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

CONCERNING FINANCIAL REPORTING
AND
THE ROLE OF THE INDEPENDENT AUDITOR

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Chairman Dingell and Members of the Subcommittee:

The Securities and Exchange Commission appreciates the opportunity to address issues concerning financial reporting and the role of the independent auditor. As requested in your letter of June 10, 1986, this statement discusses recent private sector, regulatory and legislative initiatives including a bill (H.R. 4886) currently pending in Congress, entitled the "Financial Fraud Detection and Disclosure Act of 1986."

I. INTRODUCTION AND SUMMARY

The United States has the most sophisticated and progressive financial reporting system in the world. Congress, the Commission, and the accounting profession have the common goal of assuring the public that this reporting system provides accurate information to investors. Cases of illegal payments in the 1970's and prominent business failures and publicized cases of improper reporting or business practices in the early 1980's have drawn the active attention of all three bodies. Congress has been overseeing the area and reviewing the need for further legislation; the Commission has made financial fraud a primary enforcement, review and oversight concern; and the accounting profession is further reviewing its responsibilities to search for financial fraud.

The independent auditor, in certifying financial statements, performs a crucial function in helping ensure full and fair disclosure to investors and other users. The system of checks and balances on the accounting profession continues to evolve in response to changing business and economic conditions and to the expectations of those who rely on the auditor's work.

The evidence concerning alleged audit failures suggests that the system is working well. For example, member firms of the American Institute of Certified Public Accountants' ("AICPA") SEC Practice Section ("SECPS") audit about 84% of all SEC registrants, including companies that account for over 98% of the combined sales volume of publicly-traded companies. These firms are required to report to the SECPS certain litigation, proceedings, or investigations which allege audit or reporting deficencies in connection with filings made by their SEC clients under the federal securities laws. Since the inception of this requirement on November 1, 1979, 176 such cases have been reported. These alleged, not proven, audit failures represent a fraction of one percent of the audits performed during this period.

There are about 11,000 publicly-owned companies that file reports and registration statements with the Commission. The financial disclosures of these companies have been a top priority of the Commission's programs to ensure compliance with the securities laws. */ Between fiscal 1981 and 1985, full disclosure filings have

*/ The Commission's programs were summarized in the March 6, 1985 testimony before this Subcommittee.

increased 26%. The Commission's reviews of such filings have been increased by over 50%.

The Commission's primary concern, of course, is with fraud that materially impacts the public financial reports of registrants. While the Commission has been unable (and it is unaware of any study that has been able) to quantify the nature and impact of such fraud, it is clear that fraudulent accounting or disclosure practices, however isolated, can cause substantial harm to investors, creditors and others. Therefore, false and misleading financial disclosures remain a major Commission concern and have resulted in approximately 143 enforcement cases in the past three years. In approximately 100 cases (42 in fiscal 1985, and 33 and 25 in fiscal 1984 and 1983, respectively) the Commission alleged financial accounting and disclosure violations against issuers or their employees. In approximately 43 cases (14 cases in fiscal 1985, and 18 and 11 in fiscal 1984 and 1983, respectively) the Commission alleged misconduct on the part of accounting firms or their partners or employees.

The Commission believes that the record demonstrates that the current regulatory system governing registrants is working well. Nonetheless, the Commission is in full support of cost-effective measures to improve the current system.

At recent SEC Roundtable discussions with nationally-recognized authorities, and in other fora, several private sector, regulatory and legislative initiatives have been discussed. In addition to H.R. 4886, these include:

- A number of AICPA projects, mostly by the Auditing Standards Board ("ASB"), under SEC oversight, such as:

  - Re-examination of auditing standards that deal with errors, irregularities and illegal acts. The project will clarify auditor responsibilities relating to the various kinds of misstatements, detection issues and reporting issues;

  - Re-examination of audit standards relating to evaluation and reporting on internal accounting controls. This project will re-examine the extent to which an internal controls review is required if no reliance on such controls is planned for audit purposes, as well as reporting responsibilities, among other issues;

  - Development of performance and reporting standards to govern the issuance of opinions on the application of generally accepted accounting principles ("GAAP");

  - Consideration of whether the auditor should be required to attest to an assertion by management on the entity's ability to continue in existence;

  - Consideration of auditor communications, including the language of the audit opinion and required communications by the auditor within and outside the client organization;

  - A study of possible ways to improve communication of risks and uncertainties facing a business enterprise; and

  - A study by the AICPA Special Committee on Standards of Professional Conduct for Certified Public Accountants ("Anderson Committee"), which has re-examined the AICPA Code of Ethics and concluded that the accounting profession should establish a mandatory program to monitor practice to improve quality. The Committee recommended, in effect, that the firms auditing SEC registrants be required to be SECPS members.

- A position paper by Price Waterhouse entitled <u>Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence</u> ("Price Waterhouse Proposals"), which recommends:

- Modified standards which would require an auditor (1) to review and evaluate a company's management controls, and (2) to identify circumstances indicating higher risk of management fraud and to perform tests if necessary;

- Formation of a statutory self-regulatory organization ("SRO") under the securities laws which would require membership by auditors practicing before the SEC; and

- A variety of initiatives to limit accountants' liability, from self-help measures such as the formation of professional corporations and a joint captive insurance company, to reform of state tort laws, federal securities laws and the civil liability provisions of the Racketeer Influenced and Corrupt Organizations Act ("RICO").

* Publication and presentation to the AICPA Board of Directors of a position paper entitled The Future Relevance, Reliability, and Credibility of Financial Information by the heads of seven major accounting firms ("Seven Firms' Proposals"), which principally recommends:

  - Increased disclosure of risks and uncertainties in SEC filings and auditor association with such disclosures;

  - Mandatory membership in the SECPS by firms practicing before the SEC;

  - Extension of SEC jurisdiction to cover additional "public interest" entities; and

  - Elimination of the potential abuse of "opinion shopping."

* Formation of the National Commission on Fraudulent Financial Reporting ("NCFFR"). The NCFFR seeks to examine:

  - The impact of management fraud on the integrity of financial reporting;

  - Reasons for such fraud;

  - Possible declines in professionalism on the part of corporate finance officers and internal auditors;

- The role of the auditor in the search for fraud;
- The role of law enforcement in curtailing fraud; and
- Attributes of corporate structure which may inhibit fraud prevention or detection.

Two SEC staff members are on the NCFFR's advisory committee. NCFFR expects to issue a draft report in early 1987.

While these various initiatives evolved independently, their focus is similar. Each deals with one or more of the following issues:

- Responsibility for detecting and reporting on fraud and illegal acts;
- Evaluation of and reporting on internal accounting controls;
- Management disclosure of risks and uncertainties in financial statements and auditor association with such disclosures;
- The efficacy of the accounting profession's program designed to maintain and enhance the quality control aspects of independent audits; and
- The limitations on liability costs, which ultimately are borne by consumers and investors.

The above initiatives are discussed more fully in this testimony.

II. CURRENT AUDIT STANDARDS CONCERNING DETECTION AND REPORTING OF FRAUD AND ILLEGAL ACTS

The Subcommittee has requested that this statement focus on fraud detection and reporting. Any meaningful discussion of these issues requires an understanding of present standards in

this area. The Auditing Standards Division of the AICPA summarized auditors' responsibilities regarding fraud and illegal acts under current generally accepted auditing standards ("GAAS"), in the July 1985 newsletter In Our Opinion, as follows:

> The auditor's responsibility to detect and report fraud is set out in Statement on Auditing Standards ("SAS") No. 16, The Auditor's Responsibility for the Detection of Errors or Irregularities, (1977) and SAS No. 17, Illegal Acts by Clients, (1977). The standards were developed as a direct result of problems in the business community in the mid-1970s. The disclosure of client frauds, such as Equity Funding, and questionable payments, primarily in foreign countries, stirred the profession to adopt more specific standards in the area of client misconduct.
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> SAS No. 16 establishes an affirmative requirement for auditors: the auditor is required to plan the examination to search for material errors and irregularities and to carry out the search with due skill and care. The auditor's responsibility with regard to illegal acts is less distinct: because auditors are not lawyers trained to recognize illegal acts, they are not expected to search for illegal acts, but rather to be aware that some matters that come to their attention during the examination might suggest that illegal acts have occurred. [*/] If the auditor discovers an error, irregularity, or illegal act, he is required to report it to management, and depending on its significance, possibly to the Board of Directors or its Audit Committee. The auditor is also required to assess the effect on the financial statements and, if material, to insist on adjustment or additional disclosures in the statements or to qualify the auditor report.

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*/ SAS No. 17 also advises that the further removed an illegal act is from the financial statements, the less likely it is that the auditor would become aware of the act or recognize its illegality. For example the auditor would be significantly less likely to recognize a violation of Environmental Protection Agency regulations than a tax underpayment.

> Auditors recognize that, although there is an affirmative responsibility to search for material errors and irregularities, there is a chance that they won't be found. The auditor tests selectively; that is, accounts are usually sampled rather than examined 100 percent. Thus, if the sample does not identify a fraudulent transaction, the auditor will be less likely to suspect one in the unsampled portion of the financial statements. Auditors, of course, control this sampling risk, but to eliminate it would require auditors to examine all of the entity's transactions for the year -- which would result in astronomical audit costs and this still would not necessarily detect cleverly forged or unrecorded transactions.

If improprieties are suspected or known, the auditor may have to render a qualified audit report. If the auditor is unable to conclude whether a situation represents an irregularity or illegal act or whether its effect is material (either due to a limitation imposed by management or an inability to obtain sufficient competent evidential matter), or if it is determined that the financial statements are materially misstated or materially deficient in disclosure, and management refuses to make appropriate changes, a modified opinion is required with a description of the reasons for such modification included in the report.

In the case of both suspected or known illegal acts, and errors or irregularities, current auditing standards also require that the auditor consider the implications of such acts in determining whether internal accounting controls or management representations can be relied upon. GAAS also requires that the auditor consider whether withdrawal from the engagement is necessary. */

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*/ In the event of a withdrawal or dismissal from the engagement which involves a disagreement over the accounting for or disclosure of an illegal or questionable act, disclosure to the SEC must be made in Form 8-K which would identify the existence of the illegal or questionable act. The Commission staff reviews all 8-Ks which disclose a change in accountants.

III. FINANCIAL FRAUD DETECTION AND DISCLOSURE ACT OF 1986, H.R. 4886

A. Detection and Reporting of Illegal and Irregular Activity

1. Description of bill

The "Financial Fraud Detection and Disclosure Act of 1986" would require those performing "financial examinations" */ to include procedures to "reasonably ensure" "detection and reporting of any illegal or irregular activity by any ... person associated with, the entity [being] audited or examined". The bill cautions that "[n]othing in [the bill] shall be construed to relieve any auditor or examiner from the responsibility to detect and disclose any illegal or irregular activity ... because such activity ... is not material to the ... document that is being prepared or certified."

The bill would also require that the auditor or examiner identify in a report and in each securities filing any activities detected that are or may be illegal or irregular and report such activities to the Commission and other authorities with jurisdiction. The Commission in turn would be required to report such activities to the Attorney General and other authorities. Finally, the bill provides legal protection for auditors or examiners who in good faith report known or suspected illegal or irregular activities to the appropriate authorities.

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*/ The term "financial examinations" is used throughout the bill. While it is not clear what this term means, for purposes of this testimony it is used interchangably with "audit."

2. Analysis

H.R. 4886 would substantially expand auditor responsibilities. First, the auditor would be responsible for detecting and reporting an illegal or irregular activity regardless of whether it is material. Second, the auditor would be required to make certain disclosures concerning that activity, that currently are not required under GAAS. */

On the one hand, H.R. 4886 may limit losses to investors, assuming that detection is possible early enough in the perpetration of an illegal or irregular activity to prevent or minimize misappropriation of assets, or that earlier disclosure may prevent investor losses. On the other hand, it is unclear whether the benefits of the bill would exceed the potential costs. For example, identifying all possibly illegal activity regardless of its materiality may be impossible or extremely costly, **/ as well as additional costs associated with increases in auditor liability (including insurance costs) and the increase

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*/ Presently, detected or suspected illegal or irregular activity would be reported in the audit opinion or through the Form 8-K mechanism, if not appropriately dealt with by management, but there is no absolute requirement to separately notify authorities.

**/ Statistics concerning average audit costs are not readily available; however, in its September 1985 "Report for Congress and the Public," the accounting firm of Deloitte Haskins & Sells reports having 2015 public clients generating aggregate fees of $179.8 million, or an average of $89,230 per company. The amount by which audit fees would increase if H.R. 4886 is enacted is difficult to estimate. The Commission staff believes that increases of three to four times present levels are not unreasonable.

in the SEC and Justice Department budgets to follow up on reported violations. Finally, it is not clear whether auditors have the expertise or tools needed to comply with the requirement of H.R. 4886 to identify all potentially illegal or irregular acts. Auditors are not lawyers, and they have limited knowledge of laws dealing with environmental protection, health and safety, and many other federal, state and municipal laws and regulations.

The ASB may soon clarify auditor responsibilities. The current project includes reconsideration of:

- Definitions of "errors," "irregularities" and "illegal acts" to distinguish between intentional and unintentional misstatements, and management and non-management irregularities.
- Detection issues, such as providing an expanded list of "red flags" which might suggest the presence of errors, irregularities or illegal acts, and impact of the presence of such warning signals on audit procedures.
- Disclosure issues, including the auditors' responsibility for reporting errors, irregularities and illegal acts.

In addition, the NCFFR report should provide valuable insight into the need for and nature of changes in the area of detecting and reporting fraud.

3. Commission views

The SEC shares the concerns about the importance of preventing and detecting improper financial reporting. However, there is no evidence that H.R. 4886 would be cost-effective without a materiality standard. The Commission would rely instead on proposals such as those currently under consideration by the ASB, looking to a modification of generally accepted auditing standards in response to these problems. Therefore, the Commission has serious reservations about the detection and reporting provisions of H.R. 4886.

H.R. 4886 would change the role of the independent auditor. It would inhibit candid communication with the client, create an adversarial relationship between the auditor and his client (more like a bank examiner or policeman), and seems to shift fraud detection accountability from corporate management to the independent auditor. The primary accountability for financial reporting should continue to lie with management and boards of directors. Auditors may certify the financial statements and review internal control systems, but management (under the oversight of the board or its audit committee) prepares the financial statements and designs, implements and promotes adherence to the system of internal controls.

The federal securities laws impose an obligation on registrants to file documents with the Commission and release information to the public which is not misleading due to the occurrence of fraud or for other reasons. Each document filed with the Commission is signed by members of management and, in many cases, by a majority of the board. These responsibilities of management and the board to find, deter and eliminate fraud and to disclose accurate financial information should not be lessened by the occurrence of an independent audit.

B. Internal Control Aspects of H.R. 4886

1. Description of bill

H.R. 4886 would require those conducting "financial examinations" to evaluate both the accounting and administrative controls

of a registrant to determine whether these controls "reasonably ensure" that "(A) receipts and expenditures comply with applicable law; (B) funds and other assets are properly safeguarded against waste, loss, unauthorized use, and misappropriation; and (C) receipts and expenditures are recorded and accounted for properly." It also would require those conducting such examinations to issue a written report that "contains a statement of the auditor's or examiner's evaluation of the internal accounting and administrative controls ... and an identification of any weakness in such controls." Further, the bill cautions that "(n)othing in [the bill] shall be construed to relieve any auditor or examiner from the responsibility to detect and disclose ... any defect in any internal accounting and administrative control because such ... defect is not material to the ... document that is being prepared or certified ...."

2. Analysis

It is not clear under the proposed bill whether the auditors' requirement to determine that the controls "reasonably ensure" that corporate assets are handled properly is intended to recognize that controls need not be designed to be foolproof. However, the bill appears to require auditors to detect and report any weaknesses in such controls, regardless of whether the weakness is material.

Absent a materiality threshold, costs of this provision could be prohibitive. In 1979, when the Commission proposed rules that would have required a management report in Form 10-K and annual reports to shareholders on internal accounting controls (a narrower definition than that included in the bill), the

Financial Executives Institute surveyed 500 companies on the estimated costs of the proposals. The results of the survey indicated that:

- The annual cost of a management report on controls averaged an estimated $94,000 per company (mostly internal costs); and
- The annual cost of an independent auditor's opinion on the internal control system (with no materiality threshold) averaged an estimated $219,000 per company.

While these amounts were estimates, they do indicate a substantial cost for the rules proposed in 1979. In today's dollars, the amounts would be considerably higher.

Additionally, the ASB is considering comprehensive revision of the standards currently in effect regarding the study and evaluation of internal control performed in the course of an audit. The project will include reconsideration of:

- the extent to which a study and evaluation of internal controls is required if no reliance on them is planned for audit purposes;
- the appropriate definitions of various terms used relating to internal controls;
- the impact of internal control on audit testing; and
- reporting responsibilities relating to evaluation of controls in an audit.

Additionally, the NCFFR is studying attributes of corporate structure which may inhibit fraud prevention or detection. In this work, the role of corporate controls will be a major focus.

3. Commission Views

Internal control systems are an important measure in assuring corporate accountability. Adequate controls, and strict adherence

to those controls, in many circumstances will serve to deter fraud and aid in the detection of fraud. The Commission's concerns with the internal control provisions of H.R. 4886, therefore, center on definitions of certain terms (e.g. the scope of terms such as "financial examination") and the cost-benefit aspects of the bill. In reviewing a similar 1979 proposal, the Commission found that the costs of requiring a management report on internal controls exceeded the benefits, and this bill would compound the requirements by including an examination and report by the auditors of controls, including administrative controls. Therefore, the Commission does not support the internal control provisions of H.R. 4886.

C. Personal Signatures on Reports

H.R. 4886 would require that the auditor's report on controls and illegal acts be "signed personally by the auditor or examiner, and by the partner or manager (of the firm employing such auditor or examiner) who is responsible for the conduct of the audit or examination by the firm."

A similar proposal was recommended in 1978 by the Metcalf Subcommittee. */ At that time, the Commission staff noted that audit reports are the product of a number of auditors and the quality control system of the firm as a whole and did not perceive sufficient benefit from implementing the recommendation to urge the profession to adopt it. The current Commission shares that view.

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*/ See, "Improving The Accounting of Publicly Owned Corporations and Their Auditors," Report of the Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs, U.S. Senate, November 1977, page 16.

IV. PRICE WATERHOUSE PROPOSALS

A. Responsibilities for the Detection and Reporting of Fraud and Illegal Acts, and Evaluation and Reporting on Internal Control

1. Description of Proposals

PW recommends requiring an auditor, (1) to review and evaluate the company's system of management controls, and (2) to "identify symptoms within the company's business environment that would indicate a higher risk of an intentional misstatement of the financial statements." The Proposals include a list of such symptoms including, for example: domineering management combined with an ineffective board of directors; a deterioration in quality of earnings; or the existence of large or unusual transactions at year-end.

Under the PW Proposals, if such symptoms exist, the auditor would be "required to consider performing certain substantive audit procedures." The proposal sets forth suggested procedures relating to each symptom. For example, in the event of large or unusual transactions at year-end that are material to the financial statements, the auditor should consider: selecting all large or unusual transactions for testing; ascertaining appropriate approvals; testing of the timing of revenue and expense recognition; and the appropriateness of management judgments with respect to complex accounting issues.

The auditor also would be required to review and evaluate accounting and management controls, regardless of whether the controls are to be relied upon in determining the scope of auditing

procedures. */ PW indicates that such a review is necessary for the auditor to gain a more complete understanding of how a client operates and controls its business. This understanding of the client business, in PW's opinion, would help the auditor: (1) find acts of omission and commission that may make financial statements materially misleading; (2) recognize unacceptable accounting practices; (3) recognize serious financial difficulties facing the client; and (4) recognize where material weaknesses in the internal control system create a higher risk environment for the occurrence of mangement fraud. In reviewing "management controls", the auditor would examine organizational (assignments of responsibility and delegation of authority), operating (adherence to policies and procedures, including profit planning and budgeting), and information system (providing information to appropriate levels of mangement) controls.

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*/ The auditor's present responsibility for evaluation of a company's internal control systems is set forth in GAAS: "There is to be a proper study and evaluation of the existing internal [accounting] control as a basis for reliance thereon and for the determination of the resultant extent to which auditing procedures are to be restricted." (SAS 1, Section 320)

There is no requirement under GAAS to assess controls other than as necessary in performing the audit. Most auditors agree that even when very little or no reliance on the system is planned, some work must be performed associated with internal controls in order to understand the system in planning appropriate audit tests. However, opinions as to the extent of such required work may vary. Certainly in large public companies a review and evaluation of internal controls is necessary to a cost-effective audit. Opinions as to the extent of such required work may vary, according to the individual entity.

PW indicates in the proposal that the profession will have to develop standards if these proposals are adopted. Further, the PW proposals do not specificially suggest a requirement to report on management fraud or management controls. They do, however, recognize that the accounting profession should address the reporting issue.

2. Analysis

The Price Waterhouse Proposals regarding both fraud detection and internal controls could be beneficial in further refining existing standards. Highlighting specific red flags and subsequent audit procedures may be useful to the auditor in planning his examination. It should be noted that the proposed changes for the most part constitute amplifications of current standards. The auditor has long been required to assess risks associated with the audit of a particular entity, and plan the audit accordingly. */

Further, PW's suggested requirement that internal controls be reviewed by the auditor in every engagement would better identify weaknesses in the systems. While it is likely that a required internal controls review will add to audit costs, because of the

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*/ Statement on Auditing Standards No. 22, Planning and Supervision, acknowledges that the steps required in performing a proper audit are based on conditions at the entity. SAS 22 states:

> In planning the examination, the auditor should consider, among other matters... [c]onditions that may require extension or modification of audit tests, such as the possibility of material errors or irregularities or the existence of related party transactions...

materiality criterion, the increased costs would not be as significant as those called for by H.R. 4886. In the recent Commission Roundtable on financial reporting and the role of the independent auditor, some participants opined that additional auditor association with internal controls could be cost-beneficial even for smaller companies, but no data has yet been provided in support of such opinions.

3. Commission Views

Price Waterhouse has suggested new audit standards. The Commission believes that these should be considered in the first instance by the ASB, in connection with their current initiatives previously discussed. The Commission will consider the Price Waterhouse proposals in reviewing the ASB's proposed audit standards. We also believe that the recommendations of the NCFFR, whose mandate goes well beyond the role of auditors in the fraud area, will be important in assessing cost-effective changes in this area.

B. The Accounting Profession's Quality Control Program

1. Description of Proposals

The Price Waterhouse Proposals implicitly acknowledge that the accounting profession's quality control program, including peer review, has been a valuable step in meeting the public interest, but concludes that further refinement of the voluntary program will not satisfy the profession's critics. In its position paper, Price Waterhouse states:

Fine-tuning the current peer review program might improve its performance, just as any system is capable of improvement; but it is unlikely that enough could be done in that regard to satisfy critics that the public's interest is being adequately served. Nevertheless, the AICPA program is far too valuable an investment of the profession's resources to be abandoned. The answer lies instead between the two extremes of complete abdication to government regulation on the one hand, and narrow but significant modification of the present system on the other.

The revised self-regulatory system should therefore include the following elements: It should combine much of the profession's current system of quality control standards and compliance review with a formal structure--as opposed to the present informal arrangement--for government oversight. That oversight should also extend to the disciplinary component of the system. The system, however, should remain essentially one of self-regulation, within a framework of overall government supervision. The model that best strikes this balance is an appropriately tailored, statutory self-regulatory organization under the Securities Exchange Act of 1934. */

The net effect of this proposal would be to:

- Move the profession's program from the auspices of the AICPA's Division for CPA Firms to Commission supervision; and to

- Require mandatory participation in the peer review process by accounting firms practicing before the Commission. Most other elements of the present program, including confidentiality of information concerning alleged audit failures, would remain the same as the current program.

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*/ The Price Waterhouse Proposals, p. 48.

2. Analysis

Subjecting the approximately 800 (mainly smaller) non-SECPS member firms */ that audit public companies to the membership requirements, including peer review, of a quality control organization should enhance the overall quality of practice before the Commission. In addition, required membership would increase the ability of the program to set higher standards, take additional and perhaps more timely remedial actions, and impose sanctions without concern about members resigning from, or potential members declining to join, a voluntary program. However, the vast majority of all public companies (particularly in terms of sales volume) are presently audited by firms that are subject to a peer review requirement.

Further, it is recognized that peer review is a quality control mechanism that represents but one element of the system of checks and balances of the accounting profession. For example,

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*/ The Commission understands that some of the reasons expressed by smaller firms for not participating in the SECPS relate to concerns about large firm domination of the program and cost-benefit considerations, including the cost of peer review. The vast majority of non-SECPS member firms practicing before the Commission are smaller firms with only one or a few SEC clients. The AICPA has indicated, however, that the annual dues for SECPS membership are $15 per professional staff member in the firm but not to exceed $100 if the firm has less than five SEC clients. The average cost of a triennial peer review, by an AICPA appointed team, for "small" firms (generally less than 20 professional staff members) ranges from $2,200 to $6,000. The average cost of a peer review of a Big 8 firm is approximately $800,000. All large and most "medium" sized firms already belong to the SECPS.

the Commission's enforcement program provides a mechanism whereby individual practitioners and firms, both large and small, are disciplined for substandard work. */ In addition, private litigation is a significant part of the environment of practicing public accounting. **/ With respect to the greater leverage that mandatory peer review might provide, it should be noted that under the present voluntary system, the Commission expects the SECPS to set adequate standards and take appropriate actions, under oversight of the Public Oversight Board ("POB") and the Commission.

3. Commission Views

In the Commission's view, the incremental benefits of a mandatory peer-review requirement have to be weighed against the costs of further governmental regulation. The Commission has not reached a conclusion on the need for a mandatory SRO. In any event, the Commission does not support the idea of a limited SRO with a "Chinese Wall" between the Commission and such an SRO.

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*/ In settling disciplinary proceedings against non-SECPS member firms the Commission has often required the firm to join the SECPS and receive a satisfactory peer review report as a condition of future practice before the Commission.

**/ See prior testimony before this Subcommittee dated March 6, 1985, Section E.

C. Limitations on Accountants' Liability

1. Description of Proposals

Price Waterhouse has coupled its proposals to increase auditor responsibilities with a range of alternatives designed to limit accountants' liability under federal and state law. These approaches include self-help options, such as the use of professional corporations or the creation of a joint captive insurance company. Price Waterhouse also suggests narrowing the construction of the federal securities laws, strengthening the application of the privity doctrine in state tort cases, establishing a ceiling on liability and apportioning liability in accordance with the relative degrees of fault between plaintiffs and defendants. PW also focuses on the Racketeer Influenced and Corrupt Organizations Act ("RICO").

2. Analysis

There is growing concern that there is a liability crisis facing individuals and businesses engaged in a variety of activities, including accounting. Narrowing the scope of accountants' liability would reduce the burdens that litigation and heavy jury-awarded damages impose on accounting firms and individual accountants, which are ultimately borne by consumers and the investing public.

Efforts to respond to these concerns have translated into a range of proposals. For example, in addition to the Price Waterhouse Proposals, there have been a number of efforts to limit civil liability under RICO, which would have the effect of reducing the

liability of accountants and others. The Commission has proposed amending RICO to limit civil RICO claims to cases (1) with earmarks of organized crime (e.g., extortion, bribery or arson) or (2) in which the defendant has a history of criminal misconduct, evidenced by a prior criminal conviction. The proposed amendments would not affect criminal RICO cases.

The Attorney General's Tort Policy Working Group recently issued a report on the causes, extent and policy implications of the current crisis in insurance availability and affordability. The report contains eight recommendations for tort law reform. Among the recommendations that could affect accountants' liability are elimination of joint and several liability, reduction of awards by collateral sources of compensation for the same injury, modification of contingency fee arrangements, and development of alternative dispute resolution mechanisms. To date, the bills introduced as a result of this study would not affect accountants' liability. However, a number of other bills have been introduced recently that could reduce tort liability for damages. */ These legislative proposals would apply to a variety of businesses and individuals, including accountants.

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*/ See, e.g., H.R. 4874. See also S. 2038, S. 2046, H.R. 4460.

3. Commission Views

Price Waterhouse has suggested a number of possible approaches to the liability question. The Commission is concerned about the liability problem and believes these proposals deserve further study.

V. SEVEN FIRMS' PROPOSALS

A. Disclosure of Risks and Uncertainties; Auditor Association with Such Disclosures

1. Description of Proposals

Seven of the "Big Eight" accounting firms as a part of their proposal for The Future Relevance, Reliability, and Credibility of Financial Information stated that "... It is well understood that users are interested in the timing, amount and uncertainty of future cash flows. Given the rapidly changing environment ... current financial statements do not contain enough information on risks and uncertainties."

In furtherance of this position, the group recommends that "the risks disclosures required in initial registrations of securities (such as in filings under the Securities Act of 1933) should be adapted for disclosures in annual financial statements (such as those filed under the Securities Exchange Act of 1934)."

The examples cited in the proposals for the types of disclosure that could enhance a user's capacity to evaluate a public company's financial statements and anticipate future difficulties were:

(1) information on risk concentration (internal risks, such as financial and operational, and external risks, such as competitive, technological and economic);

(2) information on uncertainties;

(3) information on significant judgments, assumptions and estimates in the financial statements; and

(4) an enhanced management's discussion and analysis of the company's financial condition, changes in financial condition and results of operations.

The group believes that the SEC's current requirement for a Management's Discussion and Analysis ("MD&A") has two major weaknesses. First, the requirement is stated too generally to result in meaningful disclosure and, second, the information is not subject to audit. Moreover, the group points out that the requirement applies only to companies filing with the SEC.

The Seven Firms' Proposals advocates auditor association with disclosures of risks and uncertainties. Until any new requirements are effective, the group proposes requiring audit coverage of existing MD&A.

2. Analysis

The Seven Firms' Proposals advocates frank and complete disclosure of risks and uncertainties associated with the entity. Such disclosure is beneficial.

However, current regulations already require disclosure of all material known risks that have or are reasonably expected to impact the issuer. The current disclosure requirements of the Commission relating to the description of business and related financial information presently impose an obligation on the issuer to perform adequate risk assessments in order to respond fully to the requirements. For example, in addition to the

requirement to describe the impact of any known trends or uncertainties that will or that are reasonably likely to have an impact on the registrant, registrants also must disclose the names of principal customers if a significant portion of the business is derived from a single or limited number of customers where the loss of any customer would adversely affect the registrant, disclose any existing or anticipated shortages of raw materials, and to discuss the nature of competition and principal methods of competition. */

In addition, a description of significant judgments, assumptions and estimates necessary for an understanding of the financial statements or to make the financial statements not false or misleading already is generally required pursuant to Accounting Principles Board Opinion No. 22, "Disclosure of Accounting Policies," as well as various other required financial statement footnotes. Management's Discussion and Analysis also elicits a discussion of these kinds of issues.

The present Management's Discussion and Analysis requires disclosure of trends and uncertainties that are both known to the registrant and that will or that are reasonably likely to have a material impact on the registrant. The rule does not contain an enumeration of the types of items to be included in order to provide registrants with the flexibility needed to produce a

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*/ Item 101 of Regulation S-K.

meaningful discussion, rather than legalistic boilerplate responses. The recommendation that the requirements of the Management's Discussion and Analysis be made more specific raises significant concerns that such revisions could result in the discussions moving toward a recitation of possible or remote risks or those common to a particular industry and away from the intended analysis of those that are reasonably likely to have an impact on the specific issuer.

Sufficient reason may not exist to require registrants in their annual reports either to include all risk discussions in a single section or to include a "highlight" section of risks discussed more fully elsewhere in the documents. In addition, this recommendation also must be viewed against the possibility that the inclusion of a "risk factors" section could result in lengthy discussions of risks inherent in the industry as well as generalized discussion of risk which are at best only possible risks and sometimes remote. The criticism has been made, and not without justification in some instances, that many companies use their Securities Act filings as "disclaimer documents" to protect themselves, rather than "disclosure documents" to inform their shareholders.

3. Commission Views

The Commission has long been concerned about the adequate discussion of trends and risks. In each review of a full disclosure filing, MD&A and other relevant disclosures are reviewed. Comments are frequently issued to registrants regarding improvements in such filings.

In the Commission's view, continuing improvements in disclosures under current regulations through the review process is preferable to new rules which could lead to boilerplate discussions or lengthy recitations of remote risks.

While the Commission is interested in exploring the implications of auditor involvement in the area of risk disclosures, such an expansion of the accountant's role would appear to be justified only if: (1) it can be demonstrated that the auditor could reasonably be expected to review for adequacy and completeness such forward looking information; (2) such auditor involvement would be cost effective; and (3) such involvement would not reduce the flexibility and the expansive nature of the disclosure item.

B. The Accounting Profession's Quality Control Program

1. Description of Proposal

The Seven Firms' Proposals discuss the profession's quality control initiatives and, in their view, the need for mandatory peer review for all firms practicing before the Commission. On this point, the Seven Firms' Proposals state:

> All auditors of SEC registrants should be members of the AICPA's SEC Practice Section and thus subject to its extensive programs of quality control, peer review, and, where required, remedial action. In order to achieve this result, the SEC should explore the powers it has under current statutory authority to make membership *de facto* obligatory. For example, the SEC might promulgate a rule establishing additional eligibility criteria for auditors practicing before the SEC. These might, for example, require certification as a CPA, continuing professional education, and membership in a professional organization that has a peer review program and an independent oversight function. The principal effect of comprehensive membership in the SEC Practice

Section for all auditors practicing before the SEC would not be the extended coverage of the Section -- the vast majority of assets and revenues of public companies are already audited by member firms -- but the greater leverage the Section would have to set high standards, mandate effective remedial actions, and, if necessary, impose suitable sanctions. The Section could take these actions without significant concern about members resigning from, or potential members declining to join, the Section, because a firm could not practice before the SEC without being a member of this or an equivalent organization. */

2. Analysis

The benefits of the Seven Firms' Proposals regarding mandatory membership are:

- Enhanced consistency and quality of practice as a result of additional firms becoming subject to the peer review process; and
- Possible increased ability to set higher standards, take remedial actions and impose sanctions.

Offset against these benefits are the costs of additional regulation for SECPS coverage of the firms auditing a small number of SEC registrants. (See the analysis section in IV B.2 above).

3. Commission Views

The Commission believes that the peer review process enhances the consistency and quality of practice before the Commission. The Commission staff is studying various methods to require peer review, including a public rulemaking initiative.

C. Extension of SEC Jurisdiction

1. Description of Proposal

The Seven Firms' Proposals recommends that all companies with "a sufficient public interest" in the reliability of their financial

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*/ The Seven Firms' Proposals, p. 6.

statements be subject to SEC jurisdiction. Examples of companies with such a public interest that are not now subject to SEC jurisdiction include nonpublic depositories, and insurance companies that are statutorily excluded from federal regulation.

2. Analysis

The advantages of the Seven Firms' Proposals include the improved public disclosure (e.g., a requirement for MD&A plus a business description) that would be expected to result from SEC jurisdiction over public reporting. Further, such entities would then be encompassed within the requirement that the registrant be audited by a firm subject to peer review.

The major offsetting consideration to this proposal is the cost associated with a new layer of regulation over a large number of entities which are already subject to pervasive regulation by state and federal agencies.

The Commission has repeatedly supported initiatives to place regulation of the financial reporting of approximately 700 publicly-owned banks and savings & loans under the jurisdiction of the SEC. */ Enactment of the other recommendations, including possibly placing under SEC jurisdiction the reporting requirements of over 17,000 other depository institutions, would be a massive change and duplicative of their present regulatory requirements.

*/ See, Statement of John Shad, Chairman of the Securities and Exchange Commission before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, concerning S&L Accounting and Financial Reporting, July 19, 1985.

3. Commission Views

The Commission believes that a major thrust of the Seven Firms' Proposals could be accomplished by a re-definition of the companies with which the SECPS is concerned to encompass more of the type of public interest entities mentioned in the proposal. For example, in July 1985, the SECPS amended its membership requirements so that quality control procedures such as concurring partner review and required partner rotation be extended to certain entities (such as publicly-held banks and S&L's reporting to other regulatory agencies pursuant to Section 12(i)). The Commission supports these requirements.

D. Opinion Shopping

1. Description of Proposal

The Seven Firms' Proposals recommend a number of steps to address "opinion shopping," including:

(1) the SEC should strengthen the Form 8-K requirement on auditor changes as to the level of disclosures and the degree of follow-up when there are reported differences as to accounting or auditing matters;

(2) regulatory agencies other than the SEC (for example, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, and the state insurance commissions) should require disclosures concerning auditor changes similar to those required by the SEC in Form 8-K;

(3) peer reviewers should scrutinize all engagements assumed since the last peer review where there was disclosure (in Form 8-K and similar filings) of a significant disagreement or the former accountant resigned; and

(4) auditing standards should require a successor auditor to focus more sharply on auditor-change circumstances where there is no Form 8-K or similar filing.

2. Analysis

With respect to the first recommendation, the Commission issued a Concept Release seeking views on opinion shopping in July 1985. The comments received have been analyzed by the staff, and possible proposals for the Commission's consideration later this year are being evaluated.

With respect to the other proposals, the benefits appear to relate primarily to improving scrutiny of auditor changes in non-SEC registrants to the same level as SEC registrants. The costs include the manpower of other federal agencies, auditors and peer reviewers.

3. Commission Views

The Commission has taken steps to maintain auditor independence and address abusive opinion shopping. */ All filings on Form 8-K related to changes in auditors are reviewed by the staff. The SEC has brought enforcement cases focusing on this area. The staff is currently evaluating costs and benefits of additional initiatives.

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*/ These steps are more fully described in the March 6, 1985 testimony before this Subcommittee, pages C-4 through C-8. Further, the Commission notes that the ASB is adopting performance and reporting standards for opinions on the application of GAAP to nonclients and the SECPS has adopted requirements for firms to develop policies in this area which will be tested during peer review.

The Commission encourages other regulators to adopt rules similar to the 8-K requirements on auditor changes. The Federal Home Loan Bank Board has already adopted requirements in this regard.

The remaining recommendations on SECPS and audit administration appear salutory and the SEC encourages their adoption by the AICPA.