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For the past 15 years, Hayden, Stone Incorporated, stock brokers, have conducted forums to which prominent corporate and financial officials are invited to give the outlook for their companies to the investment banking community. The forum at which Mr. Trueblood spoke was the fifth in a series dealing primarily with accounting principles.

A SEASON OF HEAD-HUNTING?

Leaders must look ahead—they must try to detect and to weigh those events and conditions of the present which provide clues to the events and conditions of the future.

This duty applies to leaders in any field. Certainly it is true with respect to business.

You gentlemen represent leadership groups in all parts of the business world. And it is my purpose today to lay before you what I believe to be signs of potential dangers to business and to suggest what can be done to avert them.

Ever since there has been such a thing as "big business" in our country, its reputation with the public has fluctuated. In the latter part of the 19th Century and the early years of this one, business was violently attacked. That was the period of muckraking and trustbusting. Newspapers and magazines were full of diatribes against the railroads and the great industrial organizations of the day. A book called "Wealth Against Commonwealth" which appeared in 1894, had an immense circulation and was enthusiastically applauded in press and pulpit. Public hostility toward some of the business practices of the day expressed itself in the Interstate Commerce Act, the Sherman Anti-Trust Act and other regulatory measures.

Another wave of anti-business sentiment came in the 1930's. The air-waves vibrated with denunciation of "princes of privilege" and "malefactors of great wealth." This time, bankers were the favorite whipping-boys. And once again legislators—the elected representatives of the people—responded to popular sentiment by enacting a long list of regulatory measures: the Federal Securities Act, various banking acts, the

Robert M. Trueblood, partner-in-charge of our Chicago office, recently completed his term as president of the American Institute of CPA's and has just received a presidental appointment to the 16 member Commission on Budget and Accounting for the Federal Government. Mr. Trueblood is our National Director of Accounting and Auditing and Chairman of the Touche, Ross Policy Group.

Public Utilities Holding Company Act, the Securities & Exchange Laws.

All of us would agree today that these measures and those of the earlier period have, on balance, turned out to be salutary. But I think we would also agree that businessmen lost prestige and influence by waiting to have discipline forced upon them.

In the period of both the late 19th Century and the 1930's, large numbers of Americans were suffering economic hurt. And in conformity with human nature at all times and in all places, they looked around for someone to blame.

The public's decision that businessmen were the villains, solely and directly responsible for what was going on, was undoubtedly over-simplified and exaggerated. But we would be deluding ourselves if we attributed the public's decision merely to ignorance or malice. For, in my view, the business community, by various acts—and, even more importantly, by certain failures to act—had nominated itself as a chief candidate for the scapegoat's role.

It has been said that history teaches us only that we do not learn from history. But certainly all of us who are in business, or who, like members of my profession, are intimately associated with it, must hope that we would draw lessons from those times in the past when business has been shoved in the doghouse.

Aristotle declared that the future is always contained in the present and that it is the wise man who recognizes it. Taking this as our premise, let's consider what there is in the present that may affect the future standing of business and businessmen.

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An editorial in the *Wall Street Journal* some weeks ago listed some disquieting events, among them—a board chairman of an important company indicted on charges which included filing false reports with the Securities and Exchange Commission; the biggest bank collapse to occur since 1933; two partners of an accounting firm brought under indictment. The editorial stated:

"Naturally we are not passing judgment on any of these developments; in fact, we would stress that (officials involved) have all made spirited rejoinders to their critics.

"Still, the events suggest an atmosphere. An atmosphere in which seven United States banks . . . have closed so far this year. An atmosphere in which the Comptroller of the Currency is concerned about the evaluation of loans being made by national banks to finance companies, one of which recently defaulted. An atmosphere in which many observers deplore the deterioration of the quality of credit."

In addition to the incidents listed in the editorial, a quick glance through newspapers of the past month or two turns up stories about a stockholders' lawsuit against two officers and the occounting and public relations firms of an oil company, charges by the SEC against the head of another company alleging "gross misconduct and abuse of trust," 12 persons indicted for stock manipulation, resignation under fire of three corporate officers suspected of profiting on sales to their own firm.

On top of these specific cases, there are possible portents in the broad economic conditions of the present—the sharp drop in the stock market, the prospect of a profit-squeeze, high interest rates, and cramped credit. Under these circumstances, some companies that are entirely without taint of manipulation or fraud may encounter difficulties they would otherwise have escaped. Certain enterprises, dependent on the credit market for leverage and simultaneously involved in a stagnant or downturning segment of the economy, will almost certainly have difficulty in surviving the cross-currents with which they are confronted.

I make no claim to prophecy and do not want to be misunderstood as suggesting that spectacular collapses are imminent. But I do suggest that a few of them are not impossible and that, if they do occur, cries of pain and indignation from those who are injured will mount in volume. If this happens, demands will be voiced for action by the Government because the people have no other common court of appeal.

To put it briefly, I believe that we may be moving toward an environment which, as in some periods of the past, will induce a search for scapegoats—that we may face a season of head-hunting.

I speak of this with considerable feeling because accountants are among those who can be regarded as prospective quarry. In fact, there have already been some dozens of instances in which, as you know, distinguished accounting firms have been named in lawsuits. The number of such cases is infinitesimal compared with the hundreds of thousands of engagements which certified public accountants perform every year. But we CPAs cannot, and most certainly do not, take comfort in statistics of this sort.

I'm going to take a minute to discuss the criticism lately leveled against accountants, not only because it is a phenomenon I have naturally pondered with particular care, but also because such criticism is relevant to my general theme.

Investors or credit grantors, being human even as you and I, usually do not like to admit that losses they have sustained may be mainly due to their own carelessness or poor judgment. If they think they can recoup a loss by suing someone, they're inclined to sue. Incidentally, in nearly all the legal actions I am talking about, the accounting firms involved do not stand as single targets. Instead accounting firms have been lumped among several defendants, in the thought, no doubt, that if the plaintiff doesn't recover from one, he can proceed to others on down the line. The co-defendants in a typical stockholders' or creditors' suit include the enterprise itself, its officers and directors, and investment bankers—as well as accountants. And once one person or institution gets the idea of attempting to indemnify himself in this way, it suggests the same course to others, and the actions snowball.

Recent public criticism of the accounting profession has centered chiefly on questions of generally accepted accounting principles. But all the lawsuits against accountants of which I am aware—save a very few—have nothing to do with questions of accounting principles. Instead, they are based on allegations of auditing deficiencies or inadequate disclosures. Therefore, the issues in most of the suits would not be affected even if every question of generally accepted accounting principles were resolved overnight. Nevertheless, the questions that have been raised in the press about accounting principles have undoubtedly contributed to an atmosphere promotive of litigation.

Fundamentally, in my view, the spate of lawsuits reflects lack of understanding of what an accounting firm does do, and does not do, in making an audit. Auditors *do not* examine every one of a company's millions of transactions over the course of a year. Rather, they test the company's accounting records and internal controls by examining a sample of transactions. The profession's main objective is to assure fair presentation of financial position and net income in all material respects.

An audit may detect fraud, but that is not its main objective. And if fraud is perpetrated by collusion among top officials of a company, even the auditor can be hoodwinked.

An auditor's opinion on a company's financial statements represents an expert opinion based on training and wide experience. But it *is* an opinion, *not* a warranty. It involves estimates and projections as to the future, and does not guarantee that they will all turn out as may reasonably be expected.

An auditor's "clean" opinion on financial statements *is* major evidence for a banker or investor or analyst in forming a judgment about a company—but it *is not* insurance against loss.

As far as I can see, the recent suits involving accountants spring from disappointment that the auditor's foresight was not so clear as the complainant's hindsight.

In all of this, I am quick to say, we accountants are not altogether blameless. We have perhaps been tardy in dealing with important questions of accounting principle, though I am bound to point out that problems of this kind are not simple or susceptible to easy solution. And I must add that the Accounting Principles Board of the American Institute of Certified Public Accountants is putting an immense amount of effort on these matters and has speeded up its output notably. Seven major research studies are now well underway and three formal opinions on significant subjects will be issued shortly.

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The present problems of my own profession, however, might prove to be only a patch on the problems of the business community as a whole if the economy began to show serious fatigue and strain. And after five years of virtually uninterrupted economic gains, some pause for rest and adjustment would not be surprising.

Earlier I cited several newspaper items as indications of possible squalls in the offing. Here is still another example: Not long ago a business magazine stated editorially, "It's past time certified public accountants were called to account for practices that are so loose that they can be used to conceal, rather than reveal a company's true financial picture."

The most disturbing element about a comment such as this, no matter how ill-founded, is that it tends to erode public confidence in financial reporting. Now, if the public were to lose confidence in the auditing process, it follows that the value of financial statements would be impaired—with a resultant loss of confidence in business management. Our whole system of "people's capitalism" is based on accumulating capital from a myriad of sources, and this process is predicated on confidence in corporate financial reports. If this confidence were undermined, the results would be serious for the entire economy.

Now, what should we of the business community do to reduce the chances of such development?

It is my thought that every part of business should look to its own house to see that it is in order. Every part of business should strive to be as far beyond reproach as is humanly possible. We should all examine ourselves and our organizations to see whether prosperity has brought on careless practices, relaxation of standards, or a lowering of a sense of responsibility to the public. If and whenever such weaknesses are found, we should move vigorously to correct them.

In making this statement I do not have in mind instances of outright rascality. There have always been crooks in every part of society—in government, labor, the professions, business. Happily, they are few and everybody realizes this, so when one of the wrongdoers is caught (and especially if his own group takes action against him) the entire group of which he is a part is not disparaged.

No, it is not this sort of case that should cause concern. Rather our concern should relate to the situations which are not just black-and-white but range through several shades of gray. Our primary attention should be directed not so much to actions that are clearly illegal (for there are agencies to take care of these things) as to actions which are morally questionable.

The situations about which most concern of all should be felt, because they are the most common, are those in which upright men fail to take action on matters where they should act—not deliberately but through carelessness.

Lest all this sound very abstract, I'll get down to specifics.

Starting with my own profession, I believe that CPAs must continually strive to improve the technical and professional standards under which they operate. At the same time they must never lose sight of the fact that as auditors their first responsibility is to the public. They must zealously guard against any infringement of their long-established principles of independence and objectivity, both in fact and in appearance. Insistence on the application of accounting principles which the auditor believes to be most appropriate, is a case in point. Because of the confidential relationship between an auditor and his clients, the public is not aware of the intensity of debates that sometimes take place between them on matters of accounting principles. And when a CPA and client part company on matters of principle, the CPA, because of his confidential relationship, cannot bring his story to the public.

* * *

I believe that an investment banker should never attempt, by implied threat of reprisal or otherwise, to induce an auditor to alter a presentation in order to improve the earnings per share of a company whose securities the banker is planning to underwrite. I believe that no credit grantor should ever say to a borrower that CPA firm X can be replaced if the firm requires its client to capitalize the "off-balance-sheet" debt which is involved in certain kinds of leases.

I believe that the most thoroughgoing measures should be adopted to avoid even the opportunity for conflict of interest in business. A few years ago a chief executive of an important industrial company was obliged to leave his post because of an undisclosed interest in a supplier firm. This incident triggered intensive self-examination in corporations across the nation, and stimulated the adoption of measures to prevent such an occurrence in their own ranks. It is my impression, however, that—since the immediacy of that highly publicized incident—attention to the possibilities of conflict of interest in industry has dwindled. I believe that the measures to prevent day-to-day conflict of interest are not so stringently supervised as they were only a short few years ago.

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On the matter of conflicts and privileged information, I think some serious thought should be given to membership on a company's board of directors by investment and commercial bankers and lawyers who do business with it—even though such relationships are fully disclosed. CPAs have met this problem head-on. Partners of accounting firms naturallly have a great deal of intimate information about companies they serve as auditors. But they are forbidden by the profession's code of ethics from serving on the board of any company they audit and are forbidden to perform an audit for any company in which they—or any of their partners, or any member of their immediate families—own stock. And this requirement is rigidly enforced.

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A few years ago several upper-middle-level executives of important companies were convicted for glaring price-fixing. Yet we still read of price-fixing cases brought against major corporations and settled by nolo contendere pleas. The customary explanation by public relations men is that their company entered the nolo contendere to avoid the costs of litigation. But the public may wonder whether the plea would have been entered if management really believed the accusation was groundless.

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Great wealth and special privilege for a favored few have made for problems throughout history and they are basic causes of political ferment in many countries today. Even in this country, conspicuous affluence can be a source of irritation and possible protest. During periods of general prosperity the public seems to be tolerant of this situation, but when things are not going well animosity is aroused.

What goes through the mind of a small shareholder, for example, when he reads of extravagant salaries and bonuses which seem unusual in relation to others in the industry? Or how does the small shareholder regard complicated deferred compensation arrangements which appear to be available only to a few and which constitute a long-term charge against a company's earnings?

* * *

I am not attempting to answer these questions nor to pass upon their fairness. I am merely suggesting that these are questions which business leaders should be thinking about.

My motive in so suggesting is that I am personally devoted to the Jeffersonian idea of the minimum of governmental regulation that is necessary in a particular society at a given time. In the economic sphere, I firmly believe that our system of democratic capitalism—with whatever imperfections it may have—is superior to anything that we can now conceive as replacing it. I think that a massive expansion of government regulation of business—perhaps adopted in haste, or for purposes of political power, or in a spirit of exasperation—would be not only hurtful to business but would be contrary to the common welfare.

That is why I say, let us take heed whether we are facing a season of head-hunting. And let us take care that our heads are not those that are sought.