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Interim Report on the Committee's Study of Displacement of CPA Firms, An Address by John W. Hoyt before The American Institute of Certified Public Accountants 83rd Annual Meeting, September 22, 1970, New York, N.Y.

John W. Hoyt

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An Address
by
John W. Hoyt
before
The American Institute of Certified Public Accountants
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Technical Session
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The Committee's organizational meeting took place on January 23, 1970 and the following objectives were adopted:

1. To collect as much information as possible about the circumstances surrounding displacements of accounting firms when clients go public, and the extent to which firms have been able to resist displacement.
2. To establish liaison with investment bankers, stock exchanges and the SEC in an effort to inform all concerned of the capability of many local and regional CPA firms to perform the type of work required for public offerings of securities.
3. To inform accounting firms how to avoid the problem of displacement by anticipating the client's capital needs and by guiding him through the accounting aspects of an initial offering of securities to the public.
4. To assemble data regarding underwriters which will assist accounting firms confronted with displacement.

Following the first of the adopted objectives . . . which was to collect information, a questionnaire was designed by Marshall Armstrong and Dave Lanman to draw from the AICPA membership information that the Committee needed to understand the nature and the magnitude of the problem of displacement. The case summary sheet accompanying the questionnaire requested information in the event of displacement or avoidance regarding the managing underwriter, size of offering, who informed the accounting firm of the need for a change of accounting firms for the registration and other pertinent information.

The questionnaire, unfortunately, was mailed on March 20, with the reply requested to be returned by April 30. We have heard some negative comments as to the timing. However, it was determined by the Committee that in view of the importance of the objectives of the Committee and the need to make this progress report, we could not delay the mailing. The

Committee's decision was justified by the response received from the membership. There were approximately 2,400 questionnaires mailed to member firms on March 20. By May 15, 730 firms returned the questionnaire along with 181 summaries. In addition to the summaries returned, we received several letters expanding on the firms' experience.

It isn't good form to recite statistics, however, we feel it is desirable in this instance so that you may share our concern about displacement.

Of the 730 replies received, approximately 600 of the firms had less than ten members; 70 firms had over 20 members. Of the 730 firms, 165 have participated in a filing under the Securities Act of 1933 preparatory to a public offering; the remaining 565 have not participated. Of the 165 firms who have participated in a filing, 103 have been displaced by another accounting firm in a filing.

The case summary sheet was requested only in instances of displacement or avoidance of displacement. Of the 181 summaries returned, 123 described displacement and 58 described avoidance. The 123 displacements involved 110 different underwriters. However, the 58 avoidances involved 50 different underwriters with some of the same underwriters showing up on both lists.

The questions concerning the size of the offering and the size of firm indicate that displacement and avoidance are both more frequent as the size of the offering is increased. Of the accounting firms responding to the questionnaire, the larger firms have apparently had a greater percentage of displacements and avoidances. This is not to say the smaller firms don't have greater exposure since they are likely to have fewer clients ready to make public offerings.

The question concerning who informed the accounting firm of the need for a change in accounting firms for the filing indicate it was the client in over 50% of the cases for both displacement and avoidance. More important than who informed the local or regional firm of the need for displacement was the reason for displacement. Almost universally, the reason expressed was that the underwriters informed the client that a "nationally known firm" was necessary to sell their offering at the highest possible price. And so it was 98 times out of 123 displacements, "nationally known firms" were engaged.

The efforts to avoid displacement were made mainly through the client or the underwriter. They were equally successful and by the same token equally unsuccessful. The main reason for avoidance was the strong support of the client and the excellent reputation and record of the local or regional firm. In approximately 30% of the cases, and this is important, avoidance was achieved with the cooperation of a national firm. The part of excellent support by the accounting firm's client cannot be over emphasized and by the same token, it appears that in some cases "going public" has afforded the client an opportunity to make a desired change of accounting firms.

The suggestion by the underwriter that the local or regional firm be displaced thus becomes an excuse for the client to an action that he may previously have been reluctant to perform because of a long association with the local firm. In other words, the underwriter in a limited number of cases may become a handy "whipping boy" for the client to blame for an action he intended to take in any event.

It is also pertinent that out of the 123 cases of displacement, 26 indicated withdrawl due to recognition of their own limitations as a small independent firm and 9 gave no reason for displacement. A total of 78 of the 123 gave full responsibility to the underwriter for displacement, with the remaining 10 citing a variety of other reasons.

We also received a summary from the SEC computer concerning the accounting firms on 2,918 of the approximately 4,700 registration statements filed with SEC during 1969. The print-out showed that 513 firms other than the twenty-five largest firms participated in 722 registrations which was 25% of the total, and the eight largest firms participated in over 65% of the total included in the statistics. We are not sure how the information was collected, however, if it is indicative, it would lead one to believe there are many unreported cases of avoidance.

This has been our activity to date on the Committee's first objective.

The second objective includes liaison with investment bankers, stock exchanges and the SEC. Evidence of our progress on this important objective is the successful efforts of John Queenen and Dick Nest in having Andy Barr and Roger Cortesi on our program today.

In addition, John and Dick have visited informally with a selected group of large and medium size underwriters. They have also gathered more information this summer but are not far enough along with their interviews to report at this meeting.

Informing underwriters of the competence of local and regional firms in public offerings is a very difficult task until the Committee can present the underwriters with specific recommendations how to determine a firms' competence and experience that does not necessitate a time consuming investigation. I am sure we will hear more concerning this matter by Mr. Cortesi shortly.

Our third objective was to inform accounting firms how to avoid displacement. We have already heard Andy Barr speak on "Who is Qualified to Practice". We also believe that points made by Mr. Barr in his article entitled "Accounting and Auditing Problems with Particular Reference to New Registrants With the Securities and Exchange Commission" printed by The New York Certified Public Accountants in January 1961 and J. S. Seidman's From the President Message entitled "Minimizing Displacement on Engagements" printed in the July-August 1960 copy of CPA are recommended reading for all firms that have clients who are potential registrants with the SEC. The February, 1970 issue of the Pennsylvania CPA Spokesman also has several worthwhile articles.

One of the best ways for firms without limited previous SEC experience to avoid displacement appears to be having developed a close relationship with a national firm before the client has decided upon an underwriter. This relationship can vary considerably but might well be as a consultant to small firms which could include planning the engagement, advising while the engagement is in process, lending employees, reviewing the financial statements and even the audit file or perhaps a combination of the planning, advising and reviewing functions. This type of arrangement will probably be on a fee basis and the billing would be to the accounting firm and not to the client.

Ralph Kent has determined that there is little, if any, evidence of a clear-cut policy with respect to assistance rendered by national firms to smaller firms in their SEC engagement. We have obtained a written policy of an anonymous national firm and it is that firms' policy not to advise or otherwise participate in SEC filings for a fee unless the firm has examined the most recent audited financial statements appearing in the prospectus. They do state that they are prepared to advise local practitioners, without fee, where no substantial amount of time is involved and also make available their library facilities, securities services, etc.

Avoiding displacement can also be minimized if the local firm anticipates the client's capital needs. Recognizing your client's need is important in building a strong relationship. Your client can be a very substantial ally in avoiding displacement. The client should be aware that the easy thing for the underwriter to do is ask for an accounting firm with whom the underwriter is acquainted rather than investigating and taking time to know the local firm. But this doesn't mean the underwriter won't if the client refuses to make a change. The underwriter can and will find a way to justify the unknown accounting firm when forming an underwriting syndicate if he is satisfied as a result of his investigation and the progress of the preparation of the registration to date. I might add that several underwriters with whom we have worked have a CPA with national firm experience on the underwriting department staff which greatly enhances the relationship.

Our fourth objective of assembling data regarding underwriters who have worked with local and regional accounting firms is being gathered. ¶ Our information to date indicates that the main thrust of the Committee's future activities should be in the following three areas:

1. Relationships with underwriters: We must build confidence of underwriters, and particularly the managers of the syndicate departments, in the ability of local and regional accounting firms to perform SEC filings efficiently and competently. We must encourage underwriting firms to adopt a fair policy in negotiating with the long-term clients of local and regional accounting firms and not demand a change in accounting firms, which is usually quite costly to the client, before making an investigation.

2. Relationships between accounting firms: We must encourage large accounting firms to adopt a policy to be scrupulously ethical and fair in their dealings with local and regional accounting firms with respect to SEC filings and post filing audits. Since practice growth is usually a criteria of performance, we should encourage that this policy be administered by a national partner.

   The Committee must try to come up with a program that is acceptable by the large firms as to what is a logical course of action of the large firm when approached by an underwriter on a SEC filing that is a client of a local firm. This will probably include consulting and advising the local firm and other assistance that is yet to be defined by the Committee. We will welcome suggestions as to the type of help desired by local firms.

3. We must encourage local and regional accounting firms without any or limited SEC filing experience to protect their own interest by:

   a. Maintaining a close client relationship that will assure them of being alerted to the client's financial needs and having an advocate in negotiating with the underwriters.

   b. Teaching partners and staff about SEC filings against the time when a client wants to go public.

   c. Being alert to the independence standards of SEC.

d. Being willing to staff up their organizations to handle SEC work.

e. Being willing to accept the inordinate liability risks imposed by the SEC acts.