connection with a tender offer. See TENDER OFFER.

DUE DILIGENCE MEETING. A meeting that is held shortly before the effective date of the registration statement for the purpose of allowing underwriters or other parties the opportunity to raise questions concerning the registration statement. The due diligence meeting supposedly helps underwriters in carrying out their due diligence requirements under the 1933 Act.

EDGAR. Electronic Data Gathering, Analysis and Retrieval—an electronic filing, processing, and dissemination system developed by the SEC that enables registrants to file reports electronically, and permits users to access the information instantly via computer.

EFFECTIVE DATE. The date on which the registrant can sell a new security issue. A registration statement will automatically become effective 20 days after filing with the SEC unless an amendment is filed or the SEC issues a stop order. However, the registration process generally takes from 30 to 70 days to complete.

EQUITY SECURITY. A security, such as a stock, that conveys to its owner the risks and rewards of owning an enterprise. In addition to stocks, equity securities include those securities that are convertible into stocks or that convey the right to purchase stocks.

ESCROWED SHARES. Shares, generally cheap stock, that are placed in escrow to satisfy certain state merit regulation requirements. To protect investors, certain states might require a portion of any cheap stock to be placed in escrow in situations where holders of cheap stock can leave a start-up company by selling their shares immediately after the firm goes public. A typical provision of many escrow agreements is to release the escrowed shares after meeting a specified earnings test over a three-year period. See CHEAP STOCK.

EXCHANGE. An organization that provides a market for the purchase and sale of securities.

EXECUTED COPY. The copy of the registration statement or other SEC report which contains the manual signatures of those individuals required to sign. See CONFORMED COPY.

EXEMPTED SECURITIES. Securities that do not have to be registered under the Securities Act of 1933. Certain securities are exempted since they may be regulated by other federal laws or may not have a sufficient impact on the public's welfare to warrant regulation. Examples of securities exempted from registration under the 1933 Act include securities issued by the federal government, industrial development bonds not exceeding five million dollars, and securities issued by religious or charitable organizations.

EXEMPTED TRANSACTIONS. Transactions that are exempt from the registration requirements of the 1933 Act. Certain types of transactions are exempted since there may not be a critical need for investor protection. For example, securities issued in a private offering are exempt because the investors, usually sophisticated institutions, have their own sources of information about the offering.

EXHIBITS. Documents which are filed with the registration statement to reflect information called for by Regulation S-K, or which may be filed as part of the registration statement on a voluntary basis. Examples of information filed as exhibits include a copy of the company charter, underwriting agreement, and in the case of a bond issue, a specimen bond. See REGULATION S-K.

EXPERT. Any party who has assisted in the preparation or certification of a part of the registration statement and whose profession conveys authority to a statement made by that individual. Parties that are referred to as experts in a registration statement include, among others, accountants, attorneys, actuaries, appraisers, and engineers. Since experts may be held liable for any portion of the registration statement that they have prepared or certified, the SEC requires the experts' consent to the use of their names in a registration statement. In addition, an experts paragraph may be included in the registration statement. See CONSENT LETTER; See EXPERTS PARAGRAPH.

EXPERTS PARAGRAPH. A section of the prospectus that defines the responsibility assumed by an expert who has rendered an opinion on the registrant's financial statements. Often a statement may be included in the prospectus asserting that certain information has been included which relies on the reports of experts. Experts must be careful that their names are not used in such a way as to indicate greater responsibilities than are intended. For an accountant, the experts' paragraph should indicate that the statements are management's, and that reliance is extended only to the accountant's report. The expertising process should cover only those statements that were audited. See EXPERT.

EXTENDED OFFERING. See SHELF REGISTRATION.

FILING. The act of preparing a registration statement for submission to the SEC.

FILING DATE. The date on which the SEC receives a registration statement.

FILING FEES. Fees that are charged by regulatory agencies to process a registration statement. Currently, the SEC charges 0.02 percent of the security issue's total offering price. The current National Association of Securities Dealers (NASD) filing fee is 0.01 percent of the total offering price plus $100, up to a maximum of $5,100.

FINANCIAL REPORTING RELEASES (FRRs). Pronouncements by the SEC that, primarily, provide guidance on accounting disclosure matters. FRRs become an integral part of Regulation S-X.

FIRM COMMITMENT. See FIRM UNDERWRITING.

FIRM UNDERWRITING. An agreement to distribute a securities issue wherein the underwriting syndicate agrees to purchase the entire issue at a specified price. Only well-established, reputable companies can command a firm underwriting, since the effect is to guarantee the issue's success by transferring the marketing risk to the underwriters.

FISCAL YEAR. The annual accounting period; the fiscal year may end on December 31 or any other month-end as long as the books are closed consistently on that date. In addition, some firms, such as retail companies, may use a 52-53 week fiscal year.

FIXED CHARGES. Charges consisting of (1) interest and amortization of debt discount and expense and premium on all indebtedness, (2) that portion of rent expense representing interest, and (3) preferred stock dividend requirements of consolidated subsidiaries. The SEC requires a registrant to disclose the ratio of earnings to fixed charges if debt securities are being registered.

FLOAT. The aggregate market value of voting stock held by nonaffiliates.

FOREIGN CORRUPT PRACTICES ACT OF 1977. A Congressional act which makes certain bribery payments to foreign officials illegal, and requires public entities to keep reasonably detailed records and establish and maintain an effective internal control system.

FORMS. Documents that certain public companies must file with the SEC in order to comply with the Securities Acts. The type of form to be used in a given situation is a legal determination; however, the type of transaction, the size of the offering, and the type of business are among those factors which determine the type of form to use.

FORM S-1. The most common document used to register securities under the Securities Act of 1933. Form S-1 is used when no other forms are applicable; it requires disclosure of information relating to approximately 17 different items, including financial statements.

FORM S-2. A registration form that is shorter than Form S-1 and less expensive to file. If certain requirements are met, such as having met all cumulative prefered dividend payments within the most recent 12-month period, Form S-2 may be used to register a new security issue under the 1933 Act. The basic information package—which includes the financial statements, the summary of selected financial data, and management's discussion and analysis—may be presented in the prospectus or may be conveyed by delivering an annual report containing the basic information along with the prospectus.

FORM S-3. An abbreviated registration form in which much of the required information may be incorporated by reference to other documents that have already been filed with the SEC, such as Form 10-K. In addition to meeting all Form S-2 requirements, a float test must be met in which at least $150 million of the firm's voting common stock is held by nonaffiliates. The intent of the SEC is to restrict security registrations on Form S-3 to large, well-known firms whose financial information has already been widely disseminated. See FORM 10-K; FORM S-2.

FORM S-4. A registration form which may be used, under certain circumstances, to register securities in connection with a merger or consolidation. Form S-4 reduces filing difficulties that sometimes arose under the requirements of Forms S-14, and S-15, both of which are now superseded by Form S-4.

FORM S-8. A registration form that, under certain circumstances, may be used to register securities of the registrant that are to be offered to the registrant's employees in accordance with an employee benefit plan. At the present time, the SEC is allowing a Form S-8 registration statement to become effective without a review.

FORM S-18. A simplified registration form which may be used to register security offerings not exceeding $7.5 million; Form S-18 may be utilized by companies that are not already subject to the reporting requirements of the 1934 Act. The objective is to aid small firms in raising limited amounts of capital by simplifying registration procedures. While Form S-18 requires audited financial statements, only a two-year income statement and a balance sheet for the most recent fiscal year are required.

FORM 8-K. A special report form which must be filed with the SEC by companies registered under the Securities and Exchange Act of 1934. Form 8-K is filed whenever certain events occur, such as a change in control of the registrant, a change of auditing firms, bankruptcy, or a major acquistition or disposal of assets. When these events occur, an 8-K must be filed within 15 days.

FORM S-R. A periodic report filed with the SEC following a public offering. The form shows the number of securities sold and unsold, as well as the use of proceeds. The initial form is filed within 10 days of the end of the first three months following the effective date. Subsequent reports are filed at six-month intervals until the final report is filed at the later of the termination of the offering or the application of the offering proceeds.

FORM 10. A registration form which is used to register securities under the 1934 Act. The required disclosures are similar to those required on a Form S-1. See FORM S-1.

FORM 10-K. An annual report form which must be filed with the SEC by companies registered under the Securities Exchange Act of 1934. Form 10-K is divided into four parts. Certain items may be incorporated by reference. Form 10-K generally must be filed within 90 days of the company's fiscal year end.

FORM 10-Q. A quarterly report form which must be filed with the SEC by companies registered under the 1934 Act. Form 10-Q contains condensed financial statements whose footnote disclosures are much less extensive than those of year-end financial statements. Form 10-Q must be filed within 45 days of the end of the company's first three fiscal quarters each year.

FORM 12b-25. A form used to notify the SEC of the late filing of 1934 Act reports.

FORM 20-F. A report used for registration of securities of foreign private issuers pursuant to sections 12(b) or 12(g) of the 1934 Act, and for annual reports of foreign private issuers filing under sections 12 or 15(d) of the 1934 Act.

FREE RIDING. An illegal act wherein a would-be purchaser of a security issue plans on profiting by subscribing to buy at the offering price and reselling at a premium; however, the subscriber intends to withdraw the order if the price falls.

GOING PRIVATE TRANSACTION. A related party transaction in which a public company reduces the number of shareholders to the point that the firm is no longer subject to the reporting requirements of the 1934 Act. The danger of "going private" transactions is that unaffiliated shareholders may be frozen out, since after the transaction, no market may exist for the stock, and any remaining shareholders do not have the protection of the federal security laws. See RELATED PARTIES.

GOING PUBLIC. A process wherein a privately-held company issues its equity securities to the public. Going public usually entails registering the securities with the SEC and can be a very expensive and time-consuming process necessitating the assistance of investment bankers, attorneys, and independent auditors.

GREENMAIL. A target company's payment of a high premium to purchase its shares from an unfriendly suitor to prevent a takeover. Although not enacted, the SEC issued a proposal in 1984 that would have made this practice illegal.

GREEN SHOE. An overallotment provision in an underwriting agreement that allows an underwriter the option of buying additional securities for the purpose of covering a short position. The short position may arise when underwriters, in order to obtain adequate buyers, obtain more buyer indications of interest for shares than the number of securities available. The National Association of Securities Dealers (NASD) restricts the green shoe to 15 percent of the shares the underwriter is committed to buy.

GROSS SPREAD. The difference between the price the issuer receives for the securities and the price at which the securities are sold to the public by the underwriters.

GUNJUMPING. A process whereby an entity seeks to arouse interest in a proposed security issue before the appropriate registration statement is filed with the SEC. Section 5 of the Securities Act of 1933 prohibits gunjumping since potential investors should have access to relevant information about the investee before making an investment decision. Thus, entities are forbidden to advertise their future security issue before the filing date, and even then, advertising is restricted until the effective date of the registration statement.

HEADNOTE. An introductory message to the summary of operations which usually identifies the independent accountants, and states which periods have been reported upon and which portions are unaudited. When stub periods are presented, the headnote usually warns the reader that operating results for the latest stub period are not necessarily indicative of operations for the full year. See SUMMARY OF OPERATIONS.

HOT ISSUE. A security that trades at a premium in the secondary market when the secondary market begins.

IN REGISTRATION. A term which refers to the period of time during which a company strives to register a new issue of securities with the SEC. The period extends from the time the issuer reaches an understanding with a broker-dealer who is to manage the underwriting to the time the registration statement becomes effective. When securities are in registration, the issuing company cannot seek to sell the securities, but the issuer can respond to questions concerning the firm's financial condition.

INCORPORATION BY REFERENCE. A practice used in SEC reporting whereby a registrant may refer to information contained in a prior report rather than repeat the information verbatim; for example, requirements for certain information in a Form 10-K may sometimes be met by referencing data already included in the annual report to stockholders. The registrant must be careful, however, to avoid incorporation by reference in circumstances where it is not permitted, such as in a Form S-1 prospectus. See FORM S-1; FORM 10-K.

INDEMNIFICATION PROVISION. Provision in an underwriting agreement whereby the registrant and underwriters agree that if one party is primarily responsible for a misstatement in the registration statement, that party will pay the other for any resultant loss from liability. In regard to 1933 Act liability, the SEC holds that agreements where a firm indemnifies officers and directors are not in the public interest; where such agreements exist, the SEC may refuse to accelerate the effective date of the registration statement unless the issuer agrees to submit the indemnity provision to a court before making the indemnification payment.

INFORMATION STATEMENT. A statement which a company must provide to its stockholders, containing information concerning a forthcoming stockholders meeting. An information statement is used in place of a proxy statement in situations where management is not soliciting proxies; the information contained in the information statement is similar to that found in the proxy statement.

INITIAL MARGIN PERCENTAGE. See MARGIN REQUIREMENTS.

INSIDER. A person who owns 10 percent or more of any class of equity securities, or any officer or director of that company. The SEC closely regulates insider transactions and requires that insiders return short-swing profits to the company. In addition, insider transactions must be reported to the SEC and to the exchange on which the shares were traded within 10 days of the end of the month in which the transactions occurred.

INTEGRATED DISCLOSURE SYSTEM. A disclosure system implemented by the SEC during the 1980s that tries to coordinate disclosure requirements of the 1933 and 1934 Acts. Under the integrated disclosure system, a registration statement provides information that is both transaction specific and issuer oriented. For example, when registering the securities, the registrant provides transaction-related information such as intended use of the proceeds and risk factors related to the issue. In addition, issuer-oriented information, such as audited financial statements, is provided. The issuer-oriented data is updated in future periods as the registrant files periodic reports with the Commission.

INTRASTATE OFFERING. A security which is a part of an issue offered and sold only to persons residing within a single State or Territory, where the issuer of the security is a person residing and doing business—or, if a corporation, incorporated by and doing business—within that State or Territory. Intrastate offerings are exempt from federal security regulations.

INVESTMENT BANKER. An entity that underwrites and sells a new issue of securities for an issuing company. An investment banker may distribute the entire issue or may join with other investment bankers in order to market the securities. See UNDERWRITING.

INVESTMENT DISCRETION. The authority by which a person may influence the purchase or sale of securities for another person's investment account.

INVESTMENT LETTER. A letter written to the SEC by the purchaser of securities in a private offering, in which the purchaser states an intent to hold the securities for investment purposes. The purchaser must specify that the securities will not be immediately resold. Unless the investment letter is filed, the SEC may view the transaction as a public offering and the issue would be subject to registration requirements.

INVESTMENT LETTER SECURITIES. See RESTRICTED SECURITIES.

ISSUER. Any person who issues or proposes to issue any security.

ISSUER-DIRECTED SHARES. Shares of an offering that are designated by the issuing firm to be sold to specific individuals. These individuals must commit to the purchase within one day of the effective date; issuer-directed arrangements must be disclosed in the prospectus, and not over 10 percent of an offering can be issuer directed.

LANGUID REGISTRATION STATEMENT. A registration statement that has been on file with the SEC for more than nine months without becoming effective. The SEC notifies the registrant that it has 30 days to amend or withdraw the statement, after which it will be considered abandoned.

LETTER OF COMMENTS. See DEFICIENCY LETTER.

LETTER OF INTENT. A letter written by the originating underwriter to the prospective issuer wherein the underwriter states an intent to sponsor the security issue. The letter of intent usually specifies the amount of the issue and may reflect proposed maximum and minimum offering prices. The letter often calls for the formation of an underwriting group and for the preparation of a registration statement.

Normally, the letter of intent does not bind either party, unless the issuer is committed to reimburse the underwriter for expenses where the offering does not proceed.

LETTERS FOR UNDERWRITERS. See COMFORT LETTERS.

LEVERAGED BUYOUT. Layering of debt and other securities which are senior to a relatively small amount of common equity, to finance the acquisition of a company. The SEC regards leveraged buyouts as going private transactions and thus subject to Rule 13e-3 disclosure requirements.

LISTED SECURITY. A security that is traded on a securities exchange, rather than over the counter.

LISTING APPLICATION. An application which must be filed by a company seeking to have its securities listed on a national securities exchange. The application contains information that is similar to that contained in a Form 10. A copy of the Form 10, which is filed with the SEC, must also be sent to the exchange. See FORM 10.

MAJORITY-OWNED SUBSIDIARY. A company whose parent entity owns, directly or indirectly, more than 50 percent of the company's stock.

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A). An essential component of the SEC's required basic information package that must be presented in the annual report to shareholders. MD&A focuses on the firm's liquidity, capital resources, and results of operations. The detailed requirements are covered in Item 303 of Regulation S-K. See REGULATION S-K.

MANAGING AGENT. A person, such as a trustee, who directs the affairs of an unincorporated organization which is not a partnership.

MARGIN CALL. An act whereby a broker-dealer requires an investor-client to deposit additional collateral to secure securities that the client purchased on credit. Exchanges require investors who purchase securities on credit to maintain adequate collateral on the loan; usually the collateral consists of the securities purchased. If the securities' market value falls, the value of the collateral may fall below that required by the exchange. At that point, the broker demands that the client either pay off part of the loan or deposit additional collateral, so that the exchange's minimum maintenance requirement is met.

MARGIN REQUIREMENTS. The percentage of the purchase price that an investor must pay in cash in order to buy securities; the remainder of the purchase price may be financed via a loan from a broker or a bank. The securities themselves serve as collateral on the loan. Margin requirements are regulated by the Federal Reserve Board.

MARKET MAKER. A securities dealer who maintains an inventory in an over-the-counter security and is willing to buy and sell the security to other broker-dealers.

MATERIAL. A disclosure criterion that limits required disclosures to those matters about which an average prudent investor ought reasonably to be informed.

MEMBER. (1) An individual who can buy or sell securities on the floor of a particular stock exchange without utilizing the services of a broker. (2) A broker or dealer who is registered with a particular exchange and who has agreed to be regulated by that exchange.

MERGER PROXY. A document in which a corporation or other person requests that its security holders approve a stock for stock merger as described in Schedule 14A or Regulation 14A and Rule 145. When a merger proxy is solicited, the registrant generally files a Form S-4 with the SEC for the purpose of registering the securities that are to be issued in exchange for the other entity's securities. See FORM S-4.

MERIT REVIEW. A review of a security offering conducted by certain states for the purpose of determining whether investors would be getting a fair deal. For example, state examiners might be concerned if holders of cheap stock could receive proceeds from a firm's liquidation before public shareholders had received an amount equal to their initial per share investment. Note the difference between this objective and the full disclosure objective of the Securities Act of 1933.

MINIMUM MAINTENANCE REQUIREMENT. The amount of collateral that a stock exchange requires an investor to maintain as security for stocks or bonds purchased on credit.

MUNICIPAL SECURITIES. Securities that are the obligation of, or whose principal and interest are guaranteed by, a State or political subdivision thereof. Municipal securities are exempt from registration under the federal securities acts.

NEGATIVE ASSURANCE. A form of limited credence (usually accompanied by a disclaimer of opinion) that auditors sometimes provide to unaudited financial statements by stating in their report that "nothing came to our attention which would indicate that these statements are not presented fairly." Underwriters normally request comfort letters containing negative assurance on unaudited stub periods. Such assurance aids underwriters in meeting due diligence requirements under the Securities Act of 1933. Usually, auditors will provide negative assurance regarding financial data that was generated under the client's internal control system when the internal controls have been verified by prior audits.

NEW ISSUE. A class of securities that is being offered to the public for the first time.

NEWSPAPER PROSPECTUS. "An advertisement of securities in newspapers, magazines, and other periodicals which are admitted to the mails as second-class matter and which are not distributed by the advertiser" (General Rules and Regulations under the Securities Act of 1933).

NINE-MONTH PROSPECTUS. See BRING-UP PROSPECTUS.

NINETY-THREE DAY RULE. A consolidation rule specified by the SEC. The rule prohibits a registrant from consolidating any subsidiary whose financial statements are, as of a certain date, more than 93 days different than the registrant's statements.

NO-ACTION LETTER. A letter written by the SEC's Division of Corporation Finance for the purpose of advising an issuer of securities on a particular filing matter. For example, the letter might state that, on the basis of facts presented to the Commission, the proposed security offering appears to be exempt from registration requirements and no action would be recommended to the Commission.

NONRESIDENT BROKER OR DEALER. A broker or dealer whose principal place of business is not subject to the jurisdiction of the United States, and who neither resides in nor is incorporated in a place subject to United States jurisdiction.

NOTIFICATION FORM. A document, such as Form 1-A, that is used to inform the SEC that a public offering is being made which is exempt from registration by the Securities Act of 1933.

OFFERING CIRCULAR. A document that contains information similar to that found in a prospectus. An offering circular is filed by companies that are issuing securities to the public and yet are exempted from filing a registration statement. For example, corporations making a Regulation A offering should file an offering circular with the SEC. See PROSPECTUS.

OFFERING "AT-THE-MARKET". An offering of securities into an existing market for outstanding shares of the same class, at other than a fixed price, on or through a national securities exchange, or to or through a market maker other than on an exchange.

OFFICER. A president, vice president, secretary, treasurer, comptroller, or principal financial or accounting officer, or any person who performs similar functions for any organization.

OPEN-END INVESTMENT COMPANY. A corporation whose principal profit-making activity is investing in the securities of other corporations. An open-end investment company offers its shares for sale to the public on a continuing basis and will buy back shares that have been previously issued to its shareholders. See CLOSED-END INVESTMENT COMPANY.

OVER-THE-COUNTER MARKET. A market in which securities that are not listed on an exchange are traded. The over-the-counter market is the primary market for trading securities of small companies, municipal securities, and United States Government bonds. In 1964, the Exchange Act was amended, and many over-the-counter traded companies were required to register with the SEC and became subject to the SEC's reporting requirements.

PAC MAN DEFENSE. A takeover defense wherein a target company makes a tender offer to take over control of the original tender offeror. See TENDER OFFER.

PARENT. A company that controls another company either directly, or indirectly through one or more intermediaries.

PERSON. An individual, company, trust, agency, government, or political subdivision.

POISON PILL. A restrictive by-law or charter provision designed to discourage unfriendly takeovers, such as a provision allowing a firm to issue "blank check" preferred stock.

POST-EFFECTIVE AMENDMENT. An amendment which a company makes to its registration statement after the effective date of the statement.

PREFERABILITY LETTER. A letter addressed to the SEC from a registrant's independent accountant wherein the accountant states whether or not a change to an alternative accounting principle is preferable under the circumstances. The SEC requires that the preferability letter be submitted as an exhibit to the first Form 10-Q that is filed after a change in principle occurs.

PREFILING CONFERENCE. A conference held between the registrant or the registrant's representative and the SEC staff before a registration statement is filed. The purpose of a prefiling conference may be to discuss a specific filing problem or to discuss filing problems in general; however, the SEC will not review a registration statement in a prefiling conference.

PREFILING PERIOD. The period before a registration statement is filed with the SEC. During the prefiling period, the registrant is prohibited from engaging in any type of selling or promotional effort on behalf of the proposed securities offering.

PRELIMINARY PROSPECTUS. See RED HERRING PROSPECTUS.

PRELIMINARY PROXY STATEMENT. A proxy statement that must be submitted to the SEC at least 10 days before being sent to stockholders. The preliminary proxy statement must be corrected if the SEC notes any deficiencies. See PROXY STATEMENT.

PRICING AMENDMENT. An amendment which a company makes to its registration statement for the purpose of inserting the price at which the securities are to be sold. The pricing amendment is usually the final amendment to be filed and is made on the day before the registration statement becomes effective. This allows underwriters to make last-minute market assessments before committing themselves to a price, an important consideration where a firm underwriting is involved. See FIRM UNDERWRITING; see ACCELERATION.

PRIMARY DISTRIBUTION. The sale of securities by the issuer of such securities. Most primary distributions that constitute public offerings and are sold in interstate commerce are subject to the requirements of the 1933 Act. See SECONDARY DISTRIBUTION.

PRINCIPAL HOLDER OF EQUITY SECURITIES. A holder of record or a known beneficial owner of more than 10 percent of any class of equity securities of the registrant or other person, as of the date of the related balance sheet filed.

PRINCIPAL UNDERWRITER. The underwriter in a security distribution who is in privity of contract with the issuer, and who assumes the primary responsibility for the distribution of the securities.

PRIVATE OFFERING. A securities offering which is made to a few individuals and is exempt from registration requirements. While it is not always certain whether the SEC will deem an offering to be private, relevant criteria include the number of offerees and their need for information. See REGULATION D.

PRIVATE PLACEMENT. See PRIVATE OFFERING.

PRIVATE PLACEMENT EXEMPTIVE RULE. Rule 146 of the General Rules and Regulations under the 1933 Act. The private placement exemptive rule requires that offerees have access to the same kind of information required under the 1933 Act.

PRO FORMA INFORMATION. Information that is presented on an "as if" basis. For example, the SEC may require that financial statements be prepared on a pro forma basis to reflect the effects on a merged company's earnings as if the merger had occurred at the beginning of the fiscal period. The SEC does not require auditors to report on pro forma statements, but they may do so at the request of the client or underwriters.

PROMOTER. (1) Any person who aids in founding and organizing an issuer's business. (2) Any person who, in connection with the founding and organizing of a business of an issuer, receives in consideration thereof 10 percent or more of any class of securities of the issuer, or 10 percent or more of the proceeds from the sale of any class of securities.

PROSPECTUS. A document containing information about a company that is issuing securities in a public offering. The prospectus becomes Part I of the registration statement and, therefore, must be filed with the SEC. In addition, the prospectus must be distributed to each party to whom the securities are offered for sale. Financial statements, a description of the company, and the terms of the offering, among other items, must be disclosed in the prospectus. See BRING-UP PROSPECTUS; RED HERRING PROSPECTUS; SUMMARY PROSPECTUS; STATUTORY PROSPECTUS.

PROXY. A document that is signed by a shareholder and grants another party, such as a member of management, the right to exercise the shareholder's voting rights at a stockholders' meeting. The proxy states the matters that are to be voted on, and for each item, the shareholders check a box indicating whether they are for or against the proposal.

PROXY SOLICITATION. A request by a company to its shareholders to allow another party, such as a management group, to vote for them at a stockholder's meeting. Companies listed on the New York or American Stock Exchanges are required to solicit proxies. While the SEC does not require proxy solicitations, the SEC's proxy rules must be followed whenever a firm does solicit proxies. See PROXY; PROXY STATEMENT.

PROXY STATEMENT. A statement of information that a company must furnish to its stockholders and to the SEC in connection with management's solicitation of proxies. While proxy statements are not required by the SEC, the Commission does require that a proxy statement be provided to shareholders if proxies are solicited. If management solicits the proxies, Schedule 14A defines the content of the proxy statement; if stockholders make the solicitation, Schedule 14B is used. The proxy statement must be mailed to the stockholder at least 20 days before the stockholders' meeting. See PRELIMINARY PROXY STATEMENT; DEFINITIVE PROXY STATEMENT.

PUBLIC OVERSIGHT BOARD. A five-member board of the AICPA's SEC Practice Section (SECPS). The Board monitors the activities of the SECPS and periodically reports its assessment of those activities to the SEC.

PUSH DOWN ACCOUNTING. The establishment of a new accounting and reporting basis for an entity in its separate financial statements. It is based on a purchase transaction in the voting stock of the entity which results in a substantial change in the ownership of the entity's outstanding voting stock. The price of the stock, as reflected in the transaction, is "pushed down" to the entity and used to restate the assets, liabilities, and equity.

RED HERRING PROSPECTUS. A preliminary prospectus that can be distributed to interested parties before the effective date of the registration statement. The objective of a red herring prospectus is to provide for the dissemination of information about a security offering to prospective investors during the waiting period. Due to a legend that must be printed in red ink on the front cover, this prospectus received the name red herring.

REDEMPTIVE STANDBY OFFERING. A contingent offering of securities wherein a firm seeks protection against price declines by signing a standby underwriting agreement. Major price declines may lead holders of convertible securities to redeem, rather than convert the security. In order to protect itself from redeeming debt securities with cash, issuers may enter into a standby underwriting agreement. Under the standby agreement, the underwriter agrees to buy the remaining convertible securities, convert them, and sell the equity securities.

REGISTRANT. A company that has registered with the SEC by filing a registration statement.

REGISTRATION STATEMENT. A statement that must be filed with the SEC when a company desires to issue securities to the public. The securities can be sold only after the registration statement becomes effective. Most registration statements have two parts. Part I is called the prospectus and contains the company's financial statements, as well as other information about the company and the proposed securities. Part II contains supplementary schedules and the consents of experts such as attorneys and accountants.

REGULATION A. An SEC regulation that exempts offerings of up to $1.5 million from the normal registration procedures. An offering that qualifies for Regulation A treatment is simpler and less expensive than registered offerings. While an offering circular is required, the financial statements that must be included therein do not have to be audited, and disclosure requirements are less stringent than for a normal registration statement.

REGULATION C. An SEC regulation containing the general rules governing filings under the 1933 Act. These rules cover such diverse topics as shelf registrations, incorporation by reference, amendments, and filing fees, among others.

REGULATION D. An SEC regulation containing a series of six rules (Rules 501–506) dealing with certain exemptions from registration requirements of the 1933 Act. Rules 501, 502 and 503 set forth definitions and general conditions; Rules 504 and 505 deal with exemptions under Section 3(b), while Rule 506 covers exemptions under Section 4(2) of the 1933 Act.

REGULATION S-K. An SEC regulation that states the disclosure requirements for nonfinancial statement information contained in registration statements and other reports filed with the Commission in accordance with the securities acts. Regulation S-K calls for specific details concerning the description of the business, description of property, information on directors and executive officers, pending legal proceedings, security holdings of management, management remuneration and transactions, selected financial data, management's discussion and analysis, and various other topics.

REGULATION S-X. An SEC regulation that prescribes the form and content of financial statements that are filed with the SEC in accordance with the securities acts. Regulation S-X consists of 12 articles, including those pertaining to specialized industries. Amendments to Regulation S-X are made via Financial Reporting Releases.

REGULATION 12-B. An SEC regulation containing the general rules governing filings under the 1934 Act. This regulation covers, among others, such topics as safeharbor rules, signature requirements, and "late filing" requirements. See SAFE HARBOR.

REGULATION 14A. A regulation imposed by the SEC which establishes standards for the solicitation of proxies; Regulation 14A requires that a proxy statement be provided to each person from whom a proxy is solicited.

RELATED PARTIES. (1) A company's affiliates, principal owners, management, and members of their immediate families; (2) entities for which investments are carried using the equity method; (3) any party that has the ability to significantly influence the policies of the reporting firm, to the extent that one of the transacting parties might be prevented from fully pursuing its own separate interests.

RESTRICTED SECURITIES. Securities acquired from an issuer in a private offering. The purchaser must send a letter to the SEC stating that the securities are being purchased for investment purposes and will not be subject to immediate resale.

RULES OF PRACTICE. A group of administrative rules by which the SEC establishes standards of professional conduct for parties practicing before the Commission. Rule 2(e) can be used to deny an accountant the privilege of practicing before the SEC. Violating the federal securities laws or engaging in unethical conduct could lead to rule 2(e) proceedings.

SAFEHARBOR. Agreement by the SEC whereby the registrant or the registrant's independent auditors are provided sanctity against liability as long as they acted in good faith. Safeharbors may be granted in situations where there are few if any standards to guide auditors in performing their work, for example, auditors associating themselves with financial forecasts.

SALE. A transaction in which a security or an interest in a security is exchanged for cash.

SECONDARY DISTRIBUTION. The sale of securities by a party other than the issuer of the securities. Secondary distributions are usually made by individuals or estates who desire to liquidate a large block of a firm's securities. The 1933 Act applies to a secondary distribution only if the party making the sale is in a control relationship with the issuer. See PRIMARY DISTRIBUTION.

SECONDARY OFFERING. See SECONDARY DISTRIBUTION.

SECTION 10(a) PROSPECTUS. See STATUTORY PROSPECTUS.

SECTION 12(b) COMPANY. A company whose securities are registered on a securities exchange.

SECTION 12(g) COMPANY. A company which trades its securities in the over-the-counter market, but also meets certain size tests requiring registration under Section 12(g) of the 1934 Act. Presently, such firms having assets exceeding $5 million and a class of equity securities with 500 or more shareholders must register with the SEC.

SECURITIES. Tangible personal property in action; instruments that represent the right of a party to recover money or property vested in another party. Examples of securities include, among others, notes, bonds, stocks, options, and warrants.

SECURITIES ACT OF 1933. A federal statute that provides for registration of the initial distribution of a class of securities that will be issued to the public in interstate commerce. The broad objectives of the 1933 Act are two-fold: first, to provide investors with material information concerning the security issue, and second, to prevent fraudulent practices in the sale of securities.

SECURITIES AND EXCHANGE COMMISSION (SEC). A federal agency established by the Securities Exchange Act of 1934 for the purpose of administering federal securities laws. The SEC has primary responsibilities for administering the Securities Acts of 1933 and 1934. The SEC also has responsibilities relating to the Public Holding Company Act of 1935, the Investment Company Act of 1940, and the Investment Advisors Act of 1940, among others. The Commission is composed of five members who are appointed by the President of the United States; their term of office is five years.

SECURITES EXCHANGE ACT OF 1934. A federal statute that established the SEC and provided for the regulation of the trading of public securities in secondary markets. Firms whose securities are listed on a national securities exchange must register under the 1934 Act, as must public entities having assets in excess of $5 million and having 500 or more holders of a class of equity securities. The 1934 Act also gives the SEC power to regulate institutions such as brokerage houses and stock exchanges, as well as transactions such as insider trading, proxy solicitations, and tender offers.

SECURITIES RELEASE. An information release issued by the SEC for the purpose of informing interested parties about matters that the SEC is considering, or on which a decision has been reached. A Securities Release may relate to accounting or non-accounting matters. The medium for issuing exposure drafts on future Financial Reporting Releases (FRRs), as well as the final FRR, is the Securities Release.

SELECTED DEALER AGREEMENT. A contract in which the underwriting syndicate agrees to sell a portion of a new security issue to selected dealers for the purpose of broadening the market and selling all of the security issue.

SELECTED FINANCIAL DATA. A comparative summary, usually covering five years, of key financial information such as total assets and earnings per share, that must be included in a registration statement. The specific disclosure requirements are contained in Item 301 of Regulation S-K. The general objective is to highlight trends in the registrant's financial condition and results of operations. See REGULATION S-K.

SHELF REGISTRATION. A registration in which the issuance of securities may be delayed or extended, as in the case of stock option plans. A shelf registration is only permitted in particular circumstances, such as with an S-3 filing. The objective is to allow firms to quickly go to market with their security issues. The specific requirements for shelf registrations are covered in Rule 415 of Regulation C. See FORM S-3; REGULATION C.

SHORT SWING PROFITS. Profits on the sale of a security within six months of the purchase of the security. Section 16(b) of the 1934 Act imposes liability on insiders to surrender short-swing profits to the corporation whose security was traded. The objective is to protect the public by preventing unfair use of information by insiders before it becomes public knowledge.

SHORT TENDERING. An illegal practice in which a broker offers securities in a tender offer even though he or she does not own them. See TENDER OFFER.

SIGNIFICANT SUBSIDIARY. A subsidiary meeting any one of the following conditions: (1) The registrant's and its other subsidiaries' investments in and advances to the subsidiary exceed 10 percent of the total assets of the registrant and its subsidiaries, consolidated as of the end of the most recently completed fiscal year; (2) The registrant's and its other subsidiaries' proportionate share of the total assets of the subsidiary (after intercompany eliminations) exceeds 10 percent of the total assets of the registrant and its subsidiaries, consolidated as of the end of the most recently completed fiscal year; (3) The registrant's and its other subsidiaries' equity in the income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle of the subsidiary exceeds 10 percent of such income of the registrant and its subsidiaries, consolidated for the most recently completed fiscal year.

SOFT DATA. Information required or encouraged by Regulation S-K, such as forward-looking projections, that supplements the disclosure requirements of Regulation S-X. See REGULATION S-K; REGULATION S-X.

SPREAD. See GROSS SPREAD.

SQUEEZE-OUT. A type of going-private transaction that is designed to eliminate the minority interest in a close corporation.

STABILIZING. A practice whereby underwriters effect transactions in a particular security in an attempt to stabilize or maintain the market price of that security at a level above that which might otherwise prevail in the open market. If the registrant believes that the underwriters will seek to stabilize the market price, this intention must be noted prominently on the inside front cover page of the prospectus.

STAFF ACCOUNTING BULLETIN (SAB). An information release issued by the SEC's Chief Accountant which reflects interpretations and practices followed by the Division of Corporation Finance and the Chief Accountant in administering the disclosure requirements of the federal securities laws. While SABs are not official interpretations by the SEC Commissioners, they do represent the unofficial position of the SEC staff.

STATUTORY PROSPECTUS. The final prospectus, which includes complete information, including the security offering price. See PROSPECTUS.

STICKER. An adhesive label, attached to the front cover of a prospectus, containing data that supplements information found in the prospectus. The purpose is to apprise the SEC of important events occurring subsequent to the registration statement's effective date, such as new developments in litigation.

STOP ORDER. An order issued by the SEC for the purpose of preventing a registration statement from becoming effective and securities from being sold. A stop order also may be issued after a registration statement has become effective in order to suspend trading of a firm's securities.

STUB PERIOD STATEMENTS. Statements that reflect key operating items for the period from the end of the last fiscal year to the date of the latest balance sheet required. The stub period information is also shown for the corresponding period of the preceeding year. Stub period statements are usually unaudited.

SUBSIDIARY. A company controlled by another company either directly, or indirectly through one or more intermediaries.

SUBSTANTIVE AMENDMENT. An amendment to a registration statement that changes something of substance, as opposed to a pricing amendment or a delaying amendment.

SUCCESSION. The direct acquisition of the assets of a going business, either by merger, consolidation, purchase, or other direct transfer.

SUITABILITY STANDARDS. Standards that a registrant may establish to aid in determining the acceptance of subscription agreements. If suitability standards are established, they should be described immediately after the cover page of the prospectus. See PROSPECTUS.

SUMMARY OF EARNINGS. See SUMMARY OF OPERATIONS.

SUMMARY OF OPERATIONS. A condensed statement of earnings information that generally includes, among other data, such items as net sales, cost of goods sold, interest expense, income tax expense, extraordinary items, net income or loss, and dividends and earnings per share information.

SUMMARY PROSPECTUS. A summarized form of prospectus that may be prepared by the registrant or by a financial publishing service. The type of summary prospectus prepared by the registrant may become part of the registration statement itself, and can be used during the waiting period or after the effective date. The type of summary prospectus prepared by a publishing company can be used only during the waiting period. See PROSPECTUS.

SUSPENDED OFFERING. A situation wherein the sale of newly offered securities to the public is suspended within 15 days after the effective date of the registration statement. Unless the reason for the suspension was given in the prospectus, the registrant must inform the SEC of cause of the suspension.

SYNDICATE. A group of brokerage firms that combine their efforts in order to successfully underwrite a large block of securities.

TAKEOVER BID. See TENDER OFFER.

TENDER OFFER. An offer to acquire five percent or more of a corporation's shares from the present shareholders. The bidder usually offers a price above the stock's current market value in hopes of gaining control of the company. The SEC regulates tender offers via filing and disclosure requirements.

TOMBSTONE AD. An advertisement of a security offering. A tombstone ad is usually placed in financial newspapers and periodicals and derives its name from the starkness of its content, which is strictly regulated by the SEC. The ad must state that it is not an offer to sell, nor a solicitation of an offer to buy. The purpose is to inform potential investors of the offering and to allow them to request a prospectus if more information is desired. Tombstone ads cannot be placed until after the filing date of the registration statement.

TOTALLY HELD SUBSIDIARY. A subsidiary (1) substantially all of whose outstanding equity securities are owned by its parent and/or the parent's other totally held subsidiaries, and (2) which is not indebted to any person other than its parent and/or the parent's other totally held subsidiaries, in an amount which is material in relation to the particular subsidiary, excepting indebtedness incurred in the ordinary course of business which is not overdue and which matures within one year from the date of its creation, whether evidenced by securities or not. Indebtedness of a subsidiary which is secured by its parent by guarantee, pledge, assignment or otherwise is to be excluded for purposes of (2) above.

TRANSFER AGENT. A party engaged by a registrant to perform such functions as registering the transfer of the firm's securities, and exchanging or converting those securities.

TRANSMITTAL LETTER. A cover letter that accompanies a registration statement filed with the SEC. A transmittal letter is very important because it includes: disclosure or accounting problems; key representations from the registrant as to appropriateness of the particular filing form; statements of whether all 1934 Act reports have been filed and, where applicable, that a repeat filing is modeled after a recent effective filing. The letter should also include a desired time schedule for effectiveness.

TRIPLE WITCHING HOUR. Currently occurs four times a year (Friday of the third weeks of March, June, September, and December) when stock-index futures and options contracts expire simultaneously. It has resulted in wide price swings for stocks as arbitragers attempt to eliminate spreads between index futures and stock options.

UNDERTAKINGS. Actions that the registrant agrees to take if the registration statement becomes effective. For example, the registrant undertakes to file periodic reports with the SEC as required by the 1934 Act. The undertakings are stated in Part II of the registration statement.

UNDERWRITER. Any person who assists an issuer in the distribution of securities.

UNDERWRITING. An act of distributing securities, generally undertaken by an investment banker. The underwriting agreement specifies the responsibilities of both the issuer and underwriter.

UNDERWRITING AGREEMENT (UA). A contract that establishes the rights and obligations of underwriters and the issuer of securities in a public offering. Among other things, the UA sets forth: the nature of the underwriter's commitment; obligations of the issuer, such as amendments to the prospectus; various representations of the issuer, such as the absence of material omissions in the registration statement; indemnity agreements; and conditions of the underwriter's obligations to buy the securities, such as the receipt of comfort letters from the independent auditors.

UNDERWRITING DISCOUNT. A commission that the issuer of securities pays to an underwriter as compensation for services rendered in distribution of the securities. The discount constitutes the difference between the proceeds received by the issuer and the gross amount which the public must pay for the total security issue.

UNLISTED STATUS. See UNLISTED TRADING PRIVILEGE.

UNLISTED TRADING PRIVILEGE. The privilege of having one's securities traded on an exchange, even though the company is not listed on that exchange. An unlisted trading privilege can be granted by the SEC.

VOTING SECURITIES. Securities that convey to their holders the right to vote for directors.

WAITING PERIOD. The period of time from the filing date of a registration statement to the effective date. During the waiting period, a registrant may place tombstone ads and issue a preliminary prospectus to interested parties, but offers to buy the proposed securities cannot be accepted. See PRELIMINARY PROSPECTUS; TOMBSTONE AD.

WHITE KNIGHT. A friendly company that agrees to take over a target company at the target firm's request, in order to save the firm from an unfriendly takeover.

WRAPAROUND PROSPECTUS. A registration statement consisting of a copy of the proxy statement and the underwriting data necessary to make the filing current in terms of the requirements of the form. A Form S-4 registration statement is sometimes called a wraparound.

WHOLLY OWNED SUBSIDIARY. A subsidiary, substantially all of whose outstanding voting shares are owned by its parent and/or the parent's other wholly owned subsidiaries.

Book Review

PROPHETS OF REGULATION

by THOMAS K. McCRAW

Reviewed by Robert Bricker

Thomas McCraw's *Prophets of Regulation* offers insights into the nature of business regulation by tracing the lives of four men who helped shape business regulation in America. He also challenges the ability of the traditional modeling approach to explain regulatory development. He argues instead that historical analysis, with its emphasis on the importance of particular individuals and environments, provides greater understanding than modeling.

AN OVERVIEW OF THE ISSUES OF REGULATION

In recent years, the literature of government regulation has drawn a distinction between regulatory origination (the genesis of regulation) and regulatory process (the administration of regulation following its enactment). Some of the issues that have been addressed in this literature include:

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consideration of the use of the agency versus the judicial approach in the administration of regulatory law; legislative versus bureaucratic control of agencies; and public-interest versus group-interest models of regulatory origination and process.

Economics and political science have contributed a large volume of regulatory research literature. Economists have traditionally approached regulation by attempting to develop applicable models. These have included general models, such as those discussed by Posner (1974), as well as more detailed but more limited models. Issues of particular interest to economists have been the use of bureaucratic agencies for regulation administration, and group-interest models of regulatory origination and control. Often these economic models argue that small interest-groups either have regulations enacted which are beneficial to their interests, or subsequently "capture" control of the regulatory agency. Most often, this interest-group is seen to be the object of regulation. Kolko (1963), for instance, argued that the Interstate Commerce Commission was desired by the Railroads in order to eliminate competition and fix prices.

Political scientists have more often viewed regulation in terms of a dynamic process of voting, lobbying, and competition among a variety of interest-groups. Wilson's book, *The Politics of Regulation* (1980), provides a recent example of this perspective. Some scholars, such as Peltzman (1976) and Mitnick (1980), have attempted to synthesize hybrids from political science and economics. Journal articles of this sort may be found in journals such as *Public Choice* and the *Journal of Political Economy*.

McCRAW'S ALTERNATIVE TO MODELING–HISTORICAL ANALYSIS

The discussion above, while providing only a thumbnail sketch of the issues of regulation, highlights scholarly interest in the development of models and theories of regulation. Thomas McCraw, in *Prophets of Regulation,* argues that detailed models do not provide good explanations of the development of regulation. Instead, he argues that better understanding of the origination and administration of business regulation may only be obtained by studying particular individuals and environments.

This provides an interesting contrast to the modeling approach noted earlier, and illustrates the tension between the two views of building knowledge about social phenomena. One such view, provided by some historians and social scientists, holds that theories and models of the sort formulated in the more basic sciences do not provide either good explanations or predictions of social phenomena such as regulation, because of the complexity and reflexivity of human beings.

McCraw argues explicitly that formal models of regulation will fail. He writes:

> As the historical record shows, the regulatory tradition has been adapted to many different ends and purposes. . . . In view of these diverse and sometimes contradictory functions, all overarching theories and heroic generalizations about "Regulation" (with a capital R) run an extremely high risk of being in error. No single theory from any academic discipline can predict precisely which industries will be regulated and which will not (pp. 300–301).

These are not loose assertions, for McCraw has studied models of regulation carefully. In fact, his articles entitled "Regulation in America: A Review Article" (1975), which appeared in the *Business History Review*, surveys extant regulatory models. McCraw asserts that only broad understandings of regulation may be obtained, and these may be had by carefully examining particular situations of regulation and the individuals involved.

In *Prophets of Regulation*, McCraw examines the origination and subsequent administration (process) of several government agencies, primarily by examining the lives of four influential and closely associated individuals. This is not, then, a history of the development of the governmental agency approach to business regulation. Instead, McCraw employs an historical and biographical approach to demonstrate the importance of particular individuals in particular situations to the origination and administration of various regulatory agencies. Specifically, McCraw traces the lives of four men prominent in the regulatory arena: Charles Francis Adams, Louis Brandeis, James Landis, and Alfred Kahn.

While among these four only Kahn was regarded as a theoretician, all were well recognized and published, and all were extremely influential in the establishment and administration of their respective agencies. McCraw's analysis of the four reveals markedly different personalities and attitudes towards the regulation of business. Charles Francis Adams, presidential grandson, gained his reputation as a commissioner of the Massachusetts Board of Railroad Commissioners. While many other state boards implemented coercive regulatory laws, Adams championed the so-called "sunshine" form of regulation, which to a great exrtent encouraged the railroads to regulate themselves. This also became known as the "weak" approach to regulation. In contrast to this, Louis Brandeis, attorney and later Supreme Court Justice, spent much of his life battling what he perceived to be the abuses of big business, and was a strong supporter of the coercive or "strong" form of regulation. His personal influence and writings were important in the development of the Federal Trade Commission. James Landis, one of Felix Frankfurter's "Happy Hotdogs," was influential in the drafting of the 1933 and 1934 securities acts. His appointment as a commissioner of the Securities and Exchange Commission (SEC) shortly after its formation was important in establishing the SEC's early focus. Landis, of course, was a pioneer in his views of the value of bureaucratic agencies, and in his conviction that business regulation could be used to serve the public good. McCraw may hold similar beliefs, for the entire book assumes a public-interest approach to business regulation. Finally, Alfred Kahn provided the "economist's hour." His reputation in regulation developed from his scholarly work. He strongly advocated the use of economic concepts in regulatory administration and demonstrated great abilities in implementing his ideas, first as a New York utility commissioner, and later as the deregulator of the commercial airline industry.

The influences of these four men are presented chronologically, with intervening chapters used to provide a broader historical context to the book. General and specific biographical information is included for each of the four, and McCraw attempts to tie this biographical information into the subject's regulatory thought and action. In the final chapter, "Regulation Reconsidered," McCraw presents some of his own thoughts, stressing again his belief in the impossibility of the development of general models of regulation which have good explanatory and predictive power.

Accountants will be particularly interested in the entire chapter on James Landis, which chronicles the development of the securities regulations and the role of the accounting profession during the period. Also, a discussion of pre-SEC financial reporting is briefly discussed. The notes to this material (pp. 349–351) are extremely valuable and yield additional discussions on the cooperation between the SEC and the profession. This includes a discussion of the effect of the McKesson and Robbins cases on auditing standards and oversight.

CONCLUSION

While McCraw's claim of the impossibility of general models of regulation is debatable, he does a convincing job of demonstrating the importance of individuals in molding regulation. While some profound influences on business regulation are omitted, this is not a failure, given McCraw's intent and focus. In general, this book is well researched and provides insighttful and enjoyable reading. Accounting academics both in the areas of regulation and history should find the research method and analysis interesting. There is also a more general value. As Congress continues to consider the performance of the accounting profession, it is worth the time to gain an appreciation of McCraw's views of regulation.

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Book Review

GIANT KILLERS

by MICHAEL PERTSCHUK

Reviewed by Barbara Uliss

INTRODUCTION

As a Washington insider who has spent "25 years mucking about in the legislative process," Michael Pertschuk has unabashedly extolled the virtues of the public interest lobbyist in *Giant Killers*. He has produced chronicles of selected lobbying campaigns which culminated in victorious passage of public interest legislation. In the telling, a clarification of the nature of lobbying activities emerges, helping fulfill Pertschuk's aim to demystify a process which thrives mainly behind the scenes. More importantly, lessons in how to go about maximizing (or harming) one's cause by way of personal (or group) initiative become apparent as the stories unfold.

He is not an impartial reporter. As a staff member of the Senate Commerce Committee in the mid-1960s, Pertschuk took on the role of "guerilla

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fighter for truth and light." As a Carter appointee to the Federal Trade Commission, and its chairman from 1977 to 1981, he was a self-described "demon regulator." His fervor is captured in his description of the successful campaign by arms control groups to stop production of the MX missile. Pertschuk describes it as "a story of democratic possibility, of the hitching of a citizen movement to the skills needed to translate the moral force and energy of that movement into effective action . . . the essence of public interest lobbying at its best."

LOBBYING FOR THE PUBLIC INTEREST

Pertschuk originally envisioned writing about great moments in the history of public interest lobbying. The current work is imbued with greater ambitions. One is to attempt a demystification of the lobbying process. Another is to provide a remedy for the lack of general attention paid to public interest lobbying by journalists. The blame for this lack, he muses, might be placed on the lack of corruption (and subsequent lack of juicy stories) among public interest lobbyists. He also cites the lack of attention to the subject paid by political scientists, who "tend to weigh lobbyists by the gross," thus passing over the fine points—the individual nature—of plying the craft.

The heart of the book is a collection of stories recounting public interest campaigns. In them, the author's voice shares the stage with those of the lobbyists who were principal players. (They were mainly from the public interest faction, but comments from opposing lobbyists were included as well.) No attempt is made to eliminate Pertschuk's biases in favor of public interest groups, or "white hats." A part of the larger purpose in relating these stories is to strike a "note of hope" for those who find it difficult to believe that democratic institutions will respond to citizens' movements in the face of giant private interests. To those who are disposed to participate in these movements—the activists, leaders, and volunteers—Pertschuk tries to "convey a sense of the requisite skills, strategies, and tactics by which citizen groups with limited resources can prevail." He recognizes, and trys to dispel, the "lingering aversion to the moral untidiness and ambiguity of politics . . . especially of lobbying." He reverently cites the advantages of the public interest lobbyist's career (as well as acknowledging its comparative economic drawbacks), with emphasis on the potential for individual satisfaction. The stories demonstrate that one lobbyist can make a difference, even on a national level.

Pertschuk's personal proclivities are also evident in the criteria he established for selecting his stories. The first was a blunt statement that he "wasn't going to celebrate anybody [he] didn't like." The second, which buoys the reader's interest throughout, is the requirement that each story "yield at least a modest quota of suspense, villainy, drama, humor, and heroism." In addition, each chosen campaign had as major actors both public interest lobbyists and grass-roots activists, and served to illustrate the skills which lobbyists bring to their work. Finally, each story had to be an effective vehicle for illustrating lobbying techniques applied at various stages of the legislative process and teaching something about "the secrets of giant killing." This selection process delivered a set of stories which command the attention of the reader and deftly impart the intended lessons.

The first of these stories recounts part of a long-running battle over a cigarette labeling law. In this case, the law would require new, more strongly worded labels on cigarette packaging, advertisements, and billboards. The legislation was, of course, opposed by tobacco interests and by the tobacco lobby, that "mythic untouchable of corporate lobbies."

This story had special meaning for Pertschuk. The first cigarette labeling bill, enacted in the 1960s, was a part of his personal history. As a staff member of the Senate Commerce Committee, he was assigned to guide the bill through the legislative process. Generously, he describes his chagrin when, as an inexperienced young lawyer and Congressional staffer, he fell victim to the subtle manipulation of corporate lobbyists. The "elegant and captious" lawyers deftly convinced him, in the name of "fairness and objectivity," to soften his reports to the Commerce Committee regarding testimony from hearings. Showers of ingratiating solicitude paid Pertschuk by lobbyists captured his attention. Displays of their powerful Congressional connections persuaded him that only acceptance of their revisions would insure passage of this important legislation. His idealism was tempered by this revised sense of the possibilities, with the result that the bill was written to incorporate major provisions favoring tobacco interests. His belated awakening to the situation resulted in an attempt to undo the tobacco influence in the bill he had helped to formulate, but it was too late. The bill passed with the tobacco lobby's offensive provisions substantially intact.

It seems to have been these bitter memories which made the tale of the eventual defeat of the tobacco lobby poignant for Pertschuk. This is because it was their unorganized chicanery which led to the tobacco interests' demise. Incensed by the tobacco lobbyists' manipulative dishonesty, loyal supporters turned away, and Congressional powerhouses (John Dingell, for instance) became fierce opponents.

In addition to having an uplifting moral, this story serves as a lesson for potential public interest lobbyists in the art of facing a Goliath. The tale includes the formation of a formidable public health lobby, beginning with a coalition of voluntary organizations (the Cancer Society, American Lung Association, and the American Heart Association). United under a single effective leader, the considerable resources which the coalition could produce allowed the exercise of new-found political strength. The coalition had the potential to assemble what Pertschuk considered to be the minimum resources for successful public interest lobbying. They had an organized "grassroots" movement, professionally sophisticated lobbyists, and supportive experts. They could also muster the leadership efforts of Congressional insiders, and the attention of the media. In the interest of good storytelling, Pertschuk has foregone organizational analysis of his subjects, but these elements are consistently in evidence.

In the second tale of the public interest lobby, media attention played the leading role. The "enemy" in this case was primarily the American Medical Association, which, with the support of other professional groups, supported passage of the "professions" amendment. The amendment would have granted "a special exemption from antitrust and antifraud prosecution by the Federal Trade Commission of any member of a 'learned profession.' " The AMA lobby was a well organized, well supported, powerful opponent. After all, "who could match the potential for trust, respect, and affection of a congressman's fond family practitioner?"

Pertschuk's story is dominated in this case by the use of familiar tactics. He recalled, "It was Ralph Nader who taught us how the skillful priming of the news media can serve to turn the economic resources of powerful private interest lobbies back against themselves." So it was in this campaign, crafted by a former member of Nader's "Congress Watch," the media joined with the public interest lobbyists in characterizing the AMA's profuse campaign contributions (particularly PAC contributions) as "coarse symbols of vote-buying." It proved to be the key to victory.

Similar stories of public interest victories and how they were wrought concern the fight to preserve the Tolumne River wilderness, and the battle to renew the Voting Rights Act (in the face of the Reagan administration's push for deregulation). Finally, the reader is made privy to details of the struggle to halt production of the MX missile and concurrently to demonstrate the citizens' power to have their voices be heard in the arena of nuclear decision-making.

CONCLUSION

Pertschuk proves to be a master storyteller. Combining his own recollections with those of others involved in the campaigns, he demonstrates how intricate and individualized the lobbying process is, and how even an elegant central strategy must be buffered by the power of contacts, by knowledge which can only be gathered by inside experience, and by the ability to make adroit use of the turns of fortune. It is also clear that a lobby is distinctly characterized as an efficiently but loosely knit group of individuals. They work together under a common banner, but each is driven by personal interests or ideals, making use of personal relationships and skills in pursuit of their goal. The flexibility of this arrangement allows the "lobby," as an agile swordsman, to parry, dance between the feet of a giant, and thrust from behind. The stories are inspiring, but more importantly, educational. The Congressional lobby is an integral, but little understood part of our democratic system. It is an institution which should be of particular interest to those who are students of the legislative process, and would like to learn to make a difference. In *Giant Killers* Pertschuk has given of himself to entertain, instruct and, admittedly, to recruit readers to his cause.

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