

MEMORANDUM

October 8, 1974

TO : Commissioner Evans

FROM: Quinton Seamons

RE : Disclosure of Auditor-Client Relationships

Generally, Sandy's proposals are designed, among other things to provide the accountants more leverage in their relationship with management. Most of these items quite frankly, and Sandy admits readily, do go to substance not disclosure, and the release is drafted to make that fairly clear. Once that basic hurdle is passed, the proposed requirements take on a more favorable appearance. However, Corp. Fin. is rather troubled by this approach on the basis that, in effect, the disclosures impact on the auditor-client relationship and it raises the issue as to whether that is the proper role of the Commission and the disclosure philosophy.

In looking back on the various items that the Commission has promulgated recently in the accounting area, I believe that it is a fair statement that the Commission has taken a more substantive approach. Thus, Sandy believes that his recommendations are consistent with this approach, and, as this matter is only going out for comment, it is probably best that public exposure be obtained on these matters.

With respect to the particular rule proposals, there are some rather innovative requirements. One of these is paragraph (d) of Item 8 of Schedule 14A of the proxy rules requiring that the proxy statement indicate whether the accountants for the current year and the most recently completed fiscal year are expected to be at the shareholders' meeting to make a statement and respond to questions. Sandy indicates that, as a practical matter, accountants attend a majority of the shareholder meetings and that this requirement would simply institutionalize that practice. The more sweeping and innovative requirement is that relating to whether the accountant will make a statement at the meeting.

Sandy believes that response to this requirement will be mixed, but that he believes it to be most effective in instances where a change of auditors has occurred so that if the change occurred because of a disagreement, the accountants can present their case to the shareholders. Firms will object to this increased responsibility, and management will be rather dubious but the thrust is to get the disagreement out in the open. Another point in this area, and Sandy does not have a ready answer, is to the nature of the statements and what impact they will have. No doubt we are in uncharted waters on this requirement, but Sandy believes it a worthwhile endeavor.

Another requirement is Rule 3-16(u) of Regulation X which would require that if there is a change in accountants because of a reported disagreement, subsequent and similar transactions must not only be treated by the new accountants, but the new accountants must account for the transaction in a footnote using the preferred accounting of the prior accountant.

My first reaction was that this could be rather confusing to investors, but Sandy's point is that the most common reason for a change in accountants in this context is that management wants the lower standard or threshold accounting of the new accountant. Under this requirement, that would not be possible because the former accountant's system would be given effect in footnote disclosure. Thus, Sandy believes that this requirement would have a deterrent effect and would be utilized in isolated instances only.

A third requirement is Rule 2-02(b) of Regulation S-X which requires the new accountant to furnish as an exhibit to his initial report indicating whether he has read all the Form 8-K's reporting a change of accountants and whether he fully discussed these matters with the former accountants. Corp. Fin. Points out that this will not result in more discussions by the prior accountants because they are not required to furnish anything. In this kind of situation Sandy says that he has tried to discuss matters with former accountants but they have refused to do so.

Another interesting requirement is Item 8(a) of the proxy schedule 14A which requires the process by which an accountant is recommended and selected to be disclosed. Sandy readily admits that, if the truth were known, the accountant was selected on the golf course, over dinner, or through some other connection, but not through any formal process. Nevertheless, he believes that this process should be developed formally and be institutionalized, and that this requirement may initiate that development.

There are other requirements, but I believe these four are the most significant. On balance, recognizing the Commission's more substantive accounting approach, I believe that these matters ought to be published for comment with the understanding that the Commission will take a hard look if and when they are recommended for adoption.