

STATEMENT OF JOHN S. R. SHAD
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE
HOUSE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
OF THE COMMITTEE ON ENERGY AND COMMERCE

MARCH 6, 1985

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INTRODUCTION

The Federal securities laws provide for the audit of financial statements of publicly-held corporations by independent accountants. Thus, those laws have placed upon the accountant important responsibilities in facilitating the capital formation processes, and as a result, the economy as a whole.

Today, the accounting profession is subject to a unique combination of public and private sector initiatives that is designed to ensure that the profession meets its public responsibilities. This framework has been built over time and is subject to continued refinements and improvements.

In the 1970's, this framework came under close scrutiny by various Congressional committees. The most important result of this scrutiny was the formation, by the American Institute of Certified Public Accountants, of the Division for CPA Firms and its peer review program. This mechanism, together with other private sector standards-setting initiatives, the Commission's programs (including active oversight), state licensing activities and private civil litigation against accounting firms constitutes the environment of practicing public accounting today.

This statement summarizes the Commission's role in ensuring compliance with the accounting and financial disclosure aspects of the Federal securities laws.

The primary Commission programs are:

- Rulemaking initiatives which supplement accounting standards, implement financial disclosures and establish independence criteria for accountants;
- The review and comment process which results in improvement of filings, identification of emerging accounting issues (which results in rulemaking or private sector standards-setting), and identification of problems warranting enforcement actions;
- The enforcement program, which imposes legal sanctions and serves to deter irregularities by enhancing the care with which registrants and their accountants analyze accounting issues; and
- Oversight of private sector efforts to establish accounting and auditing standards, and to improve the quality of audit practice.

The Commission's direct efforts are multiplied by the efforts of the Financial Accounting Standards Board, the American Institute of Certified Public Accountants and the other activities of the profession under Commission oversight. In addition to Commission enforcement actions, significant numbers of actions are brought by private litigants, aggregating hundreds of millions of dollars per year, many of which are a direct result of Commission actions.

The cumulative effect of the Commission's programs, private sector initiatives and civil litigation comprises a comprehensive system under which the integrity of financial reporting for public companies is constantly being challenged, modified and improved.

SECTION A - STATUTORY AUTHORITY

Issuers of securities are required to include certain financial information in registration statements, periodic reports and other documents filed with the Commission. ^{1/} The Commission has the authority to prescribe the form in which the required information shall be set forth, the items to be shown in the balance sheet and the earnings statement, and the methods to be followed in (i) the preparation of accounts, (ii) the appraisal or valuation of assets and liabilities, (iii) the

^{1/} The Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77a et seq., requires, subject to certain exemptions, the registration of any public offering of securities. Section 7 of the Act, 15 U.S.C. 77g, and Schedule A, 15 U.S.C. 77aa, prescribe the type of information required in Securities Act registration statements. Section 7 also provides, however, that the Commission has flexible powers to require additional information, or to dispense with statutorily-specified disclosure requirements, if it finds either action to be necessary or appropriate for the protection of investors or in the public interest. Once a public offering is made, the issuer may be required to file certain periodic reports under Section 15(d) of the Securities Exchange Act of 1934, 15 U.S.C. 78o(d).

The Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. 78a et seq., requires, subject to certain exemptions, registration of any exchange traded equity security or any equity security, held by more than 500 persons, of an issuer with over \$1,000,000 in assets. See, 15 U.S.C. 78l. Rule 12g-1, 17 CFR 240.12g-1, promulgated under Section 12 of the Exchange Act, however, exempts from registration any issuer having total assets not exceeding \$3,000,000 on the last day of its most recent fiscal year. The general nature of the information required in such a registration statement is described in Section 12(b) of the Exchange Act, 15 U.S.C. 78l(b). Section 13 of that Act, 15 U.S.C. 78m, requires issuers that have filed under the Exchange Act to file periodic reports with the Commission. Proxy or information statements, and tender offer documents, are required by Section 14 of the Exchange Act, 15 U.S.C. 78n.

The Public Utility Holding Company Act of 1935 ("1935 Act"), 15 U.S.C. 79a, et seq., requires, with certain exceptions, the registration of any company which owns or controls a public utility. See, 15 U.S.C. 79b(7), 79d and 79e. The general content of a registration statement filed under that Act is described in Section 5(b) of the 1935 Act, 15 U.S.C. 79e(b).

The Investment Company Act of 1940 ("1940 Act"), 15 U.S.C. 80a-1, et seq., requires the registration of any investment company, as defined in Section 3 of that Act. See, 15 U.S.C. 80a-3, 80a-7 and 80a-8. The general content of a registration statement filed under that Act is described in Section 8(b), 15 U.S.C. 80a-8(b).

determination of depreciation and depletion, (iv) the differentiation of recurring and non-recurring income, (v) the differentiation of investment and operating income, and (vi) the preparation of separate and/or consolidated balance sheets or income accounts of any person affiliated with the issuer. 2/ In addition, the Commission may define accounting terms. 3/

Issuers subject to the Exchange Act must also comply with certain accounting requirements established in the Foreign Corrupt Practices Act of 1977 ("Act"). 4/ The Act also makes it unlawful for such issuers, or any domestic concern not subject to the Exchange Act, to engage in certain corrupt practices with respect to foreign officials.

The Commission also has broad authority over certain persons engaged in the securities industry. National securities exchanges, exchange members, registered

2/ Authority for these requirements lies in Sections 7, 19(a) and Schedule A, Item (25) and (26) of the Securities Act, 15 U.S.C. 77g, 77s and 77aa(25) and (26); Sections 12(b) and 13(b) of the Exchange Act, 15 U.S.C. 78l(b) and 78m(b); Sections 5(b), 14, 15 and 20 of the 1935 Act, 15 U.S.C. 79e(b), 79n, 79o and 79t; Sections 8, 30(e), 31 and 38(a) of the 1940 Act, 15 U.S.C. 80a-8, 80a-30(e), 80a-31 and 80a-37(a).

3/ Section 19(a), Securities Act, 15 U.S.C. 77s; Section 3(b), Exchange Act, 15 U.S.C. 78c(b); Section 20(a), 1935 Act, 15 U.S.C. 79t; and Section 38(a), 1940 Act, 15 U.S.C. 80-37(a).

4/ The Act requires most companies registered with the Commission to make and keep books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and disposition of assets of the issuer; inaccurate books, off-the-book accounts and related practices are proscribed by the Act. Reporting companies are also required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that: (i) transactions are executed in accordance with management's specific authorization; (ii) transactions are recorded as necessary: (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria; and (b) to maintain accountability for its assets; (iii) access to assets is permitted only in accordance with management authorization; and (iv) the recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

broker-dealers, securities associations, municipal securities dealers, securities information processors, transfer agents, clearing agencies and the Municipal Securities Rulemaking Board are required to make and keep such records and reports as the Commission may require. 5/ Every registered broker or dealer is also required to annually file with the Commission a balance sheet and an income statement certified by an independent public accountant and other information concerning its financial condition. 6/ The form and content of these broker-dealer financial statements may also be prescribed by the Commission.

In addition to the express accounting provisions in the Federal securities laws, the Commission may require further disclosure if it finds that such disclosure is necessary or appropriate either in the public interest or for the protection of investors. 7/

Further, the Federal securities laws require, or authorize the Commission to require, registrants subject to their provisions to file financial statements with the Commission that have been "certified by an independent public or certified public accountant." 8/

5/ Section 17, Exchange Act, 15 U.S.C. 78q.

6/ Section 17(e), Exchange Act, 15 U.S.C. 78q(e).

7/ Sections 7 and 10 of the Securities Act, 15 U.S.C. 77g and 77j; Sections 3(b) and 23(a) of the Exchange Act, 15 U.S.C. 78c(b) and 78w(a); Section 20(a) of the 1935 Act, 15 U.S.C. 79t(a); and Section 38(a) of the 1940 Act, 15 U.S.C. 80a-37(a).

8/ Items 25 and 26 of Schedule A of the Securities Act, 15 U.S.C. 77aa, and 17(e) of the Exchange Act, 15 U.S.C. 78q, expressly require that the financial statements be audited. Sections 12(b)(J) and (K) and 13(a)(2) of the Exchange Act, 15 U.S.C. 78l and 78m, Sections 5(b)(H) and (I) and 10(a)(1)(G) of the 1935 Act, 15 U.S.C. 79e(b) and 79n, Sections 8(b)(5) and 30(e) of the 1940 Act, 15 U.S.C. 80a-8 and 80a-30, authorize the Commission to require the filing of financial statements that have been audited by independent accountants.

SECTION B - RULEMAKING

The Commission adopted Regulation S-X in 1940 to provide guidance as to the form and content of required financial statements and to specify the footnotes and schedules that should be included or filed together with such financial statements. 1/ Regulation S-X also addresses the qualifications of accountants, 2/ including their independence, 3/ and accountants' reports on financial statements. 4/

In addition to Regulation S-X, the Commission has adopted various rules that specify disclosure of financial and related information. For example, supplementary financial information about (i) the effects of changing prices and inflation, and (ii) oil and gas producing activities is required by Item 302 of

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- 1/ Regulation S-X is composed of twelve articles which address the following topics: application of the regulation; qualification and reports of accountants; general instructions to financial statements and consolidated and combined financial statements; rules of general application; commercial and industrial company requirements; companies in the development stage; registered investment companies, employee stock purchase, savings and similar plans; insurance companies; committees issuing certificates of deposit; bank holding companies; interim financial statements; pro forma financial information; and, form and content of schedules.
- 2/ Rule 2-01(a), 17 CFR 210.2-01 (a), provides that "[t]he Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office."
- 3/ Rules 2-01(b) and (c), 17 CFR 210.2-01 (b) and (c), require independence "in fact" and provide some guidance as to when an accountant will be considered "not independent." These rules are discussed in Section C below.
- 4/ Rule 2-02, 17 CFR 210.2-02, requires certain information in the audit report, such as statements regarding whether the audit was conducted in accordance with generally accepted auditing standards, whether accounting principles have been applied consistently and whether the accountant takes exception to any matters. In addition, it provides that "[n]othing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required"

Regulation S-K. Certain selected financial data and a management's discussion and analysis of the company's financial condition and results of operations are also required by that regulation.

To address significant accounting issues, the Commission may issue interpretive releases 5/ and, when announcing rule changes, provide guidance for compliance with new or amended rules. 6/ In addition, the Commission staff periodically issues Staff Accounting Bulletins ("SABs") to inform the financial community of its views on accounting and disclosure issues. 7/ The SABs are not rules or interpretations of the Commission nor are they published as bearing the Commission's official approval. They specify interpretations and practices followed by the staff in administering the disclosure requirements of the Federal securities laws.

5/ In Accounting Series Release No. 1 (April 1, 1937), the Commission announced that it would publish, from time to time, "opinions on accounting principles for the purpose of contributing to the development of uniform standards and practice in major accounting questions."

6/ Such accounting-related Commission releases are now called Financial Reporting Releases ("FRRs"). Earlier releases were known as Accounting Series Releases ("ASRs"). These releases and all interpretive releases are codified in the "Codification of Financial Reporting Releases" to facilitate reference to the Commission's current views on accounting, auditing and independence issues. The Codification provides guidance in six areas: general matters, annual financial statements; interim reporting; specialized industries (including banks and bank holding companies, broker-dealers, investment companies, limited partnerships, and oil and gas producing companies); information outside of financial statements; and matters relating to independent accountants.

7/ In January 1981, SAB No. 40 was published to codify the material included in previous SABs. The Codification represents an integrated package which is continually updated and indexed to make the SABs more useful to issuers, accountants and others. The SABs included in this Codification concern twelve general topics: financial statements; business combinations; senior securities; equity accounts; miscellaneous accounting; interpretations of Commission releases; real estate companies; retail companies; finance companies; utilities; miscellaneous disclosure; and, oil and gas producing activities.

Recent rulemaking initiatives have shown the Commission's desire to upgrade financial and accounting disclosures, and at the same time simplify that disclosure. Rulemaking actions during the past several years have addressed the following kinds of issues:

- . Disclosures about reserves for unpaid claims and claims adjustment expenses of property - casualty insurance underwriters (FRR No. 20).
- . Various accounting and disclosure issues for oil and gas producing activities (FRR Nos. 17, 14, 9; ASR Nos. 300, 289).
- . Various issues dealing with independence, reports and consents of accountants (FRR Nos. 16, 10, 5, 4; ASR Nos. 304, 303, 296, 295, 291).
- . Accounting for extinguishment of debt (FRR Nos. 5 and 3).
- . Disclosures about various risk elements in the loan portfolios of bank holding companies, including information about nonaccrual, past-due and restructured loans, potential problem loans, foreign outstandings, and loan concentrations (FRR No. 13).
- . Accounting for the cost of internally developing computer software for sale or lease to others (FRR No. 12).
- . Adoption of the integrated disclosure system; revision of financial statement requirements for commercial and industrial, bank holding, investment, and insurance companies; and, adoption of uniform financial statement requirements applicable to virtually all filings with the Commission and annual reports to shareholders (FRR Nos. 11, 8, 7; ASR Nos. 306, 301, 294, 281, 280).
- . Interpretations about disclosure considerations relating to foreign operations and foreign currency translation effects (FRR No. 6).
- . Pro forma financial information and requirements for historical financial statements of businesses acquired or to be acquired (FRR No.2).
- . Separate financial statements of significant subsidiaries and the parent company which supplement consolidated financial statements (ASR No. 302).
- . Management's discussion and analysis of financial condition and results of operations (ASR No. 299).

- . Property, plant and equipment disclosures (ASR No. 298).
- . Disclosure of maturities of long term obligations (ASR No. 297).
- . The Last-in, First-out method of accounting for inventories (ASR No. 293).
- . Disclosures about the effects of changing prices (ASR Nos. 290 and 287).
- . Interim financial information (ASR No. 286).

In addition, SABs have recently been issued by the staff to address:

- . Accounting for contingent stock purchase warrants (SAB No. 57).
- . Disclosures about certain reserves mandated by the various Federal banking agencies (SAB No. 56).
- . Situations known as "carveouts," where a subsidiary, division or lesser business component of a larger entity files a registration statement for purposes of obtaining public financing (SAB No. 55).
- . The application of the "push-down" method of accounting (SAB No. 54).
- . Guarantees of a subsidiary's securities by a parent (SAB No. 53).
- . Termination of defined benefit pension plans (SAB No. 52).
- . Accounting for sales of stock by a subsidiary (SAB No. 51).
- . Disclosures in filings involving the formation of a one bank holding company (SAB No. 50).
- . Disclosures by bank holding companies about loans in countries that are experiencing liquidity problems (SAB Nos. 49 and 49A).
- . The transfer of nonmonetary assets by promoters or shareholders (SAB No. 48).
- . Various accounting and disclosure issues involving oil and gas producing activities (SAB No. 47).
- . Requirements for interim financial reporting (SAB No. 46).
- . The presentation of pro forma financial information (SAB No. 45).
- . Requirements for separate financial statements (SAB Nos. 44 and 43).

- . The application of existing accounting standards to business combinations accounted for by the purchase method involving financial institutions (SAB No. 42).
- . The effect of the decontrol of oil prices (SAB No. 41).

Although the Commission has adopted Regulation S-X, promulgated other rules and disclosure requirements in the financial reporting area, and has published interpretations and guidance where necessary, it has generally refrained from prescribing the accounting methods to be followed in the preparation of financial statements.

In lieu of specifying accounting principles, the Commission has presumed financial statements to be misleading or inaccurate unless prepared in accordance with accounting principles which have substantial authoritative support. Under this concept, the Commission looks to the private sector (presently the Financial Accounting Standards Board ("FASB")) to provide the initiative in establishing and improving accounting principles. 8/

ASR No. 4 (April 25, 1938), in which the Commission first articulated this policy, states in part:

In cases where financial statements filed with this Commission pursuant to its rules and regulations under the Securities Act of 1933 or the Securities Exchange Act of 1934 are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material.

8/ See Section F for a discussion of the FASB and the Commission's oversight of the FASB.

The Commission also noted in this release:

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 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.

In response to the Commission's indication of support of private sector efforts, the American Institute of Accountants' (now called the American Institute of Certified Public Accountants' ("AICPA")) Committee on Accounting Procedure began to issue pronouncements known as Accounting Research Bulletins. When this Committee's effectiveness was questioned, the Accounting Principles Board ("APB") was created in 1959. The APB functioned until the FASB was established in 1972. Unlike the Committee on Accounting Procedure and the APB, which functioned under the auspices of the AICPA, the FASB is an independent accounting standards-setting body.

In ASR No. 150 (December 20, 1973), the Commission endorsed the establishment of the FASB. In that release, the Commission stated:

In meeting [its] statutory responsibility effectively, in recognition of the expertise, energy and resources of the accounting profession, and without abdicating its responsibilities, the Commission has historically looked to the standard-setting bodies designated by the profession to provide leadership in establishing and improving the accounting principles. The determinations by these bodies have been regarded by the Commission, with minor exceptions, as being responsive to the needs of investors. . . .

For purposes [of the policy articulated in ASR No. 4], principles, standards and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support. . . .

The Commission's policy of looking to the FASB for the development of accounting standards, subject to Commission oversight, has received widespread support. 9/

9/ In 1980, the Financial Accounting Foundation commissioned Louis Harris and Associates to conduct a poll to find out what the leaders of those institutions most affected by the standards set by the FASB think of the work and procedures of that Board. The Harris organization surveyed a carefully constructed sample consisting of chief financial and executive officers from large, medium and small business corporations; officers of investment and brokerage firms; leading scholars in accounting; key government officials; representatives of the financial media; and officials of large, medium and small accounting firms. The report concludes that "a sizable majority of all groups give [the FASB] a positive rating," and that "an overwhelming majority of all groups feel it highly important to have the private sector perform this task." Further, in 1977, after a thorough examination of the accounting profession, the U.S. Senate Subcommittee on Reports, Accounting and Management of the Committee on Government Affairs, chaired by Senator Lee Metcalf, stated in its report (the "Metcalf Report") that "(s)elf-initiated action by the private sector in cooperation with the SEC is the method of reform [in the accounting profession] preferred by subcommittee members." Metcalf Report, page 4 (November 1977).

SECTION C - ACCOUNTANTS' INDEPENDENCE

The Federal securities laws recognize the importance of the concept of "independence" by referring specifically to "independent public accountants" and by giving the Commission authority to define independence. 1/ An auditor is deemed to be independent if he is independent in fact and in appearance. He must act in an unbiased and objective manner and he must be free of any financial interest which would create the perception that he is not independent.

The U.S. Supreme Court recently emphasized the auditor's responsibility to maintain an objective attitude toward clients. In United States v. Arthur Young & Company, the Court stated:

By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. 2/ (Emphasis in original.)

The Commission has consistently sought to ensure the independence of accountants. In an early case, the Commission explained this need for independence:

...one of the purposes of requiring a certificate by an independent public accountant is to remove the possibility of impalpable and unprovable biases which an accountant may unconsciously acquire because of his intimate non-professional contacts with his client. The requirement for certification by an independent public accountant is not so much a guarantee against conscious falsification or intentional deception as it is a measure to insure complete objectivity. It is in part to protect the accounting profession from the implication that slight carelessness or the choice of a debatable accounting

1/ Section 7 of the Securities Acts, 15 U.S.C. 77g, and Section 23 of the Exchange Act, 15 U.S.C. 78w.

2/ 104 S. Ct. 1495, 1503 (1984).

procedure is the result of bias or lack of independence that this Commission has in its prior decisions adopted objective standards. 3/

Since 1937, the Commission has publicly expressed its views on independence. 4/ Later releases reflect some common independence questions raised with the staff by accountants or their clients. 5/

The accounting profession has gradually incorporated many of the Commission's independence requirements in its own rules of conduct. As early as 1947, the Council of the American Institute of Accountants stated:

...[i]n the field of auditing, the certified public accountant is under a responsibility peculiar to his profession and that is to maintain strict independence of attitude and judgment in planning and conducting his examinations and in expressing his opinion on financial statements. 6/

3/ In the Matter of A. Hollander & Son, Inc., Securities Exchange Act Release No. 2777 (1941). In an earlier case, In the Matter of Cornucopia Gold Mines, 1 S.E.C. 364 (1936), the Commission concluded that the accountant was not independent because he was an unsalaried but principal financial and accounting officer of the registrant and a shareholder.

4/ ASR No. 2 (May 6, 1937).

5/ The staff's written responses to letters requesting its views on independence questions are available for public inspection in the Commission's Public Reference Room 30 days after the issuance of the staff's response. See FRR No. 4 (October 14, 1982); Codification of Financial Reporting Policies, Section 600 et. seq.

6/ The Journal of Accountancy (July 1947).

Overview of Independence Standards

Generally accepted auditing standards ("GAAS") require independence in mental attitude. 7/ GAAS states that an accountant "must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be." 8/ The literature further explains the need for strict independence as follows:

It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners. For example, an independent auditor auditing a company of which he was also a director might be intellectually honest, but it is unlikely that the public would accept him as independent since he would be in effect auditing decisions which he had a part in making... Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence. 8/

The AICPA has also adopted a Code of Professional Ethics which states, among other things, that "the public expects a number of character traits in a certified public accountant, but primarily integrity and objectivity and, in the practice of public accounting, independence." 9/ Any member of the AICPA who engages in the practice of public accounting and is found to have violated any of the provisions of the ethics code may be admonished, suspended or expelled from membership in the AICPA. 10/ In general, the ethics code, and related interpretations and rulings,

7/ AICPA U.S. Auditing Standards, Section AU 150.02.

8/ Ibid., Section 202.02-.03.

9/ AICPA Code of Professional Ethics, Section ET 52.01.

10/ Ibid., Section ET 92.02. Expulsion from AICPA membership does not preclude an individual from practicing public accounting. That authority rests with state licensing authorities.

provide guidance similar to the Commission's interpretations of accountants' independence.

The Commission's Rule 2-01(b) of Regulation S-X 11/ provides that accountants must be independent in fact and designates certain relationships that are considered to impair independence. The Commission's releases and the independence letters written by the Commission's Office of the Chief Accountant identify additional relationships considered to adversely affect either the fact or the appearance of independence. All relationships between auditor and client are considered in evaluating the auditor's independence. 12/

For example, Rule 2-01(b) specifically states that an accountant, his firm, or any member of his firm cannot be a promoter, underwriter, voting trustee, director, officer or employee of the client (which includes any affiliate, parent or subsidiary of the client), nor can any of those persons have any direct or material indirect financial interest or any commitment to acquire such an interest in the client.

Efforts to Enhance Accountants' Independence

Through disclosure requirements and enforcement actions, the Commission has taken steps designed to enhance accountants' independence. Registrants

11/ 17 CFR 210.2-01(b).

12/ Rule 2-01(c), 17 CFR 210.2-01(c), provides as follows: "In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

are required to report on Form 8-K 13/ and in certain proxy statements 14/ any change in principal accountants and to state whether the decision to change accountants was recommended or approved by the company's Board of Directors or an audit committee. In addition, the report must describe any disagreement between the registrant and its principal accountant during the two fiscal years (and any interim period) prior to the change which would have resulted in mention in the accountants' report. When a change in accountants occurs, the registrant must request and file as an exhibit to the Form 8-K, a letter from the former auditor stating whether he agrees with the statements made by the registrant in the filing, and if not, stating the reasons he does not agree. 15/

13/ Reports on Form 8-K must be filed within 15 days after the occurrence of the event reported. Item 4 requires disclosure whenever an accountant resigns, indicates he declines to stand for re-election after the completion of the current audit, is dismissed or another independent accountant is engaged.

14/ Disclosures similar to the 8-K requirements concerning changes in accountants are required in certain proxy statements. Item 8, Schedule 14A, (17 CFR 240.14a-101), also requires disclosure of (1) the name of the principal accountant selected or being recommended to shareholders for selection or the reasons why no accountant has been selected or recommended; (2) the name of the principal accountant for the fiscal year most recently completed if different from the accountant named pursuant to the first provision or if no accountant has yet been selected or recommended; and (3) whether the accountant will attend the annual meeting and make a presentation or be available to answer questions. Item 6(d)(1), Schedule 14A, (17 CFR 240.14a-101), requires disclosure in proxy statements as to whether the company has an audit committee or a committee that performs a similar function.

15/ The following additional disclosure is required by Item 4 of the 8-K rules: the date of the resignation, declination to stand for re-election, dismissal or engagement of another independent accountant, and a statement whether the principal accountant's report on the financial statements for either of the most recent two years contained an other than unqualified opinion on those financial statements, and a description of the nature of such opinion.

Disclosure is also required in registration statements and in annual reports on Form 10-K when (i) a change in accountants and a disagreement with the former accountants was reported in a report on Form 8-K filed during the 24 months prior to the date of the most recent financial statements and (ii) material transactions or events similar to those involved in the disagreement occurred after the change and were accounted for in a manner different from that with which the former accountant would have agreed, unless the former accountant's preferred method of accounting was no longer generally accepted. Registrants must disclose the "existence and nature of the disagreement and ... the effect on the financial statements if the method had been followed which the former accountant apparently would have concluded was required." 16/

The Commission has taken certain enforcement actions which have had an effect on accountants' independence. For example, in 1984 the Commission concluded that when the succeeding accountants knew that the predecessor accountants disagreed with the company on an accounting issue, the successor accountants should have inquired about the specific basis for the disagreement, the accounting literature considered by the prior auditors, and whether the prior auditors had made inquiries of any other accounting firms and performed other research in reaching their conclusion. The Commission stated that the qualities of integrity and objectivity in accountants are even more important "with respect

16/ Item 304, Regulation S-K, 17 CFR 229.304.

to prospective clients to avoid the appearance of 'opinion shopping.'" 17/

In another case, the Commission required, as a condition of settlement, that the company maintain an audit committee of its Board of Directors which would have specific duties and responsibilities, including the requirement to review, prior to issuance, the financial statements with the independent auditors. The audit committee must also meet with the auditors to discuss the audit, and the company's policies and procedures with respect to internal auditing, accounting and financial controls. 18/

17/ In the Matter of Steven O. Wade et al., AAER No. 32 (June 25, 1984). The Commission stated: "The Concepts of Professional Ethics of the AICPA provides that '[a] certified public accountant should maintain his integrity and objectivity and, when in the practice of public accounting, be independent of those he serves.' These qualities are the cornerstone of the accounting profession and are fundamental to reliance on independent auditors."

The Commission, too, has recognized the need for independent auditors to retain a 'healthy skepticism' to ensure that a review of a client's accounting treatment is fair and impartial. In the Matter of Touche Ross and Co., AAER No. 16 (November 14, 1983) in which the Commission stated, "When circumstances so indicate, independent accountants must opine that financial statements are not presented fairly in accordance with GAAP, even if such an opinion does not comply with client desires. Otherwise, the opinions of auditors are of little value to those who rely on them - whether they be the auditors' clients or others such as investors, creditors and governmental agencies."

The AICPA's Code of Professional Ethics, addresses potential problems with "shopping." Section ET 201.03 entitled "Shopping for Accounting or Auditing Standards" states: "If a client of another public accountant who is retained to report on the client's financial statements requests a member to provide professional advice on accounting or auditing matters in connection with the financial statements of that client, the member before giving such advice must consult with the other accountant to ascertain that he is aware of all the available facts relevant to forming a professional judgment on the appropriate accounting or auditing standard to be applied. In deciding whether to provide such advice, the member should bear in mind that, among other things, the client and its public accountant may have disagreed about the facts, accounting or auditing standards, or similar significant matters." (Emphasis added.)

18/ SEC v. United States Surgical Corporation, AAER No. 22 (February 27, 1984).

Finally, accountants' independence should also continue to be strengthened by a number of the membership requirements of the AICPA's SEC Practice Section, the accounting profession's self-regulatory organization, which is described in detail in Section G.

Nonaudit Services

In 1978 and 1979, the Commission issued two releases relating to the scope of services performed by independent accountants for their audit clients. ASR No. 250 (June 29, 1978) announced the adoption of a rule requiring disclosure in proxy statements about nonaudit services, including management advisory services ("MAS") performed by accountants. In ASR No. 264 (June 14, 1979), the Commission discussed factors relevant to an evaluation of the impact of the performance of nonaudit services on auditor independence.

The disclosure about nonaudit services was intended to permit security holders to better evaluate registrants' relationships with their independent accountants. In addition, the Commission intended to monitor the disclosures to assist in developing an empirical basis from which to determine the need for any further action in this area.

In 1981, the Commission staff reviewed proxy disclosures to obtain a better understanding of the nature and extent of nonaudit services performed by accountants. There was no evidence provided by the Cohen Commission 19/ or otherwise that such services compromised accountants' independence or that such information was useful to investors. Therefore, the Commission proposed for public comment rescission

19/ The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations (1978) [hereafter cited as Cohen Commission Report]. This independent Commission was established by the American Institute of Certified Public Accountants ("AICPA") in 1974 to study the role and responsibilities of independent accountants.

of ASR No. 250 and withdrew ASR No. 264. 20/ No significant opposition was received from individual or institutional investors. The only significant opposition was from firms that compete with auditors for such services. 21/ Therefore, the Commission withdrew ASR No. 250. 22/

The AICPA's SEC Practice Section ("SECPS") requires member firms to report information concerning nonaudit services, which is available to the public. Member firms are required to report annually (1) the amount of gross fees for accounting and auditing, tax and MAS expressed as a percentage of total gross fees; (2) the amount of the gross fees for both MAS and tax services performed for SEC clients, expressed as a percentage of total fees charged to all SEC audit clients; and (3) the number of audit clients for which MAS is performed within various percentage ranges. 23/

The membership requirements prohibit member firms from performing the following: psychological testing; public opinion polls; merger and acquisition assistance for a finder's fee; executive recruitment services and certain actuarial services to insurance companies. 24/

20/ ASR No. 296 (August 20, 1981); ASR No. 297 (August 20, 1981).

21/ The letters that opposed the proposal, and in most cases also criticized the rescission of ASR No. 264, came from 36 management consultants or management consulting firms, 6 consultants' associations, 1 other registrant, 1 privately held company, and 1 law firm. In addition to the letters of comment, the Commission received a petition signed by 25 people requesting that the Commission reinstate ASR No. 264, retain ASR No. 250, and prohibit accounting firms from selling nonaudit computer-related products or services.

22/ ASR No. 304 (January 28, 1982).

23/ "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for Firms," Section IV (g).

24/ Ibid., Section IV; 3(e), f, g(10), (i) (j), and (k).

The Public Oversight Board ("POB"), which monitors MAS, concluded in its most recent annual report that: "[t]he procedures [performed by peer review teams] have not surfaced any evidence that suggest that proscribed services have been performed or that performance of MAS by member firms has diluted the objectivity required in performance of the audit function." 25/

The latest reports filed with the SECPS by member firms reveal that of the eleven firms with more than 100 SEC clients, total MAS fees ranged from 5% to 28% of total fees (from all clients); three years ago MAS fees ranged from 4% to 27% of total revenues for these firms. During this period, only one of these eleven firms received more than 20% of its total revenues from provision of MAS; the majority were significantly less than 20%. During the last three years, no firm with more than 100 SEC clients received over 19% of total SEC-client revenues from MAS work for SEC clients. The range for SEC-client MAS fees as a percent of total SEC-client revenues was 2% to 19% for these firms, with all but one firm receiving significantly less than 10% of their total fees from SEC clients for MAS work.

25/ Public Oversight Board Annual Report 1983-1984, at 16.

SECTION D - COMMISSION PROGRAMS TO ENSURE COMPLIANCE WITH THE SECURITIES LAWS

Review and Comment Process

Disclosures, including financial data, in registration statements, proxy statements and periodic reports filed with the Commission under the various Acts are reviewed by the appropriate operating division of the Commission. The review of filed documents is intended to determine, among other things, whether any material questions exist regarding:

- the adequacy of the disclosure made,
- conformity of the financial data with the requirements for the form and content of financial statements,
- whether such data are presented in conformity with generally accepted accounting principles ("GAAP"), and
- whether the financial statements are audited by independent accountants and whether there appear to be any material inconsistencies between financial information and other disclosures made.

Where a filing appears to provide inadequate disclosure of material information, or the accounting practices raise questions, the usual procedure is to call the matter to the attention of the registrant, provide a reasonable opportunity for discussion with the staff and, where appropriate, accept filing of a corrective amendment. 1/

In anticipation of the review process, registrants and their accountants sometimes discuss matters with the staff either through telephone inquiries or meetings. This process is constructive because registrants can obtain the staff's views before publishing or filing affected financial statements. Prefiling conferences as to accounting treatment and appropriate disclosure can avoid delays that may be otherwise encountered in the review process.

1/ In unusual situations, the matter may be (i) referred to the Division of Enforcement, (ii) the registrant may be informed the filing is too deficient to be processed, or (iii) other action may be taken as appropriate.

The Federal securities laws, and the regulations adopted thereunder, cannot address every individual transaction with specificity. Thus, the disclosures that are made, to a great extent, reflect the judgment of the issuer and its professional advisers as to what is material disclosure. The review process is one of the means by which the views of the staff are disseminated as to compliance with disclosure requirements. Examples of the various results of the review and comment process are discussed below.

Amendments to Filings -- Amendments as a result of the review and comment process range from inclusion of additional disclosure regarding complex transactions to revision of previously issued financial statements. For example, the accounting by Financial Corporation of America, a savings and loan holding company, for transactions purported to be GNMA dollar reverse repurchase transactions ("dollar rolls") was questioned by the staff and the registrant restated previously issued financial statements. This resulted in restating a \$75 million net income to a \$80 million net loss for a six-month period.

Accounting for single premium deferred annuity contracts by insurance companies was first questioned as a result of the review of a registrant filing. Thereafter, the staff sent comments to other insurance companies to ascertain how they were accounting for these contracts and, when appropriate, to request that they amend their financial statements to appropriately reflect those contracts in a manner consistent with that of the filing reviewed.

Additional Guidance -- The review process also identifies emerging accounting issues that should be addressed to ensure comparable and appropriate financial reporting. The identification of such issues may point out the need for clarification of the Commission's rules or changes in generally accepted accounting principles.

In one instance, after reviewing a registration statement filed for the sale of securities by a subsidiary of another company, the staff required that the subsidiary's financial statements reflect certain operating expenses that its parent had paid but previously had not charged to the company. The staff observed that offering securities of a subsidiary was becoming increasingly popular and subsequently explained its views on the appropriate accounting in a SAB. 2/

Also, when reviewing an initial public offering of stock of a subsidiary of a registrant, the staff noted that the subsidiary's balance sheet did not reflect \$64 million of costs incurred by the parent when the subsidiary was acquired. The staff required the subsidiary to record such costs and the related amortization of the costs in its financial statements. The Commission staff perceived a misunderstanding of its existing staff policy and issued a SAB on "push-down" accounting 3/ to provide additional guidance for all registrants.

In addition to publication of guidance as a result of the review and comment process, issues encountered in this process sometimes lead to new FASB accounting standards. For example, a company that produces computer software for license to others was found to be capitalizing costs of development of such products. A review of other companies in the industry found most companies to be expensing such costs, but several registrants were capitalizing them. The Commission, concerned about the potential lack of comparability among these companies

2/ SAB No. 55 (November 30, 1983).

3/ SAB No. 54 (November 3, 1983).

and the potential for increasing divergence of practice, imposed a moratorium 4/ to prevent capitalization of such costs by companies not already doing so. An AICPA Task Force was formed to study the problem; the task force prepared an Issues Paper 5/ and submitted the paper to the FASB. The FASB added the item to its agenda and issued an exposure draft which should result in a new accounting standard. Upon issuance of the new standard, the moratorium will expire.

The FASB has another project on its technical agenda which first surfaced in the review process. The staff noticed an increasing number of situations in which companies offered special terms to holders of convertible debt that were somewhat more favorable than the original terms to induce these holders to convert the debt to common stock. The accounting issue is whether a gain or loss should be recorded upon conversion and if recognized, the amount of the gain or loss. This issue was discussed with the FASB's Emerging Issues Task Force (discussed in depth in Section F) which reached a consensus that the issue should be referred to the FASB because amendment of the accounting literature was required to deal with the issue. The FASB presently has an exposure draft outstanding on this topic. 6/

Reviews of filings also result in referrals to the AICPA and its industry committees. The adequacy of disclosures of recoverability of motion picture production costs was questioned and staff concerns were communicated to the AICPA's Accounting Standards Executive Committee ("AcSEC"). A task force has been formed to study potential improvements in such disclosures.

4/ FRR No. 12 (August 8, 1983).

5/ Accounting for Costs of Software for Sale or Lease, AICPA Issues Paper, February 17, 1984.

6/ Induced Conversions of Convertible Debt, FASB Exposure Draft, December 6, 1984.

Enforcement Efforts

Overview -- The purpose of the Commission's enforcement program is to preserve the integrity, efficiency and fairness of the securities markets. In the area of financial reporting, enforcement efforts seek out and prosecute identified irregularities, knowing that these efforts enhance the care with which registrants analyze accounting and disclosure issues. Enforcement efforts also maintain and strengthen the integrity of the audit process by dealing with public accountants who are found to have (i) failed to comply with generally accepted auditing standards; (ii) violated the Federal securities laws; or (iii) aided and abetted violations of the Federal securities laws.

The enforcement program in the area of financial reporting focuses upon the key participants in the financial disclosure process. The first focus is directed upon companies which have securities registered with the Commission and file financial disclosure documents with the Commission, and the officers, directors and employees of those companies. Secondly, individual public accountants and CPA firms fall under enforcement scrutiny because they play a critical role in the integrity of the disclosure process. The performance of independent accountants is scrutinized in every case where the Commission finds financial disclosure improprieties, in order to determine whether the accountants have fulfilled their professional responsibilities.

The financial disclosure program has been a priority of the Commission's enforcement efforts for the past several years. In anticipation of increased financial reporting problems expected as a result of the 1982 economic downturn, the Commission increased the resources dedicated to this area. The "hot issues" market in 1983 also resulted in increased financial reporting problems. Therefore, although financial reporting cases are complex and require more

resources than other types of cases, the number of actions brought by the Commission has increased significantly in the past several years. For example, in fiscal 1984, the Commission brought 33 cases containing significant allegations of financial disclosure violations against issuers or their employees. This compares with 25 in 1983, and 23 in 1982.

Related to the increased number of cases alleging financial disclosure violations on the part of issuers or individuals are increased actions relating to individual public accountants and accounting firms. The Commission brought 18 cases alleging misconduct on the part of accounting firms, partners or employees in fiscal 1984. ^{7/} There were eleven disciplinary or enforcement actions against accountants or accounting firms in 1983, and three in 1982.

Furthermore, the Commission is continuing to investigate financial disclosure improprieties. Given the long period of time required to complete an investigation, and the number of financial disclosure cases currently under investigation, the Commission expects that the number of cases brought in fiscal 1985 relating to violations by issuers and their employees may exceed levels reached in prior years.

Remedies -- In the event of violation of the Federal securities laws, the Commission has several judicial and administrative remedies available which are designed to rectify such violations and prevent future violations. The principal

^{7/} Ten of the 33 enforcement cases brought against issuers in fiscal 1984 also resulted in enforcement proceedings against their auditors. The Commission is currently pursuing five additional cases, either through investigation or administrative proceedings. In six other cases, the Commission or staff determined that an action against the accountants was not appropriate. In the remaining 12 cases, there was no involvement of accountants in such a manner that they would bear responsibility for the misstatements, either because no audited financial statements were involved or for other reasons.

judicial remedy relating to violations by companies and their officers, directors and employees is a Federal court injunction. An injunction directs the subject to comply with the law in the future. Also, the Court frequently issues orders providing for additional equitable relief. Such ancillary relief can include, for example, requirements that a company's Board of Directors assign outside directors to an audit committee or engage an accounting firm to perform a special review. 8/ If an injunction is violated, contempt of court proceedings may result in imprisonment and imposition of fines.

Issuers of securities can be subject to administrative proceedings pursuant to Section 15(c)(4) of the Exchange Act 9/ for failure to comply with the disclosure requirements and certain other provisions of that Act. Respondents may be ordered to comply with applicable provisions upon specified terms and conditions, or to take steps to effect compliance. A common requirement of issuers subject to a 15(c)(4) proceeding is to reissue the financial statements of one or more periodic filings, restated to comply with GAAP. 10/ The Insider Trading Sanctions Act specifically authorized 15(c)(4) proceedings as a remedy against persons who "cause" an issuer to file false reports.

8/ See, for example, Securities and Exchange Commission v. United States Surgical Corporation, Accounting and Auditing Enforcement Release ("AAER") No. 22 (February 27, 1984); SEC v. Florafax International, Inc. et al, AAER No. 44 (November 27, 1984); and SEC v. Tandem Computers, Inc., AAER No. 41 (October 2, 1984).

9/ 15 U.S.C. 78o(c)(4).

10/ Examples of administrative proceedings pursuant to Section 15(c)(4) include those described In the Matter of Accounting for Gains and Losses Incurred in Connection with Certain Securities Transactions, AAER No. 14 (October 6, 1983); and In the Matter of Clabir Corporation, AAER No. 4 (February 16, 1983).

Upon completion of an investigation relating to financial reporting issues, the Commission can also publish reports of investigation under Section 21(a) of the Exchange Act. 11/ Such reports are directed toward the entire financial community. Their purpose is to publish the facts of a particular investigation, and disseminate the Commission's views regarding important issues, when it is has been determined that neither an injunction nor administrative proceeding constitutes an appropriate remedy. 12/

In addition to the above-mentioned actions relating to companies and their officers, directors and employees, the Commission has available remedies relating to conduct of individual public accountants and CPA firms. If a professional's conduct amounts to a violation of, or aiding and abetting a violation of, the Federal securities laws, the Commission may seek an injunction to prevent repetition of such conduct. 13/

Rule 2(e) of the Commission's Rules of Practice, provides a vehicle for discipline of accounting professionals. 14/ Pursuant to Rule 2(e), the Commission may, in administrative proceedings, censure any individual professional or firm found to be lacking in qualifications or to have engaged in any of several activities.

11/ 15 U.S.C. 78u(a).

12/ Examples of reports of investigation pursuant to Section 21(a) include those described in In the Matter of Aetna Life and Casualty Company, AAER No. 10 (July 7, 1983); and In the Matter of Seaboard Associates, Inc., AAER No. 28 (April 16, 1984).

13/ Examples of injunctions of accountants include those described in SEC v. Frederick S. Todman & Company, Litigation Release No. 10505 (August 21, 1984); and SEC v. William M. Holben and Robert A Savage, Litigation Release Nos. 10563 and 10599.

14/ 17 CFR 201.2(e).

These activities can include, among other things: (i) failure to perform an audit in accordance with generally accepted auditing standards; (ii) false certification that financial statements are in accordance with generally accepted accounting principles; (iii) violation of the federal securities laws; or (iv) aiding and abetting a violation of the federal securities laws.

Pursuant to Rule 2(e) an individual accountant or an accounting firm may also be denied, temporarily or permanently, the privileges of appearing or practicing before the Commission. Rule 2(e) actions also frequently involve imposition of additional conditions upon the practice of sanctioned individuals or firms. Such conditions can include requirements to join the SEC Practice Section, thus subjecting themselves to peer review, installation of certain auditing policies and procedures or quality control procedures, or reviews of auditing and accounting judgments on a particular client by a partner not otherwise involved with the engagement. 15/

The Commission makes public the major facts, issues and conclusions relating to each financial disclosure investigation which culminates in an action against registrants, employees or public accountants. Since 1982, such reports have been publicized in the form of Accounting and Auditing Enforcement Releases ("AAERs") to facilitate reference to the Commission's views on particular accounting and auditing matters that have given rise to Commission enforcement actions. 16/ Prior to 1982, enforcement actions were made public by means of ASRs. AAER No. 1 is a topical index to those ASRs.

15/ Examples of actions pursuant to Section 2(e) which contained significant ancillary relief include In the Matter of Fox & Company, AAER No. 9 (June 30, 1983); and In the Matter of Smith & Stephens Accountancy Corporation; James J. Smith, AAER No. 39 (September 10, 1984).

16/ Other actions are publicized in SEC Litigation Releases or Securities Exchange Act Releases.

Recent Issues -- The specific financial reporting issues and violations of the Federal securities laws vary in each recent enforcement action. In this regard, recent actions have involved: misapplication of accounting principles within the financial statements or inadequate disclosure of required information in the notes to financial statements; misleading and inadequate discussion of material events and trends in Management's Discussion and Analysis; 17/ and false statements or failure to disclose material information in press releases and other public statements. 18/

The largest group of enforcement actions relate to misapplication of accounting principles in the published financial statements of a registrant. Many of the actions involve improper utilization of various accounting devices which resulted in reporting net income at levels above what would have been reported had GAAP been fairly and consistently applied. Several such actions have involved improper revenue recognition: premature recognition of revenue although goods were not shipped until a later period; recording unordered products as sales; revenue recognition despite significant uncertainties; and improper recognition of operating leases as sales. 19/

17/ See, for example, SEC v. Ronson Corporation, Litigation Release No. 10093 (August 15, 1983).

18/ See, for example, In the Matter of Fidelity Financial Corporation and Fidelity Savings and Loan Association, Securities Exchange Act Release No. 18927 (July 30, 1982).

19/ See, for example, SEC v. Datapoint Corporation; John V. Thornton, AAER No. 31 (June 18, 1984); SEC v. United States Surgical Corporation, AAER No. 22 (February 27, 1984); SEC v. Chronar Corporation, AAER No. 40 (October 3, 1984) and SEC v. A.M. International, Inc., Litigation Release No. 9980 (May 2, 1983).

Deferral of costs and expenses has also resulted in enforcement actions as a result of: improper capitalization of legal, advertising and other expenses; improper capitalization of various expenses as long-term assets; understatement of reserves; and failure to write off permanently impaired assets or assets which could not be located. 20/ -One registrant failed to consolidate or otherwise reflect losses of an in-substance subsidiary. 21/ Devices utilized to falsely record inventories have included improper recognition of inventory liquidations, and falsification of inventory records. 22/

One of the Commission's current enforcement priorities relates to financial institutions that overstate net income. Failure to recognize loan losses on a timely basis has resulted in actions against financial institutions or responsible employees in recent years. Failure to recognize losses from complex securities transactions also resulted in overstatement of net income. 23/

Enforcement actions against both companies and public accountants seek to enhance the integrity of the audit process. The Commission considers the role of

20/ See, for example, SEC v. United States Surgical Corporation, AAER No. 22 (February 27, 1984); SEC v. McCormick & Company, Litigation Release No. 9846 (December 21, 1982); SEC v. AM International, Inc., Litigation Release No. 9980 (May 2, 1983); In the Matter of the Registration Statement of Promotion, Inc., AAER No. 26 (March 30, 1984) and In the Matter of George L. Simmon; Jerome R. Horwitz, AAER No. 12 (August 3, 1983).

21/ SEC v. Digilog, Inc.; Ronald Moyer, AAER No. 34 (July 5, 1984).

22/ See, for example, SEC v. Stauffer Chemical Company, AAER No. 35 (August 13, 1984); and SEC v. Saxon Industries, Inc., et al., Litigation Release Nos. 9765, 9790 and 9817 (September 27, 1982).

23/ See, for example, SEC v. IntraWest Financial Corporation, AAER No. 23 (February 28, 1984); In the Matter of Utica Bankshares Corporation, AAER No. 24 (February 29, 1984); SEC and Office of the Comptroller of the Currency v. Charles D. Fraser, AAER No. 37 (August 30, 1984); and In the Matter of Accounting for Gains and Losses Incurred in Connection with Certain Securities Transactions, AAER No. 14 (October 6, 1983).

accountants in every case where an action is brought against a company. The Commission has not, however, brought actions against accountants in every case where an issuer has been charged with materially false or misleading financial statements, because the existence of false financial statements does not necessarily mean that an audit was defective. For example, in the Electromedics, Inc. case (Litigation Release No. 10204, November 21, 1983), the auditor was deceived by the treasurer of the company who altered the company's inventory records for items which he observed were not test-counted by the auditors. Other tests performed by the auditors could not reasonably have been expected to discover the altered records. Another example is the IntraWest Financial Corporation case (AAER No. 23, February 28, 1984) which involved false, unaudited, interim financial statements with which the auditor was not associated.

Disciplinary actions are generally brought against accountants when it is determined that an audit was not performed in accordance with generally accepted auditing standards, and, as a result, materially false financial statements were permitted to be issued, or when accountants have violated, or aided and abetted violations of, the Federal securities laws.

There have been 32 actions against individual accountants or public accounting firms brought in the past three years. These cases have involved a failure to follow generally accepted auditing standards on the part of the accountants, and resultant improper certification of registrant financial statements which were materially misleading.

The importance of auditor independence was illustrated in a recent case involving a company's change in auditors. The Commission alleged that the issuer's public accountants disagreed with proposed accounting treatment for a transaction. After checking with several accounting firms, the company hired a

firm which was willing to support the proposed treatment. A change of auditors in the face of an accounting disagreement does not necessarily indicate improper professional conduct on the part of the replacement auditor. However, in this case, disciplinary action was deemed appropriate because the treatment approved by the replacement auditors, and reflected in the financial statements filed with the Commission, was not in accordance with GAAP. 24/

The following case illustrates the responsibilities of parties other than issuers or their employees and public accountants. The Commission alleged that a third party supplier colluded with an issuer's employees and confirmed false information to the issuer's public accountants. The Commission's action against the supplier acknowledged the importance of the confirmation process in auditing evidence-gathering, and demonstrated its willingness to bring enforcement action against all those who would subvert the audit process. 25/ Other enforcement actions have been brought as a result of false statements on the part of officers or directors of issuers to auditors. 26/

Foreign Corrupt Practices Act — Cases concerning financial disclosure by reporting companies also may involve enforcement of the accounting provisions of the Foreign Corrupt Practices Act ("FCPA"). The accounting provisions of the FCPA require, among other things, that companies maintain adequate systems of internal accounting control and adequate books and records. 27/ In fiscal

24/ In the Matter of Stephen O. Wade et al., AAER No. 32 (June 25, 1984).

25/ SEC v. The Barden Corporation; Robert P. More, AAER No. 33 (June 26, 1984).

26/ See, for example, SEC v. McCormick & Company, Incorporated, et al., Litigation Release No. 9846 (December 21, 1982).

27/ Section 13(b)(2) of the Exchange Act, 15 U.S.C. 78m(b)(2).

1984, 10 actions were brought to enforce the accounting provisions of the FCPA, compared with 12 in 1983 and 10 in 1982. These 32 cases represent 78% of all such actions brought since enactment of the FCPA in 1977.

In the first case in which violations of the accounting provisions of the FCPA were found in a trial, the Court held that since the time one individual defendant had controlled the company, the internal recordkeeping and accounting controls at the company had been "sheer chaos." 28/ Subsequent to those findings of civil violations, the individual was also found guilty of criminal violations, and among other things, of the accounting provisions of the FCPA. As a result of those criminal violations the individual was recently sentenced to ten years imprisonment and a \$60,000 fine.

Proceedings relating to the FCPA have required additional relief such as an annual review by public accountants for the adequacy of the issuer's system of internal accounting controls in those areas which were found to be deficient. 29/

28/ SEC v. World-Wide Coin Investments Ltd. et al, 567 F. Supp 724 (N.D. Ga. 1983).

29/ See, for example, SEC v. Tandem Computers, Inc., AAER No. 41 (October 2, 1984).

SECTION E - PRIVATE LITIGATION AGAINST ACCOUNTANTS

In addition to proceedings by the Commission and action by the profession's self-regulatory organizations, significant numbers of private suits are brought against accounting firms. 1/ Shareholders, securities firms, creditors and others who rely on allegedly erroneous financial statements may all seek to recover their losses from corporations' independent public accountants. 2/ Some of those actions are developed through private discovery, but many are a direct result of Commission compliance actions. These suits serve as a disciplinary force and incentive to strengthen practice. The number of legal actions against accountants and the scope of the accountant's liability are substantially increasing. The "deep pockets" of independent public accountants and their insurance carriers have become attractive targets, 3/ particularly where an entity's assets have been depleted during the failure of its business.

1/ N. Minow, Accountant's Liability and the Litigation Explosion, 76 Journal of Accountancy 70 (September 1984), in which Mr. Minow states: "The number of lawsuits against accountants has soared, the damages awarded have skyrocketed and novel theories of liability are imposed by the courts. More lawsuits have been filed against accountants in the last decade and a half than in the entire previous history of the profession."

2/ As requested by the Subcommittee, a supplemental memorandum addressing the legal liability of accountants under the Federal securities laws will be furnished. This Section is not, therefore, a legal analysis of such liability, but a recognition of the impact of such potential liability on the practice of accounting.

3/ For example, the New Hampshire Supreme Court compared accountants and manufacturers to justify the broad, new liability: "[A]n accountant, like the manufacturer under products liability law, is in the best position to regulate the effects of his conduct by controlling the degree of care exercised during the performance of his professional duty. The accountant, through the fee structure, can pass along to his clients the cost of insuring against financial loss sustained by them through reliance upon his negligent misstatement of fact." Spherex Inc. v. Alexander Grant and Co., 451 A. 2d 1308, 1312 (N.H. 1982).

The damages plaintiffs are seeking in such suits currently total hundreds of millions of dollars. 4/

Depending on the nature of the case and the forum of the plaintiff's choosing, the independent accountant may be faced with allegations of strict liability, 5/ fraud, 6/ or negligence in the performance of its audit. 7/ Under one legal theory, an accountant may be liable for financial statements which misrepresent the financial position of a corporation, even if the plaintiff never examined or relied upon those financial statements. 8/ Further, in certain

- 4/ For example, in 1982 a Federal jury determined that \$80.7 million should be paid to investors in Fund of Funds Ltd. by the Fund's independent public accountant. A Federal judge, however, subsequently reduced this award to an unreported amount. More recently, there has been a \$45 million settlement between Chase Manhattan Corporation and the auditors for the now defunct Drysdale Government Securities Corporation. The financial press has also reported that two other accounting firms have been named as defendants, with many others, in a \$160 million lawsuit involving the inclusion of allegedly misleading information in a prospectus for the sale of notes. In yet another case, an audit is reportedly being questioned by a plaintiff which suffered a \$60 million loss in speculative bond trading. In that case, the auditor and numerous financial services companies have been named as defendants.
- 5/ See Section 11 of the Securities Act of 1933; 15 U.S.C. 77(k); Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). Section 11(b) of that Act, 15 U.S.C. 77(k)(b), does however provide a "due diligence" defense to such allegations.
- 6/ See, for example, Section 10(b) of the Securities Exchange Act of 1934; 15 U.S.C. 78j.
- 7/ Rosenblum v. Adler, 461 A. 2d 138 (N.J. 1983); Citizens State Bank v. Timm, Schmidt & Co., 335 N.W. 2d 361 (Wis. 1983). See also, Sections 17(a)(2) and (3) of the Securities Act; 15 U.S.C. 77q(a)(2) and (3).
- 8/ Under the "fraud on the market theory," a defendant may be liable for material misrepresentations even where the plaintiffs were unaware of the misstatements at the time of their loss as long as reliance on the statements by others affected the price at which the plaintiff bought or sold the securities. See e.g. Blackie v. Barrack, 524 F. 2d 891 (9th Cir. 1975) cert. denied 429 U.S. 816 (1976).

circumstances, the independent accountant may be subject to claims for three times the plaintiff's actual damages. 9/ In addition to pecuniary loss from the payment of damages, court costs and attorney fees, the accountant must guard his reputation as a competent professional willing to objectively serve the needs of both the public and his client.

The role of a "public watchdog" 10/ in which the courts have placed the profession is an indication of the legal and public interest duties which accountants are called on to perform. The exposure to such legal action, in addition to the Commission's and the profession's initiatives, provides incentive to accountants and accounting firms to exercise care in the performance of audit and accounting services for both public and privately-held entities.

9/ The Racketeer Influenced and Corrupt Organization Act, 18 U.S.C. 1961-1968, includes a provision for treble damages to be awarded to private parties. 18 U.S.C. 1964. Plaintiffs have recently begun alleging that improper auditing and issuing audit opinions on client's financial statements on two or more occasions subjects auditing firms to the provisions of this Act.

10/ United States v. Arthur Young & Co., 104 S. Ct. 1495, 1503 (1984).

SECTION F - OVERSIGHT OF PRIVATE SECTOR STANDARDS-SETTING

In addition to its direct action through rulemaking and other programs, the Commission monitors the structure, activity, and decisions of the private sector standards-setting organizations.

ACCOUNTING STANDARDS-SETTING PROCESS

Financial Accounting Standards Board ("FASB")

Structure and Operating Method -- The FASB establishes standards of financial accounting and reporting. The seven member FASB is the operating part of a larger structure which includes the Financial Accounting Foundation ("FAF") and the Financial Accounting Standards Advisory Council ("FASAC"). The Board of Trustees of the FAF ^{1/} selects members of the FASB and FASAC and has general funding and structural (as opposed to technical) oversight responsibility. FASAC has responsibility for consulting with the FASB as to major policy questions, technical issues on the Board's agenda, project priorities, matters likely to require the attention of the FASB, selection and organization of task forces, and such other matters as may be requested by the FASB or its chairman. At present, FASAC has 37 members who reflect a broad representation of preparers, auditors, and users of financial information. The Commission's Chief Accountant attends FASAC meetings.

^{1/} The FAF's Board of Trustees is comprised of representatives from sponsoring organizations whose members have special knowledge of, and interest in, financial reporting. They include the American Accounting Association; the American Institute of Certified Public Accountants; the Financial Analysts Federation; the Financial Executives Institute; the National Association of Accountants; the Securities Industry Association; the National Association of State Auditors, Comptrollers and Treasurers; and the Government Finance Officers Association.

The Board decides which topics to add to its agenda after deliberation and in response to suggestions received from numerous sources, including the Commission, FASAC, AcSEC (discussed below) and preparers and users of financial statements. The Board considers broad issues of financial accounting and reporting as well as issues related to implementation of existing standards and other problems arising in practice. Additionally, the FASB has developed a conceptual framework to help define the objectives and parameters of financial statements, reporting and accounting.

The FASB's Rules of Procedure require it to follow a process which was modeled on the Administrative Procedure Act, and is open to public observation and participation. ^{2/} For major projects, the Board (1) appoints an advisory task force of outside experts, (2) studies existing literature on the subject and conducts or commissions such additional research as may be necessary, (3) publishes a Discussion Memorandum setting forth the issues and possible solution as the basis for public comment, (4) conducts a public hearing, and (5) gives broad distribution to an Exposure Draft of the proposed Statement for public comment. The Board's meetings are open to public observation and a public record is maintained. For other projects, somewhat less extensive procedures are followed. For example, the use of task forces or the holding of public hearings may not be considered necessary. Some of the more significant projects currently on the FASB's agenda include accounting for pensions, other postemployment benefits, income taxes, consolidations and the equity method, employee stock compensation plans, and computer software.

^{2/} The Metcalf Subcommittee endorsed a recommendation of the FAF structure committee that all aspects of the FASB be open to public view. Metcalf Report, page 8.

The FASB issues a variety of documents in the course of the described process:

- Discussion Memoranda define the problem, the scope of the project and the financial accounting and reporting issues; discuss research findings and relevant literature; and present alternative solutions to the issues under consideration and the arguments and implications relative to each. These serve as the basis for both written comments and oral presentations at public hearings.
- Exposure Drafts ("EDs") set forth the proposed standards of financial accounting and reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions. A comment period of at least sixty days is generally provided.
- Statements of Financial Accounting Standards ("Statements") set forth the actual standards; the effective date and method of transition (implementation provisions); background information; a brief summary of research done on the project; and the basis for the Board's conclusions, including the reasons for rejecting significant alternative solutions. They also identify any dissenting members of the Board and include individual members' dissenting views.
- Interpretations are issued to clarify, explain, or elaborate on existing FASB Statements or the pronouncements of its predecessors.
- Technical Bulletins ("TBs") are issued by the FASB staff to provide guidance on certain financial accounting and reporting problems on a timely basis.

Timely Guidance -- In October 1982, the FASB appointed a Task Force on Timely Financial Reporting Guidance. It did so in response to Commission encouragement and a 1982 recommendation of the FAF's structure committee "that the Board develop a plan, for consideration by the Board of Trustees, to provide timely guidance for implementation questions and emerging issues." 3/

After considering the public's written comments and conducting a public hearing in March 1983, the task force made two recommendations designed to improve the FASB's ability to identify and deal with implementation and emerging issues:

3/ The FAF Structure Committee also recommended improvements in communications with constituents and that the FASB devise ways to elicit improved responses to discussion documents and exposure drafts from its constituents.

- The scope of FASB TBS should be broadened, allowing them to address emerging and implementation issues, which are not specifically covered in existing accounting literature, as well as specialized industry issues of the type that the Board has previously addressed.
- An advisory group should be established to assist in identifying and defining emerging financial reporting issues and to suggest solutions if possible.

The Board accepted these recommendations and, after soliciting additional public comments, agreed in May 1984 to expand the scope of the TBS to allow them to be more responsive to emerging issues. In addition, it amended its procedures so that TBS will involve a limited solicitation of comments and Board involvement and will include effective dates.

Emerging Issues Task Force -- The FASB also created a 17-member advisory group known as the Emerging Issues Task Force ("EITF"). The group's membership is primarily practicing CPAs from accounting firms but includes representatives of Financial Executives Institute, National Association of Accountants and the Business Roundtable. Since the primary purpose of the advisory group is problem identification, the group membership was chosen to include individuals who are both knowledgeable in accounting and financial reporting and in positions to be aware of emerging problems as they develop. The Commission's Chief Accountant participates in the Task Force meetings which are open to the public and held every 4 to 6 weeks. The group is not authorized to publish solutions to issues discussed, though minutes of the group's meetings are maintained and are available to the public through the FASB. Although the group's discussion of issues and the relevant accounting pronouncements is intended to help the FASB identify and better understand the issues, it may, however, also indicate that no immediate action by the FASB is necessary if the consensus from the discussion suggests that a diversity in practice is not likely to evolve.

The results of the EITF so far are encouraging. The Task Force has discussed over forty emerging issues since its inaugural meeting in July 1984. Predictably, the types of issues discussed have been relatively narrow in focus and have involved issues such as Government National Mortgage Association "dollar rolls," instantaneous in-substance defeasance, unique financing transactions such as debt payable in common stock, and a host of issues relating to financial instruments and financial institutions. About one-half of the issues have been referred to the FASB or the AICPA for action or further consideration. On the other issues, the group reached a consensus that either (i) a single method of accounting is preferable based on existing literature, (ii) existing guidance is adequate, or (iii) the issue does not present a pervasive problem. The Commission expects the positions agreed upon at those meetings to be followed by registrants and those that do not will be asked to justify departure from consensus reached.

Conceptual Framework Project — The conceptual framework project was commenced to establish the theoretical underpinnings of financial reporting. The products of the project are Statements of Financial Accounting Concepts ("SFAC" or "concepts statements"). Concepts statements are intended primarily to guide the Board in its deliberations on accounting and reporting issues.

In December 1984, the FASB completed the project. Five concepts statements have been issued — two statements on the objectives of financial reporting (one for business enterprises and one for non-business entities), a statement on qualitative characteristics of accounting information, a statement on the elements of financial statements, and finally a statement on recognition and measurement in financial statements.

In summary form, the objectives of financial reporting, as stated in SFAC No. 1, are to provide information to help users in assessing the amounts, timing and uncertainty of prospective cash receipts from dividends or interest and the return of capital. SFAC No. 2 identifies and defines the qualitative characteristics that make financial information useful including relevance, reliability, and comparability and consistency. Such characteristics are considered in the context of the notions of materiality, understandability, and costs and benefits. SFAC No. 3 identifies and defines ten financial statement elements -- assets, liabilities, equity, owner investments and distributions, comprehensive income, revenues, expenses, and gains and losses. Assets and liabilities are defined in terms of probable future economic benefits and sacrifices, respectively. SFAC No. 4 relates to objectives of financial reporting for non-business entities. SFAC No. 5 on recognition and measurement in financial statements sets forth conceptual guidance on when and how financial statement elements should be recognized in financial statements and how they should be measured.

It is not clear how the concepts developed will ultimately affect the evolution of the financial accounting and reporting model. The FASB believes that the concepts statements developed in this Project are useful in deliberations on new standards. The ultimate success or failure of the Project, however, can only be evaluated by assessing the FASB's future standards-setting activities.

Commission Oversight of the FASB -- The Commission staff communicates its views and concerns and discusses issues with the FASB on a daily basis. The two staffs meet regularly to discuss the FASB's agenda, current problems, and other matters of mutual interest. The FASB meets with the Commission periodically to discuss topical issues. Such exchanges took place during two open Commission meetings in 1984.

Each of the projects on the FASB's technical agenda is assigned to Commission staff members who follow project developments, review comment letters submitted to the FASB, attend FASB meetings and public hearings, and confer with FASB staff. A senior staff member of the Commission's Office of the Chief Accountant serves on each FASB task force. Additionally, the Chief Accountant participates in the quarterly meetings of FASAC as well as in meetings of the FASAC Agenda Advisory Committee, a subgroup which advises the FASAC regarding items which should be considered for the FASB's agenda.

Although the Commission has traditionally relied on the FASB's standards-setting processes to deal with evolving questions, there have been times when guidance on an issue is needed more quickly than can be provided by the FASB. In these instances, the Commission has taken action, often intended to be a temporary measure, to provide guidance for and enhance comparability among registrants until the FASB addresses the issue.

Examples of the interrelationship of the FASB and the Commission can be seen in recent standards-setting activity. 4/ In 1982, the quasi-defeasance of debt was becoming increasingly popular. In quasi-defeasance of debt arrangements, assets are dedicated to the future servicing and repayment of outstanding debt; the dedicated assets and the debt are removed from the company's balance sheet even though the debt itself may not have been legally satisfied under the terms of the debt arrangement. The Commission became concerned about its proliferation, absent specific accounting guidance, and imposed a moratorium to prevent further divergence in practice. 5/

4/ See Section D for further examples.

5/ FRR No. 3 (August 24, 1982).

The FASB, after extensive deliberation, concluded that quasi-defeasance debt extinguishments should be recognized in only certain limited circumstances involving a "trust" type arrangement. 6/ The Commission carefully evaluated the new standard in December 1983, and determined that it could rescind its previous release. However, in its release announcing that rescission, 7/ the Commission included certain interpretive language to clarify possible ambiguities in the new standard and to emphasize that its provisions should be strictly applied. The Commission and FASB have closely monitored the implementation of the new standard, and the FASB has provided timely response to ensure that its application is limited to a very narrow set of circumstances.

In another recent instance, when the Commission's staff became aware of the proliferation of junior stock plans, 8/ it examined the accounting treatment and encouraged the FASB to examine this issue as well as the overall issue of accounting for employee stock plans. The FASB issued an Interpretation 9/ that addresses junior stock and is presently working on a project to reexamine APB Opinion No. 25 ("Accounting for Stock Issued to Employees"), the current literature dealing with the broader issue.

6/ FASB Statement No. 76 (December 1983).

7/ FRR No. 15 (December 22, 1983).

8/ Junior or inferior stock plans entail issuance to officers and other employees of shares of a special class of stock or options on such stock which are convertible into regular common stock of the employer corporation. The accounting issue relates to the amount of compensation, if any, that should be recognized by the issuing company.

9/ FASB Interpretation No. 38, Determining the Measurement Date for Stock Option, Purchase, and Award Plans Involving Junior Stock (August 1984).

AICPA Accounting Standards Executive Committee ("AcSEC")

AcSEC is the senior technical committee of the AICPA with respect to financial accounting and reporting matters. It consists of 15 members of the AICPA who serve on a part-time basis. Membership is staggered with members appointed annually by the Chairman of the AICPA, and normally serving for three years. AcSEC's objectives are to:

- (1) provide guidance to AICPA members on accounting issues not otherwise covered in the authoritative literature.
- (2) act as the AICPA's spokesman with the FASB, the Commission and other bodies that deal with accounting standards.

These objectives are primarily met through the issuance of issues papers, Statements of Position ("SOPs"), accounting guides, and letters of comment to the FASB, the Commission and other bodies. AcSEC's principal function is to provide input to the FASB — through its issues papers — to influence the development of accounting standards. Once an accounting problem is identified, an issues paper is prepared to define the problem, identify its causes, present a neutral discussion of alternative approaches and indicate the status of current practice. Issues papers may also contain advisory conclusions indicating the majority view as to an appropriate accounting solution.

Some of the areas that AcSEC has recently addressed through issues papers include accounting for last-in, first-out (LIFO) inventories, various insurance accounting issues including loss portfolio transfers and certain long-duration contracts, and accounting for electric utility generating plant cost phase-ins.

The resolution of accounting issues referred to the FASB by AcSEC varies. For example, AcSEC addressed the issue of accounting for a motor carrier's operating rights when Congress adopted legislation raising concerns about the

recoverability of the carrying amounts of these rights. The AcSEC issues paper concluded that the carrying amounts of a motor carrier's operating rights should be written off. The paper was submitted to the FASB which, after appropriate consideration, adopted AcSEC's recommendation. 10/

In other instances, accounting issues identified by AcSEC may relate to a larger, unresolved issue and may be deferred by the FASB pending consideration of the larger issue. For example, six different AcSEC issues papers prepared between 1979 and 1981 are presently being considered as part of the FASB's project on consolidated financial statements.

Sometimes, the FASB may refer the matter back to AcSEC for further consideration. AcSEC will usually then proceed with the issuance of an SOP or a guide. Exposure drafts of SOPs and guides are normally disseminated for public comment. SOPs are issued to deal with financial accounting and reporting in specialized areas or industries. Guides deal with particular circumstances that require special attention, such as pension plans, or with specialized industries. In some instances, AcSEC issues notices to practitioners (which are published in AICPA correspondence to its members) expressing its view as to the appropriate accounting for a particular transaction or to alert the membership to a rapidly emerging problem. 11/

10/ FASB Statement No. 44 (December 1980).

11/ As an example, AcSEC issued a notice to practitioners regarding the appropriate accounting for business combinations of thrift institutions as a supplement to the January 11, 1982 CPA Letter (which is published semimonthly by the AICPA to inform its members about topical events). The notice to practitioners, which complemented SAB No. 42 (December 23, 1981) issued by the Commission staff on the same issue, provided useful interim guidance until the FASB addressed the issue in Statement of Financial Accounting Standards No. 72 (February 1983).

Other recent notices have dealt with savings & loans (S&L) origination fees, bank deposit float, certain real estate lending activities of S&L's, reinsurance transactions in the insurance industry, and disclosure guidance regarding the recent Brazilian loan restructurings (which among other things publicized the SEC staff position as to appropriate disclosures).

This interrelationship with the FASB is necessary because AcSEC is not an accounting standards setter in the same sense as the FASB. The views expressed by AcSEC through its SOPs, issues papers, and accounting guides do not establish enforceable standards under the AICPA's Code of Professional Ethics. As a consequence, the FASB announced its intention to extract the specialized accounting and reporting principles and practices in the existing SOPs and guides and submit them to its standard setting process, eventually adopting them as FASB statements. 12/ In the interim, the specialized accounting and reporting principles are considered to be preferable accounting principles for purposes of justifying a change in accounting principle. 13/

While AcSEC's SOPs and guides do not establish accounting standards, the Commission staff believes that the guidance provided in these documents is generally followed in practice and would expect registrants to have justification for departure therefrom.

Oversight of AcSEC -- The Commission regards AcSEC as an important source in identifying emerging financial reporting problems in specialized areas or industries. The staff frequently attends AcSEC meetings which are open to the public

12/ FASB Statement No. 32 (September 1979) identified 44 SOPs and guides that contain specialized accounting and reporting principles and practices. To date, the FASB has issued 11 different statements (covering 18 different SOPs and guides) on the specialized accounting and reporting contained in the SOPs and guides. In addition, two other SOPs were later deleted because their recommended accounting was inconsistent with the accounting prescribed in subsequent FASB statements.

13/ Under Accounting Principles Board (APB) Opinion No. 20, a discretionary change from one acceptable accounting principle to another must be justified as preferable under the particular facts and circumstances.

Commission rules require that a "preferability letter" from a registrant's accountants be filed in the event of an accounting change. Regulation S-K, Item 601, Exhibit 18.

and held at approximately six-week intervals. In most instances, the staff attend these meetings as observers; however, on certain key issues such as LIFO inventories and computer software, representatives of the staff have participated actively in task force discussions. The staff reviews drafts of AcSEC's SOPs, issues papers or guides, and discusses its views with AcSEC. In addition, representatives of AcSEC's planning subcommittee meet quarterly with members of the Chief Accountant's Office to discuss emerging issues and AcSEC projects.

Governmental Accounting Standards Board ("GASB")

The Commission does not have standard-setting authority with respect to the accounting practices of governmental bodies. Although governmental bodies are not required to prepare disclosure documents with audited financial statements in connection with offerings of their securities, the antifraud provisions of the securities laws apply to transactions in such securities.

The private sector recently established new procedures for setting standards in the governmental arena. In April 1984, the FAF established the Governmental Accounting Standards Board ("GASB") to develop guidelines for financial accounting and reporting by state and local governmental units. The GASB, a separate board operating under the auspices of the FAF, similar to the FASB, was designed to standardize practices of the nation's 100,000 state and municipal entities and provide investors with a better means of comparing financial data among governmental issuers.

In July 1984, the GASB issued Statement No. 1 in its Governmental Accounting Standards Series entitled "Authoritative Status of NCGA [National Council of Governmental Accounting] Pronouncements and AICPA Industry Audit Guide." In

this statement, the GASB adopts NCGA statements and interpretations as well as the guidance contained in the AICPA Industry Guide, "Audits of State and Local Government Units," as part of GASB standards. The statement also identifies pronouncements concerning pension accounting and financial reporting that the GASB considers to be sources of acceptable principles for public employee retirement systems and state and local government employers, pending issuance of a GASB statement or statements on the subject. In the absence of a GASB standard for a particular activity or transaction existing in both the public and private sectors, governmental entities will be expected to look to FASB standards for guidance. The Commission staff monitors GASB activities.

AUDITING STANDARDS-SETTING PROCESS

The Auditing Standards Board ("ASB") is the senior technical body designated by the AICPA to promulgate auditing standards. These standards must be observed by accountants reporting on financial statements included in filings with the Commission. 14/

14/ Rule 201 of the AICPA Code of Professional Ethics specifies five General Standards that apply to all members engaged in the practice of public accounting: possession of professional competence, exercising due professional care, performing adequate planning and supervision, obtaining sufficient relevant data, and not vouching for the achievability of a forecast. Ethics Rule 202 prohibits a member from permitting his name to be associated with financial statements as an independent public accountant unless he has complied with generally accepted auditing standards. Ethics Rule 203 prohibits the expression of an opinion that financial statements are presented in accordance with GAAP if such statements contain any departure from GAAP as promulgated by a body designated by the AICPA (such as the FASB) to establish such principles. Statements on Auditing Standards issued by the ASB are considered to be interpretations of the General Standards in Rules 201, 202 and 203. Departure from these standards because of a sincere belief that it is impractical or impossible in the circumstances must be fully justified by the practitioner.

The tenets of this Code of Professional Ethics are generally incorporated in the statutes governing the practice of public accounting in each state and must be followed by all licensed CPAs.

The ASB has 15 members who are appointed to staggered 3-year terms by the AICPA's Board of Directors. The agenda of the ASB and other functions of the Board are determined by a Planning Subcommittee consisting of the chairman and four ASB members. 15/

The ASB's Planning Subcommittee evaluates the need for additional guidance in particular audit areas. The Board establishes task forces to study the issues and make recommendations. The Board normally meets 8 times each year for 2 or 3 day meetings which are open to the public. At these meetings, the Board members hear and discuss the task force reports and consider actions on proposed auditing standards or audit guides. A two-thirds majority is necessary for issuance of a pronouncement. Present projects on the ASB agenda include reporting on financial forecasts and projections, the effects of computer processing on the examination of financial statements, and levels of assurance for various levels of service provided by CPAs.

ASB pronouncements can be in the form of: (1) Statements on Auditing Standards ("SAS"), which are considered authoritative pronouncements enforceable through the

15/ An AICPA Auditing Standards Structure Committee recently reviewed the operation of the ASB and, in a 1983 report, recommended that the present structure of membership, which has been in effect since 1978, be retained. The Committee also recommended that the Auditing Standards Advisory Council which had operated since 1978, be discontinued. This Advisory Council consisted of representatives from auditing practice, industry, education, government, etc.; including lawyers, investment bankers, financial analysts and other representatives of users. It was recommended that their functions of identifying problems, reviewing the ASB agenda and proposed pronouncements, and recommending persons to serve on the ASB and its task forces be taken over by the ASB Planning Subcommittee and the ASB chairman. These recommendations were adopted by the AICPA in 1983. The ASB chairman or the Planning Subcommittee now maintains a formal liaison with representatives of several organizations interested in audit reports. This liaison includes quarterly meetings with SEC staff, the FASB staff and a committee of the Financial Executives Institute. In addition, semi-annual meetings are held with representative committees of Robert Morris Associates, the American Bar Association and other groups.

AICPA Code of Professional Ethics, and (2) Audit Guides, Procedures Studies and Statements of Position ("SOPs") which are informational and advisory only. SASs, Audit Guides and SOPs are exposed for public comment prior to their final issuance. Although Audit Guides, Audit Procedures Studies, and SOPs are not considered authoritative, they are recommendations by a professional body. Accordingly, the Commission expects auditors to have considered them and to justify any departures if questions regarding an audit are raised.

Oversight of ASB -- The Commission staff monitors the activities of the ASB through:

- Quarterly meetings with the ASB Planning Subcommittee at which time current and future agenda items are discussed and any potential concerns of the Commission or staff are expressed;
- Attendance at ASB meetings;
- Review and evaluation of drafts of proposed Standards, Guides, and SOPs; 16/
- Regular communication with ASB staff and task forces on relevant auditing issues. 17/

In the early years of the Commission's oversight activities, some auditing standard changes were prompted by Commission enforcement actions as in the case of McKesson & Robbins, which resulted in specific requirements for audits of receivables and inventory. 18/ However, recent Commission enforcement actions, rather than indicating the inadequacy of auditing standards, have shown

16/ The Commission staff receives copies of public comment letters received on exposure drafts.

17/ Questions about auditing standards or procedures may arise through the above monitoring activities, from the review of registrant filings, or from enforcement investigations.

18/ ASR No. 19, In the Matter of McKesson and Robbins, Inc. (December 5, 1940), which enumerated specific requirements for audits of receivables and inventories.

that individual auditors have failed to follow auditing standards or that accounting firms have failed to establish adequate quality control procedures to ensure compliance with those standards. Most recent ASB pronouncements have been designed to improve auditing techniques and to clarify the applications of standards to emerging areas. 19/

19/ For example, SAS No. 49, "Letters to Underwriters," was recently issued to provide guidance to accountants who are asked to provide "comfort letters" to underwriters in connection with public offerings of securities. An amendment of an earlier SAS was felt to be necessary to accommodate changes in SEC regulations, including those involving shelf registration.

SECTION G - OVERSIGHT OF ACCOUNTING PROFESSION'S SELF-REGULATORY EFFORT

In response to recommendations for self-initiated reform by the Congress, the Commission, the Cohen Commission and other private sector bodies, the AICPA established a Division for CPA Firms ("Division") on September 17, 1977. 1/ The Division consists of two sections -- the SEC Practice Section ("SECPS") and the Private Companies Practice Section ("PCPS"). The primary objective of the SECPS is to improve the quality of the practice by CPA firms before the SEC; the activities of the PCPS are directed primarily toward improving the quality of the auditing and accounting services provided to private organizations. Membership is voluntary and any CPA firm may join either or both sections without regard to whether the firm practices before the SEC.

The SECPS monitors and enforces compliance with quality control standards through periodic peer reviews, reviews the circumstances surrounding alleged audit failures, and establishes and enforces membership requirements. 2/ Its program is based primarily on voluntary compliance, cooperation, and remedial action. SECPS activities are overseen by a Public Oversight Board ("POB" or "Board").

In addition to adhering to AICPA quality control standards, member firms undertake the following:

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- 1/ Membership in the AICPA, the mechanism for the program of self-regulation then in existence, was on an individual basis so there was no role in the AICPA for CPA firms as such at that time.
 - 2/ The functions of the SECPS are conducted through three major committees: the Executive Committee, the Peer Review Committee ("PRC") and the Special Investigations Committee ("SIC").

- ° to submit to triennial peer reviews of the firm's accounting and auditing practice.
- ° to ensure that all professional employees receive at least 120 hours of continuing professional education credits every three years.
- ° to rotate audit partners on SEC engagements no less frequently than every seven years (if the firm has five or more SEC clients and ten or more partners).
- ° to ensure that a second partner review is made before an audit report is issued for SEC registrants.
- ° to abide by certain restrictions on MAS work for SEC clients and to report the volume of such services (as a percentage of total fees) in an annual report filed with the AICPA.
- ° to report to registrants' audit committees or boards of directors concerning MAS services performed and any accounting disagreements with management.
- ° to report certain litigation, investigations and proceedings regarding SEC clients to the SIC.

SECPS Membership

According to the POB 1983-84 annual report, almost 1,700 firms are members of the Division, 430 of which are members of the SECPS. Of the 430 members, 196 have one or more SEC registered clients. These 196 firms audit approximately 85% of all SEC registrants. 3/ In addition, 113 firms which are members only of the PCPS have approximately 177 SEC registered clients. It is estimated that over 800 firms (most with only one or a few SEC clients)

3/ The POB reports that members of the Division audit over 85% of the public companies listed in the eleventh edition of Who Audits America and that these companies account for over 98% of the combined sales volume of all publicly-traded companies; over 79% of these companies are audited by the 14 firms that are entitled to a permanent seat on the Executive Committee of the SECPS -- i.e., those firms that audit the financial statements of 30 or more SEC registrants. The POB further reports that members of the Division audit all but 3 companies listed on the New York Stock Exchange and all but 24 companies listed on the American Stock Exchange; approximately one-third of these companies not audited by Division members are audited by Canadian firms of chartered accountants that are affiliated with member firms.

audit the remainder of SEC registrants and are not subject to the peer review process. The Commission's staff and the SECPS are presently considering initiatives to encourage membership.

Public Oversight Board

The POB, designed to recognize and reflect the public interest in reliable financial reporting, oversees and periodically reports on the activities of the SECPS. 4/ The POB has stated that it has considerable influence on policy decisions made by the SECPS, on the effectiveness of the SECPS's operations and on the accomplishment of its objectives.

Individual Board members are assigned liaison responsibilities for each major committee of the SECPS -- Executive, 5/ Peer Review, and Special Investigations. Representatives of the Board attend SECPS meetings. All activities

4/ Current Members of the Board include Arthur Wood--Chairman (former chairman and chief executive officer ("CEO") of Sears Roebuck), John Harper (former chairman of Communications Satellite Corp. and former chairman and CEO of Alcoa), Robert Mautz (Professor of Accounting), A.A. Sommer, Jr. (former SEC Commissioner), and Melvin Laird (former member of Congress and former Secretary of Defense).

5/ The Executive Committee's major responsibilities include establishing general policies for the SECPS, administering and monitoring all its activities, determining membership requirements, and imposing sanctions, either on its own initiative or on recommendation of the Peer Review or Special Investigations Committees. The Committee currently consists of twenty-one members elected by the AICPA Council for three-year terms. The organizational document of the SECPS provides that the Committee shall at all times include representatives of all member firms that audit financial statements of thirty or more registrants under section 12 of the Securities and Exchange Act of 1934. Currently, fourteen member firms qualify for permanent Committee representation.

and decisions of the SECPS are reported and discussed at Board meetings which are held at least monthly. The POB staff actively monitors individual peer reviews as well as the special investigative process.

Because of its active involvement in monitoring the SECPS's program, the POB on several occasions has made suggestions for improvement in various aspects of such program. The Board indicates that it does not hesitate to express its dissatisfaction with a decision or proposed decision on a particular matter, such as the type of report accepted by the PRC. The POB has reported that it is satisfied that on those occasions when it has offered another perspective on an issue, serious attention has been accorded its views.

In the POB's Annual Report as of June 30, 1984, and a special report on audit quality, 6/ the POB analyzes and comments on the activities of the SECPS. It views the SECPS as part of peer regulation (that is, when practitioners, through firms or individually, affiliate with an organization for the purpose of upgrading professional performance) which must be viewed in the context of its distinction from and relationship to private regulation (that is, policies and procedures dictated and enforced by management of accounting firms) and public regulation (state entrance and licensing provisions, court actions, and federal regulatory actions such as SEC enforcement actions). The POB concludes that the regulation of a profession requires the best efforts of all three levels -- private regulation by firms, peer regulation by professional organizations and public regulation by government -- and that no one level of regulation

6/ Public Oversight Board Annual Report 1983-1984 and Public Oversight Board, Audit Quality: The Profession's Program.

is adequate alone, nor can any one of them substitute for any other. The POB indicates that it has reviewed the accounting profession's program for audit quality, both in concept and in practice, and has found that the profession's quality control standards, peer reviews of firms' compliance with those standards, and the supporting strength of the special investigative process, with both public and regulatory oversight, combine to provide a sound, comprehensive and effective assurance of audit quality.

Peer Review

Submission to peer reviews is the most significant element of the SECPS's program. Each member firm hires a peer reviewer ^{7/} to review its accounting and auditing practice and to ensure compliance with membership requirements. Every peer review includes an examination of a reasonable cross-section of the reviewed firm's accounting and auditing engagements and, in multioffice firms, a representative number of practice offices. Since peer reviewers examine only a sample of the firm's engagements, an unqualified peer review report can not be construed as a guarantee that the firm has performed all engagements, and will perform all future engagements, in accordance with professional standards. While the thrust of peer review is to identify and correct deficiencies in a firm's system of quality control, the process also

^{7/} The review can be performed by another member firm, a review team appointed by the PRC or representatives of an authorized program of an association of CPA firms, or a state society of CPAs. During the most recent three years 397 peer reviews were conducted: 182 in 1984, 144 in 1983 and 71 in 1982.

deals with instances of substandard auditing or accounting performance on individual engagements, 8/ which are required to be reported promptly to the PRC. 9/

After the reviewing firm completes its review, it prepares a report, expressing an opinion as to the reviewed firm's system of quality control and compliance with such system. Similar to audit reports, the opinions expressed can be unqualified, modified (qualified in some manner), or adverse (the firm's quality control system is either not sufficiently comprehensive or not being complied with in a manner to provide reasonable assurance that it is in conformance with professional standards). 10/ The vast majority of firms have been determined to have effective systems of quality control. However, many reviewers identify areas where improvements are needed. In those circumstances, the reviewers issued letters of comment identifying areas that should be strengthened. 11/ The reviewed firms must provide written responses to the letters

8/ The POB reports that during the (1981-1983) review cycle, peer reviewers looked at 3,247 audit engagements and found that 95 (or 2.97%) were substandard. The peer reviewers required corrective action in these cases as follows: Audit report recalled and financial statements revised and reissued (17); omitted audit procedures performed (12); cause of impairment of independence eliminated (4); and questioned GAAS and GAAP treatment to be corrected in subsequent imminent audit (59). There were 3 cases involving omitted audit procedures at June 30, 1984; the Commission staff has been advised that each of these was subsequently resolved.

9/ The PRC, consisting of fifteen persons who are partners in member firms and appointed by the executive committee, establishes standards for peer reviews, administers the peer review program, and reviews each report.

10/ In 1983 one firm received an adverse report, 7 firms received modified reports and 133 firms received unqualified reports. Prior to 1983 13 firms had received adverse reports, 64 firms had received modified reports and 396 firms had received unqualified reports.

11/ Only 12% of the firms reviewed in 1983 (and 7% of the firms reviewed in prior years) did not receive a letter of comments. In most instances, firms receiving an unqualified opinion without a letter of comment were single office firms.

of comment, outlining the corrective measures which will be implemented. The PRC reviews all reports, letters of comment, and the responses thereto, and it evaluates each firm's corrective action plan to eliminate weaknesses in its controls or to assure greater compliance with its policies and procedures. After the PRC concludes that the review was performed and reported on in accordance with SECPS standards 12/ and that appropriate corrective actions 13/ are being taken by firms, it places all these documents in a public file.

The peer review process has been improved as experience has been gained. Many of the changes reflect suggestions made by the POB staff and the Commission staff. For example, beginning with 1983 reviews, reviewers were given more specific

12/ In its 1984 Annual Report, the POB stated that uniformity in reporting of peer reviews is an area in which improvement can be effected. It indicated that the determination of whether deficiencies uncovered in a peer review are sufficiently significant to warrant the issuance of a modified report is a highly qualitative matter of judgment. The Board observed that, while one peer reviewer may now issue a clean report and a letter of comment that discusses the deficiencies, another reviewer may issue a modified report; yet the firm with the clean report may then distribute their report without the accompanying letter of comment. Accordingly, the POB recommended that a peer review report should include a reference to the letter of comment when one has been issued. A joint SECPS/PCPS task force is currently studying ways to enhance uniformity of reporting.

13/ The POB reports that, during the latest three year peer review cycle, the PRC has required eighteen firms to permit a revisit by a peer reviewer to determine whether the firm had taken appropriate corrective action. In addition, sixteen firms agreed, as a condition of continued membership, to undergo an accelerated full scope peer review, i.e., a review in the next year or two rather than in the third year.

The PRC can recommend that the executive committee impose a sanction if a firm's quality control system cannot be relied on and the firm refuses to make the corrections deemed necessary. The PRC has not yet recommended any sanctions; however, it has required some firms to comply with rather severe additional requirements when their quality control systems were deemed to be materially deficient. Since these actions were voluntarily agreed to by the firms, they have not been classified as sanctions, even though they achieved the same objective. (See footnote 22 regarding types of sanctions available.)

guidance in selecting for review a representative sample of audit work performed by other offices under the supervision of the office primarily responsible for the overall engagement. If a firm has multioffice engagements, the reviewer must now review for at least one such engagement the workpapers prepared by the primary office and at least one other office performing a significant segment of that engagement.

New procedures were adopted to further expedite completion of peer reviews. During the initial years of the peer review process, many reviews were completed much later than planned. Each member firm is now required to submit to the PRC its peer review report, letter of comments and response no later than thirty days after issuance of the report and letter of comments. Failure to do so could lead to sanctions. 14/ In addition, a reviewer failing to complete and report on a review in a timely, professional manner could be subject to disciplinary action. 15/ Review procedures also require reviewers to consult immediately with the PRC when instances of materially substandard performance are identified, thereby expediting PRC involvement and facilitating a timely resolution of such matters.

Experience has permitted certain efficiencies in the process to be adopted. For example, standards now permit reviewers, who after appropriate testing conclude that they can rely on the reviewed firm's inspection program, to use inspection findings along with peer review findings as a basis for their report. By so doing, the reviewers reduce the number of offices and the number of engagements they review, thus reducing the cost of peer review.

14/ See footnote 22 regarding types of sanctions available.

15/ See footnote 23 regarding types of sanctions available.

During 1982, the SECPS eliminated the requirement that a quality control review panel ("QCRP") be appointed for peer reviews conducted by firms or administered by associations of firms. 16/ The Commission stated in its 1982 Annual Report to Congress that it did not object to this and other changes effected with a view to significantly reducing the costs of membership, and that it supports other initiatives designed to facilitate membership in the SECPS provided they do not detract from the credibility of the self-regulatory program.

The POB and its staff devote a significant amount of time to monitoring the peer review process. Every modified or adverse peer review involving firms which practice before the Commission is reviewed and discussed by the POB. The POB staff is involved in every peer review and occasionally

16/ A QCRP, composed of up to three qualified individuals who are independent of both reviewers and the reviewed firm, was required for all reviews other than those conducted by a team appointed by the AICPA. Although the panels relied significantly on the work of the primary reviewers, they also issued a public report on the adequacy of the reviewed firm's system of quality control. During 1982, the Commission staff completed its oversight of the peer review process under an access agreement with the SECPS. As a result the staff concluded that peer review is a good test of a firm's system of quality controls and that the POB is exercising an active oversight role such that it could place more reliance on them. With respect to the QCRP, the staff found no evidence that it added much value to the process. While the panel members appeared to be active mechanically (testing the work of the reviewers, reviewing scope considerations, etc.), they did not raise any new substantive issues regarding the peer reviews. Although the QCRP may enhance the credibility of the peer review process when firms review other firms, the staff determined that it should not insist that the QCRP be retained because the benefits to the peer review process attributable to the QCRP cannot be shown to exceed the cost related thereto.

causes issues to be focused on or problems to be resolved which were not sufficiently dealt with by the peer reviewers. The POB staff attends meetings of the PRC. The POB's views are generally sought on all proposed changes in the peer review process and its comments on individual peer reviews are given considerable weight by the PRC in deciding whether the reviews were performed in accordance with prescribed standards.

SEC Oversight of Peer Review

The Commission staff has overseen the peer review process through access to POB oversight workpapers 17/ each year since 1978, and beginning in 1981, through access to certain workpapers of the peer reviewers. 18/ The staff has recently concluded its oversight of the 1983 peer reviews, and based on six years of experience has the following observations regarding the peer review process:

- The POB has been effective in its oversight role. Staff review of the well-documented POB files and comments made to the staff by the peer reviewers indicate that the POB staff is aggressive in ensuring that peer reviews are adequately performed and documented.

17/ The POB files on peer reviews consist of a thorough review program, supporting POB workpapers, and copies of the report, the letter of comment, the reviewed firms response, the reviewed firm's annual report to the SECPS, the Summary Review Memorandum (which is prepared by the peer reviewers to summarize the nature and extent of their review and the results thereof) and correspondence and memoranda related to PRC follow-up actions.

18/ The staff annually conducts an inspection of a sample of peer review workpapers and POB oversight workpapers under an access agreement, and has had full access to peer reviews pursuant to enforcement actions settled with accounting firms.

- The peer review program provides for a rigorous review of a firm's system of quality controls and accounting and auditing practice. 19/
- Peer reviews are generally well documented. All exceptions appear to have been adequately considered in determining the reported results of the peer review. When the staff has raised questions regarding the scope of the review or its findings, they have been answered satisfactorily.
- Generally the reports and comment letters are candid in that they reflect major exceptions found by the reviewers, and in cases where items were considered for inclusion in the comment letter, the reasons for not including them were well documented in the peer review workpapers or the POB files.
- Engagements excluded from the scope of peer reviews at the request of the reviewed firm were infrequent and the explanations for exclusion were documented and appeared to be reasonable. 20/
- Substantive accounting and auditing questions were raised and resolved during peer reviews. These included instances where the reviewed firm either withdrew its report or performed additional audit procedures.
- Corrective actions required during the peer review process are an effective means of improving overall firm quality and of protecting the public interest by reducing the possibility that a bad audit will occur or go undetected. Corrective actions generally take the form of an accelerated follow-up peer review or the requirement that the firm institute more stringent than normal

19/ In several recent enforcement actions, the Commission has specified that firms which have been suspended from SEC practice must join the SECPS and receive an unqualified peer review as a condition to resume SEC practice (See, In the Matter of Willie L. Mayo, AAER No. 29 (May 1, 1984); In the Matter of Smith & Stephens Accountancy Corporation, AAER No. 39 (September 10, 1984); and SEC v. William M. Holben and Robert A. Savage, AAER No. 42 (November 9, 1984).

20/ Standards for Performing and Reporting on Peer Reviews provide that "a reviewed firm may have legitimate reasons for not permitting the working papers for certain engagements to be reviewed. For example, the financial statements of an engagement selected for review may be the subject of litigation or investigation by a governmental authority, or the firm may have been advised by a client that it will not permit the working papers for its engagement to be reviewed." The peer reviewers are required to review other work of supervisory personnel who participated in the excluded engagement and other engagements in a similar area of practice to assure that review coverage is not materially affected.

review procedures. 21/ Although these corrective actions are not intended to be punitive they affect the firm the same as a sanction and as such provide a disincentive for substandard work. To date no firm has been formally sanctioned. 22/

- The SECPS has responded to various concerns raised by the Commission staff. For example, the SECPS has made changes to require peer reviewers to consult immediately with the PRC when they discover materially substandard performance, established deadlines enforceable by sanctions 23/ to ensure timely submission of peer review reports, provided more guidance for the selection for review of audit work performed by other offices assisting the office primarily responsible for the overall engagement, and agreed to notify the Commission staff if a firm with SEC clients withdraws from membership rather than submit to corrective actions or sanctions imposed by the SECPS.
- During 1982 and 1983 many firms underwent their second peer review. The staff believes that the decrease in the number of firms which received modified reports during this second cycle is evidence that the peer review process results in improvements in the quality control systems of member firms. 24/
- The Division for Firms presented its annual educational program to train prospective peer reviewers in May 1984. The staff attended the program and found the instructors to be of high caliber and the materials and presentation to be excellent.

- 21/ The POB reports that between April 1, 1981 and June 30, 1984, 34 firms have been asked to provide early assurance of voluntary corrective action, including 16 firms which were required to undergo an accelerated peer review. Two of these firms resigned rather than submit to an accelerated peer review; the details regarding the circumstances of the resignation are included in the AICPA's public files. (The resigned firms did not practice before the Commission.)
- 22/ The following types of formal sanctions may be imposed for failure to comply with membership requirements: (1) corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel; (2) additional continuing professional education; (3) accelerated or special peer reviews; (4) admonishments, censures or reprimands; (5) monetary fines; (6) suspension; or (7) expulsion from membership in the SECPS.
- 23/ Possible sanctions are referral of the reviewers to the AICPA ethics committee, or prohibition from participating as a reviewer in the future. If the reviewed firm is at fault it may be advised that it is under investigation and that a hearing will be held by the PRC to decide whether to recommend sanctions.
- 24/ Over 94% of the firms reviewed in 1983 received an unqualified report, representing an increase in excess of 10% percentage points over firms receiving such reports in prior years.

The Commission staff agrees with the POB that the peer review process is still evolving. The POB, in its 1983-84 Annual Report, comments on several significant changes effected during the past year, including those relating to consideration of litigation alleging audit failures in determining the scope of the peer review. Several of these changes were suggested by the Commission's staff in its oversight capacity. The Commission staff encourages continuing refinements in the program (such as those dealing with uniformity of reporting mentioned by the POB and the recommendation of a special committee dealing with the need for additional guidance in evaluating the scope and effectiveness of the concurring second partner review membership requirement). The Commission and its staff will continue to offer constructive suggestions to enhance the effectiveness of the program.

Alleged Audit Failures

The SIC, established in 1979, responds to concerns raised by alleged audit failures. 25/ Its primary objectives are to:

- Assist in providing reasonable assurance to the public and to the profession that member firms are complying with professional standards by identifying corrective measures, 26/ if any, that should be taken by a member firm involved in a specific alleged audit failure.

25/ The SIC consists of nine active or retired partners of member firms, no more than one from any firm. They are appointed by the executive committee for a three-year term and may be reappointed to serve for three additional one-year terms. They are not permitted to serve concurrently on either the executive committee or the PRC. They may not participate in deliberations involving their firms; they also are excluded from deliberations on matters involving other firms if they have, or believe they have, a conflict of interest.

26/ The SIC can recommend to the Executive Committee that sanctions be imposed against member firms. However, sanctions would only be imposed where member firms refused to cooperate in taking corrective actions; the POB has reported that to date no such sanctions have been necessary.

- Assist in improving the quality of practice by member firms by determining whether facts relating to specific alleged audit failures indicate that changes in generally accepted auditing standards or quality control standards need to be considered.

Member firms are required to report to the SIC certain litigation, proceedings, or investigations involving the firm or its personnel, and alleging audit or reporting deficiencies in connection with filings made by a firm's SEC clients under the Federal securities laws. 27/

The SIC monitors Commission releases and various business and financial publications to assure that firms comply with the reporting requirement. The SIC also considers publicized litigation that does not involve SEC registrants. When it deems it necessary in the public interest to do so, the SIC requests firms to voluntarily report matters that are outside the scope of the reporting

27/ Section IV.3(m) of the SECPS's organizational document requires member firms to:

report . . . , within thirty days of service on the firm or its personnel of the first pleading in the matter or within thirty days of joining the section, if later, any litigation (including criminal indictments) against it or its personnel, or any proceeding or investigation publicly announced by a regulatory agency, commenced on or after November 1, 1979 (not including additional proceedings arising out of or related to facts involved in litigation originally filed prior to November 1, 1979), that involves clients or former clients that are SEC registrants and that alleges deficiencies in the conduct of an audit or reporting thereon in connection with any required filing under the Federal securities laws. With respect to matters previously reported under this subparagraph, member firms shall report to the committee additional proceedings, settlements, court decisions on substantive issues, and the filing of appeals within thirty days of their occurrence.

The requirement is amplified by a footnote that requires reporting of all cases that involve an allegation that a member firm or its personnel violated Federal securities laws. The footnote states:

An allegation in such formal litigation, proceeding, or investigation that a member firm or its personnel have violated the Federal securities laws in connection with services other than an audit for an SEC registrant shall be reported.

requirement. The SECPS has advised the Commission's staff that all such requests have been complied with.

In its 1983-84 Annual Report, the POB reports that it actively monitors the activities of the SIC and has complete access to all SIC files. The Board concluded that the SIC has effective operational procedures, that SIC members take their responsibilities seriously, and that the SIC's decisions are sound and in the interest of the public and the profession.

In a special report entitled Audit Quality: The Profession's Program the POB comments on the SIC and how it fits into the self-regulatory program. The POB indicates that the SIC's work complements and supplements the peer review process by considering whether alleged audit failures result from "people problems," systems failures or inadequacy in professional standards. The focus of the SIC is on what steps, if any, need to be taken to protect the public from future failures. It does not look at the facts and circumstances in each case; rather it looks at indicators that surround reported cases (i.e., other work done by the office or individuals involved, industry practices, etc.). Actions taken are remedial rather than punitive in nature; sanctions would only be imposed if the member firm refused to cooperate with the SIC. 28/

28/ A Special Committee (discussed further below) also commented on the role of sanctions in the profession's self-regulatory program. It noted that actions taken against firms during the initial six-year period of operation of the SECPS, which have had the effect but not the form of sanctions, have required members to remedy or correct past deficiencies in order to avoid the recurrence of such problems in the future. Follow-up (footnote continued on next page)

The POB also comments on the need for confidentiality of SIC activities. It concludes that this policy does not restrict the effectiveness of the SIC.

In the above referenced report on "Audit Quality," the POB for the first time includes an extensive (although generalized) discussion of how the SIC operates. This includes information as to what the staff does, what data the SIC looks at, what it may discuss with the reporting firm, its evaluation of actions taken by the firm's management in response to the alleged failure, how it interacts with the peer review process and the number and disposition of cases reported to the SIC. 29/ The POB also discusses the 5 cases (involving 4

(footnote continued)

procedures, such as an early revisit by peer reviewers, an accelerated peer review or a special extended review in a particular area, are measures that have been employed to assure that member firms take actions recommended by the committees. Further, the remedial and/or corrective actions taken by member firms found to have deficiencies have involved dealing with firms' partners and professional staff whose performance contributed to the deficiencies including actions such as reassignments, significant additional training and education, restrictions as to the type of work they perform, and dismissals. Such actions have been costly to those firms in terms of expenditure of time and money. Thus, the SECPS has used the threat of sanctions to assure the cooperation of its members in abiding by its membership requirements, in taking remedial or corrective actions when required, and, ultimately, in accomplishing its objective of improving the quality of practice. In the Special Committee's view, that is the most effective way for a voluntary organization in the private sector to fulfill its self-regulatory role.

29/ The POB reports that files on 95 cases have been opened by the SIC since inception of the program in November 1979, including some involving non-SEC registrants which were voluntarily reported in response to a request by the SIC because of high public interest. The POB also summarizes actions taken and conclusions reached by the SIC concerning closed cases as follows: The allegations misstated the requirements of professional standards or the case did not indicate a need for changes in the firm's quality control system or for other corrective measures (66); appropriate AICPA technical bodies were asked to consider the need for changes in or additional guidance on professional standards (9); case was referred to the AICPA Professional Ethics Division for investigation into the work of a specific individual (2); a special review or an expansion of the firm's regularly scheduled forthcoming peer review was made (6); and the firm took appropriate corrective action that was responsive to the implication of a specific case (10).

different firms) where the SIC has conducted a special review (which is described as being like a peer review but more intensive and less extensive) of one or more aspects of a firm's quality control system. 30/ The POB also discusses the SIC's role in analyzing and evaluating the implications for current professional auditing and accounting standards of alleged audit failures.

The Commission can express no conclusions on the special investigative process or on the POB's oversight of that process because specific information about the special investigative activities is not available to it. 31/ As discussed below, a Special Committee has recommended that the SECPS provide more information about the activities of the SIC. The Commission's staff continues to discuss with the SECPS and the POB ways to give the public and the Commission more information about the process.

In addition to urging the SECPS to publicize its disciplinary activities to a greater extent, the Commission stated in its 1983 Annual Report that the SECPS should revise the requirements for reporting cases to it. Presently, member firms only need to report allegations of audit deficiencies relating to SEC registrants. The Commission said that the SIC should look into, and member

30/ According to a Special Committee (discussed further below), these investigations have consisted of attempting to find out as much as possible about the case from public documents and from the member firm on a voluntary basis and of performing special reviews of one or more areas that are related to the case, such as specific offices or individuals, certain industry specialties, or specific quality control policies and procedures. Such investigations, which are essentially special peer reviews, are intended to be preventive rather than punitive and to determine whether corrective action has been taken or should be taken by member firms to improve the quality of their professional practice and to help prevent such occurrences in the future.

31/ See the Commission's 1984 Annual Report to Congress.

firms should report, all cases which have generated significant public interest and involve allegations of audit failure. 32/

Review of SECPS

In June 1984, an AICPA committee issued a report entitled Report of the Special Committee on the Review of the Structure and Operations of the SEC Practice Section ("Special Committee"). 33/ The Special Committee, composed of seven members of the accounting profession and two representatives from outside the profession, was charged by the AICPA with a review and evaluation of the activities of the SECPS.

The Special Committee's overall evaluation is that the structure of the SECPS is sound and that it is carrying out its major programs in an effective manner.

Its principal findings include:

- The level and composition of membership in the SECPS is reasonable for a voluntary organization.
- The POB, both in concept and in performance, has strengthened the structure and effectiveness of the SECPS. It has performed commendably in reporting on and explaining the system to the public and in suggesting improvements. The stature and credibility of the POB have contributed significantly to the viability of the SECPS and are critical to public acceptance of the profession's program of self-regulation.

32/ Recently a Special Committee of the AICPA (discussed below) recommended that the membership requirements for reporting alleged audit failures to the SIC be extended to cover cases involving all entities in which there is a significant public interest as opposed to only those involving SEC registrants. This recommendation is responsive to the Commission's statements in its 1983 Annual Report and has been endorsed by the POB.

33/ The Commission staff met with the Special Committee, and its published recommendations generally reflect the concerns raised by the staff.

- The executive committee has met its responsibility to direct the program and has made changes as necessary to meet the needs of the public and the profession. The present size and composition of the committee and the procedures for selecting its members appear to be satisfactory.
- The peer review program, the major undertaking of the SECPS, is basically sound and is functioning effectively. It has been beneficial to member firms and to the public in helping to assure and enhance the quality of the accounting and audit practice of member firms.
- The requirement for member firms to undergo peer reviews every three years continues to be appropriate, and the Committee does not see the need at this time for any other fundamental changes in the peer review process.
- The investigative process complements the peer review program and has operated effectively within the established guidelines for its activities.

The Committee also made a series of recommendations to further improve the effectiveness of the SECPS. Included in the recommendations were the following:

- Efforts to attract as members all firms with SEC clients should continue. Accordingly, the SECPS should develop a broad-based public information program, including, but not limited to, the issuance of periodic reports on the scope and results of its activities so that the SECPS objectives and accomplishments become better known to, and better understood by, various interested audiences. (The Special Committee felt that this will result in increased membership as firms perceive that SECPS membership will create a better public image for the firm.)
- The Executive Committee should take initiatives to improve communications among the components of the SECPS (i.e. the PRC and the SIC) and with other groups, clarify the conditions under which it would impose sanctions, and develop new programs to enhance the benefits of membership.
- The SECPS should adopt more specific requirements relating to the evaluation in peer reviews of the effectiveness of a firm's second partner review program.
- Actions should be taken to clarify the scope of the SIC's authority and its mode of operation, disseminate more information about its activities, expand the scope of the cases that member firms are required to report, and require the cost of special peer reviews to be borne by the investigated firm.

- A standing coordinating committee should be established to facilitate and encourage greater coordination between the two sections of the Division.

In addressing the need to enhance public awareness of self-regulation, the Special Committee recommended that some degree of public disclosure relating to remedial and corrective action in the peer review and investigative processes should be considered. The Special Committee also addressed the question of whether the confidentiality of SIC activities should be modified to provide Commission access as well as to permit public disclosure of information on the actions resulting from the process.

The Special Committee concluded that confidentiality on matters relating to specific cases still appears to be desirable because of the voluntary nature of the SECPS, the possibility of substantial and often unwarranted prejudice against member firms, and the fact that the public interest has been adequately protected by the procedures followed by the SIC and the regulatory and court processes. However, the Special Committee indicated that some public information about the actions taken in the investigative process is needed to enhance the credibility of the process. Therefore, it recommended that the SIC should periodically report to the public on its activities using a format that would not identify firms or cases and that might encompass, at least, the following:

- . A description of the SIC's operations, its objectives, and the means used to assure compliance.
- . Aggregated data and statistics on the number and types of cases reported, closed, and still active.
- . Aggregated data and statistics on the number and types of remedial or corrective actions taken voluntarily by firms, either on their own initiatives or as a result of the investigative process.
- . A discussion of unusual matters encountered in the process.

- . Information on closed cases, describing by general categories the reasons for closing the cases.
- . Data on, and discussions of, matters referred to standard-setting bodies.

The Special Committee believes that such a report would provide information about the investigative process that should enhance its credibility. 34/

Finally, the Special Committee observed that:

Although the SECPS merits high marks on its performance to date, the profession cannot afford to be complacent about the results. In the long run, it will be judged not by the particulars of its programs and its own analysis and evaluation of them, but by how effectively it performs audits. Hence, the profession must continually monitor and evaluate its own performance and, on a timely basis, take the steps that are necessary and appropriate to assure that the quality of that performance meets the needs of the public.

The Commission's staff agrees with this latter point and believes that the SECPS should carefully consider the recommendations of the Special Committee and take positive steps to enhance the credibility and acceptance of the SECPS.

34/ In addition to developing a format for public reporting, the Special Committee recommended that the SECPS should consider providing the profession with educational materials based on findings in the investigative process because the nature of the facts and circumstances that contribute to allegations of audit failure in specific cases can be the source of invaluable educational material for the profession and should be accumulated and distributed.

SECTION H - OTHER MATTERS

International Accounting and Reporting

Disclosure of information by multinational enterprises continues to be of interest to user groups including investors, creditors, governments and employee organizations. A number of regional and international bodies devote substantial time and resources to improving the quality and comparability of the information.

The Commission monitors certain activities of several regional and international standard setting bodies, including the European Economic Community, the International Accounting Standards Committee and the International Federation of Accountants and supports the development of international standards of accounting and auditing. Closer correspondence among national requirements will result in more useful and understandable information for investors and other users of financial reports and will mitigate problems caused by disparate requirements applicable to domestic and foreign private issuers which register securities with the Commission.

The Office of the Chief Accountant maintains communications with various national and international standard-setting bodies and comments on the proposed standards of such bodies from time to time. A staff member from the Office serves as an expert advisor on the United States delegations to regular meetings of working groups on international accounting and reporting standards established by the United Nations and the Organisation for Economic Cooperation and Development ("OECD"). The OECD will sponsor an international forum in April 1985 on harmonization of accounting and reporting standards at the international level which could result in an important step in the harmonization process. Harmonization of accounting and reporting standards is a long term process; these efforts will continue and should improve the efficiency of the world's capital markets.

Activities of State Licensing Authorities

The Commission has endeavored to develop a close relationship with the state boards of accountancy by cooperating with the state authorities in enforcement actions. Currently, it is the Commission's policy to routinely furnish the state boards with copies of complaints, judgments, consents and related documents which deal with enforcement activities involving accountants licensed to practice in their respective states. This procedure is followed regardless of whether the accountant was acting as an auditor or was involved in some other capacity, as an officer, director, employee, etc.

The Commission staff also works directly with the National Association of State Boards of Accountancy ("NASBA"). NASBA is a voluntary organization which includes all the U.S. licensing authorities. NASBA serves as a clearinghouse for the sharing of information and as a catalyst for helping to initiate various regulatory efforts at the state level.

In September 1984 representatives of the Commission's staff attended the annual meeting of NASBA's member boards. Delegates from forty-seven boards were in attendance. This meeting was a part of the continuing effort to improve communication between the Commission and the state boards.

Enforcement Responsibilities -- In recent years, enforcement activities of state boards have received increasing attention from the Commission staff and others. Enforcement-related activities continue to be a central focus of NASBA's work, and there was extensive discussion at the annual meeting regarding these matters.

The board of accountancy of each state regulates the practice of accounting by, among other things, promulgating and administering regulations relating to accountants, especially entrance requirements for certification, and, to various degrees, by suspending or revoking licenses for deviations from professional standards. However, the vast majority of state boards still have small staffs, limited funds, and, in some cases, legislative restrictions on their authority. The state licensing authorities recognize the need for positive action to resolve these matters.

In an effort to assist the boards in establishing procedures for effective enforcement, NASBA's Committee on Surveillance and Enforcement in 1984 issued a Positive Enforcement Manual for State Boards of Accountancy. The manual recommends procedures for the review of practices to achieve an acceptable level of quality practice. It covers the development of a positive enforcement program, methods of financing such a program, and how to select, train, supervise and evaluate the reviewer, the types of reports that can be reviewed, the nature of the review and nature of available sanctions. Such a program involves not only solicitation of referrals from agencies such as the Commission, but also review of publicly available financial statements filed with governmental bodies, particularly state agencies. The program emphasizes education and rehabilitation over remedial actions and encourages active monitoring of performance as well as response to complaints. NASBA is on record as recommending that all states adopt a positive enforcement program and developed the manual to assist the state boards in doing that.

The development of positive enforcement programs has been gradual because it has often required legislative changes to increase the boards' authority and resources to conduct reviews. Also, certain jurisdictions assertedly have basic problems with the relevant state laws, in that these laws may appear to undercut their ability to function aggressively. Concerns expressed include: (1) authority to initiate an investigation into an accountant's work prior to a complaint against the practitioner; (2) potential liability that may exist by using unpaid volunteer investigators; (3) whether the confidentiality of client information is, or need be, maintained when staff investigators review auditors' work papers; and (4) the lack of authority to fine or saction practitioners short of suspending their license to practice. The Commission staff understands that the particular state boards involved are working to overcome such difficulties.

Despite these limitations NASBA officials estimate that at least 25 state boards have implemented or are in the process of implementing a positive enforcement or similar program. A heightened sense of responsibility on the part of state boards is also evident from a substantial increase in inquiries to the Commission staff by the boards concerning specific enforcement cases.

Licensing Activities -- The state boards regulate all CPAs by administering the accountancy laws of the fifty states and four jurisdictions. These laws differ significantly from jurisdiction to jurisdiction with respect to the level of education considered necessary, the quality and length of work experience required, the necessity for mandatory continuing professional education ("CPE"), and the establishment of ethical and performance requirements.

For example, the education and experience required to take the CPA examination in the fifty-four jurisdictions differ in several ways, including

the level of education required, the specific course content of required education programs, and the length and quality of experience required. The CPE requirements in the jurisdictions are also not uniform. Although about forty-three states presently have mandatory CPE requirements, there are numerous differences with respect to the types of courses acceptable to meet those requirements. Due to these differences, practitioners may find their ability to practice in other states through reciprocal agreements restricted. Additionally, performance standards and the regulatory and enforcement philosophy and procedures differ in the various jurisdictions.

Because many public companies transact business on an interstate, and even on an international basis, differences in licensing requirements may unnecessarily restrict the interstate practice and mobility of CPAs. NASBA and the AICPA have recently issued a model public accountancy bill intended to promote the enactment of uniform state accountancy laws. The model bill is intended to remove barriers to interstate and international professional practice by eliminating differences in state accountancy requirements. The bill constitutes a single comprehensive piece of legislation which can be adopted in place of existing public accountancy laws. The model bill is also designed with separable provisions, so that particular parts of the bill can be added to existing laws instead of replacing such laws entirely.

The Commission staff will continue to: (1) work closely with NASBA on matters of mutual concern; (2) monitor the development of state positive enforcement programs; and (3) improve liaison and exchange of information with state boards.

The Commission staff continues to be impressed by the generally positive attitude of state board members toward their increasingly active role in the process of assuring a high level of quality and professionalism by practicing public accountants. The progress to date provides a substantial basis for confidence that the state boards of accountancy can, and will, achieve a uniformly meaningful role in this process.