
**Report of
the National Commission on
Fraudulent Financial Reporting**

October 1987

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National Commission on Fraudulent Financial Reporting

National Commission on Fraudulent Financial Reporting

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INTRODUCTION

This report presents the findings, conclusions, and recommendations of the National Commission on Fraudulent Financial Reporting (the Commission). From October 1985 to September 1987, the Commission studied the financial reporting system in the United States. Our mission was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence.

Fraudulent financial reporting is indeed a serious problem. Infrequent though its occurrence arguably may be, its consequences can be widespread and significant. Although fraud in any form can be difficult to deter, fraudulent financial reporting can be reduced, perhaps substantially, if each party for whom we made recommendations takes the steps we recommend. The Commission's recommendations embrace the top management and boards of directors of all public companies, independent public accountants and the public accounting profession, the SEC and other regulatory and law enforcement bodies, and the academic world.

As background to the Commission and its work, this introduction discusses the Commission's sponsors, members, and advisors, the definition of fraudulent financial reporting that the Commission used, the Commission's objectives, the scope of the study, and the research program.

Following this background information is a discussion of the major conclusions that guided the Commission in developing the recommendations presented in this report.

I. The Commission

Sponsors, Members, and Advisors

The Commission was a private-sector initiative, jointly sponsored and funded by the American Institute of Certified Public Accountants (AICPA), the American Accounting Association (AAA), the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (NAA).

The six-member Commission was independent of the sponsoring organizations. The chairman of the Commission was James C. Treadway, Jr., formerly a Commissioner of the Securities and Exchange Commission (SEC), and presently Executive Vice President, General Counsel, member of the Executive Group, and a Director of Paine Webber Incorporated. William M. Batten is the immediate past Chairman of the New York Stock Exchange and the former Chief Executive Officer (CEO) of J.C. Penney Co. William S. Kanaga is Chairman of the Advisory Board of Arthur Young & Company, and served as Chairman of that firm and of the AICPA. Hugh L. Marsh is the Director-Internal Audit for ALCOA, responsible for its worldwide audit activities. He also is a past Chairman of the IIA. Thomas I. Storrs is the immediate past Chairman and CEO of NCNB Corporation, a bank holding company, and continues to serve as a Director of NCNB. Donald H. Trautlein recently retired as Chairman and CEO of Bethlehem Steel and was formerly a partner with the accounting firm of Price Waterhouse. Appendix A includes biographies of the Commissioners and the Executive Staff.

An Advisory Board, representing a broad spectrum of experience and points of view, assisted the Commission.

Definition of Fraudulent Financial Reporting

For purposes of this study and report, the Commission defined fraudulent financial reporting as intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements. Fraudulent financial reporting can involve many factors and take many forms. It may entail gross and deliberate distortion of corporate records, such as inventory count tags, or falsified transactions, such as fictitious sales or orders. It may entail the misapplication of accounting principles. Company employees at any level may be involved, from top to middle management to lower-level personnel. If the conduct is intentional, or so reckless that it is the legal equivalent of intentional conduct, and results in fraudulent financial statements, it comes within the Commission's operating definition of the term *fraudulent financial reporting*.

Fraudulent financial reporting differs from other causes of materially misleading financial statements, such as unintentional errors. The Commission also distinguished fraudulent financial reporting from other corporate improprieties, such as employee embezzlements, violations of environmental or product safety regulations, and tax fraud, which do not necessarily cause the financial statements to be materially inaccurate.

Objectives

The Commission had three major objectives:

1. Consider the extent to which acts of fraudulent financial reporting undermine the integrity of financial reporting; the forces and the opportunities, environmental, institutional, or individual, that may contribute to these acts; the extent to which fraudulent financial reporting can be prevented or deterred and to which it can be detected sooner after occurrence; the extent, if any, to which incidents of this type of fraud may be the product of a decline in professionalism of corporate financial officers and internal auditors; and the extent, if any, to which the regulatory and law enforcement environment unwittingly may have tolerated or contributed to the occurrence of this type of fraud.
2. Examine the role of the independent public accountant in detecting fraud, focusing particularly on whether the detection of fraudulent financial reporting has been neglected or insufficiently focused on and whether the ability of the independent public accountant to detect such fraud can be enhanced, and consider whether changes in auditing standards or procedures—internal and external—would reduce the extent of fraudulent financial reporting.
3. Identify attributes of corporate structure that may contribute to acts of fraudulent financial reporting or to the failure to detect such acts promptly.

Scope: Public Companies

The Commission's study focused on public companies. The term *public company* generally includes companies owned by public investors. Several types of companies fall within the Commission's definition of public company: (1) public companies that report to the SEC; (2) certain publicly owned banks, savings and loan associations, and other financial institutions that are subject to the disclosure provisions of the federal securities laws but report to one of the financial institution regulatory agencies; and (3) certain mutual thrift institutions.

The Commission included public companies of this third type for several reasons. The same federal agencies that regulate the publicly owned financial institutions regulate these mutual thrift institutions. Their ownership by depositors resembles public ownership since these companies accept public funds as capital and give depositors equity-like interests. A number of cases of fraudulent financial reporting have occurred in these institutions, with far-reaching impact.

The Commission's focus should not imply that fraudulent financial reporting occurs only in public companies or that only in these companies is its impact noteworthy. On the contrary, fraudulent financial reporting has occurred, often with serious consequences, in entities that are outside the express scope of the Commission's study and recommendations.

Among the "non-public company" entities that are at risk of fraudulent financial reporting are some entities, such as mutual insurance companies, that may in fact accept public funds as capital. Others at risk include state-regulated banks, private defense contractors and private companies in general, as well as various government and quasi-government entities. In the Commission's estimation, the overall thrust of the recommendations—especially the emphasis on top management's responsibility—is relevant and applies to all these "non-public company" entities.

Applied with proper reflection, foresight, and ingenuity, many of the Commission's recommendations should prove practicable, cost-effective, and suitable for these other entities to implement. Accordingly, the Commission urges "non-public company" entities to use the recommendations in forming individual or collective responses to the problem of fraudulent financial reporting.

Research Program and Interviews

A thorough understanding of the environment in which fraudulent financial reporting occurs is a prerequisite to identifying appropriate responses. Too often, the subject has been considered from a narrow perspective. The Commission placed a high priority on going deeper than the obvious in identifying the many forces and opportunities that may contribute to financial reporting fraud.

To this end, the Commission directed an extensive research program. Outside experts who conducted research projects for the Commission considered professionalism and codes of corporate conduct, corporate pressures, surprise writeoffs, internal control, internal auditing, the role of the SEC, litigation against public accountants, the independence of the public accountant, computer fraud, and business and accounting education. In addition, the Commission's staff completed more than 20 research projects and briefing papers, including analyses of SEC enforcement actions, pressures within public accounting firms, AICPA self-regulatory programs, and the legal and regulatory environment. Significant findings of the research efforts are incorporated into the text of the report, and Appendices B and C summarize the research.

To supplement this research program, the Commission reviewed previous and current related studies and interviewed numerous experts. The related studies the Commission reviewed are listed in Appendix C. The Commission interviewed the Chairman of the SEC, the Chairman of the Federal Deposit Insurance Corporation, the Comptroller of the Currency, the Comptroller General of the United States, the Chairman of the AICPA, the Chairman of the Auditing Standards Board, the Chairman of the AICPA's SEC Practice Section's Public Oversight Board, the Chairman of the IIA, the President of the FEI, the President of the NAA, the President of the National Association of State Boards of Accountancy, several members of the Commission's Advisory Board, and many other independent public accountants, government regulators, corporate executives, and university professors. Appendix D lists the persons the Commission consulted.

Exposure Draft, Public Comment, and Congressional Hearings

The Commission first voted on the recommendations in October 1986. Thereafter, members of the Commission and the staff delivered several speeches airing the Commission's initial findings and conclusions to "pre-expose" the Exposure Draft of the report and thus start the comment process in advance of the draft's publication in late April 1987.

In addition to those who conveyed their reactions, suggestions, and opinions informally during the pre-exposure period, approximately 50 interested organizations and individuals expressed their points of view in written comments. The Commission considered all the comments—positive, negative, and neutral—in its deliberations. In a number of areas, the recommendations in the Exposure Draft bore the imprint of these comments.

The Commission's five sponsoring organizations distributed over 40,000 copies of the Exposure Draft. Requesting and welcoming public comment, the Commission received over 200 letters in reply. These responses represented the views of substantially more than 200 interested parties, since many of them presented the collective comments of members of professional and trade organizations, including the Commission's five sponsoring organizations, as well as large national accounting firms, state and federal agencies, leading financial service institutions, and Fortune 500 companies.

The process of reviewing, analyzing, and considering the comment letters was indispensable to the Commission in completing and issuing the report. The overwhelming majority of responses complimented the Commission on its overall effort and were generous in their support of the Commission's recommendations. Those who expressed selective disagreement or raised particular concerns with regard to one or more of the recommendations made many insightful comments and constructive suggestions. The report includes a number of changes made to reflect the commentators' suggestions, criticisms, and other viewpoints. The comment letters, part of the permanent record of the Commission's work, are available to the public on request through the offices of the AICPA in New York.

Finally, the Commission appeared twice before the House Committee on Energy and Commerce's Subcommittee on Oversight and Investigations, as part of the Subcommittee's continuing inquiry into the adequacy of auditing, accounting, and financial reporting practices under the federal securities laws.

II. Major Guiding Conclusions

The Commission's recommendations, taken together, form a balanced response to fraudulent financial reporting. The Commission cannot overemphasize the importance of evaluating its recommendations in their totality; no one is meant to be singled out from the rest. Indeed, the Commission withheld endorsement of any recommendation under consideration until the research and briefing papers for substantially all recommendations had been completed and the Commission could see the web of relationships among the proposed recommendations.

From the outset, the Commission's goal was to develop recommendations that would be practical, reasonable in the circumstances, justified by the benefits to be achieved, and would lend themselves to implementation without undue burden. Guiding the Commission in this task were a number of conclusions.

Accountability

When a company raises funds from the public, that company assumes an obligation of public trust and a commensurate level of accountability to the public. If a company wishes access to the public capital and credit markets, it must accept and fulfill certain obligations necessary to protect the public interest. One of the most fundamental obligations of the public company is the full and fair public disclosure of corporate information, including financial results.

The independent public accountant who audits the financial statements of a public company also has a public obligation. As the U.S. Supreme Court has recognized, when the independent public accountant opines on a public company's financial statements, he assumes a public responsibility that transcends the contractual relationship with his client. The independent public accountant's responsibility extends to the corporation's stockholders, creditors, customers, and the rest of the investing public. The regulations and standards for auditing public companies must be adequate to safeguard that public trust and auditors must adhere to those standards.

The Need for Improvement

The extensive financial reporting by public companies is the most critical component of the full and fair disclosure that ensures the effective functioning of the capital and credit markets in the United States. The financial reporting system in the United States is the best in the world, a model for other developed nations. The Commission nonetheless concluded that it should examine the system objectively because it is so important and is such a model. Our examination caused us to conclude that steps need to be taken to improve our financial reporting system, despite its present excellence.

Quantifying the Problem

The Commission sought to quantify the problem of fraudulent financial reporting. That quantification proved to be impossible. We found no way to gauge either the amount or the significance of undetected fraudulent financial reporting or the number of cases detected but, for a variety of reasons, not pursued by law enforcement officials. As a result, estimating the true extent of the problem is not simply a matter of comparing, for example, the number of fraudulent financial reporting cases brought by the Securities and Exchange Commission (SEC) with the total number of publicly filed financial reports.

Three Relevant Factors

Even though precise quantification proved to be impossible, the Commission concluded that three other factors are relevant: (1) the seriousness of the consequences of fraudulent financial reporting, (2) the risk of its occurring in any given company, and (3) the realistic potential for reducing that risk.

Consequences of Fraudulent Financial Reporting. First, when fraudulent financial reporting occurs, serious consequences ensue. The damage that results is widespread, with a sometimes devastating ripple effect. Those affected may range from the immediate victims—the company's stockholders and creditors—to the more remote—those harmed when investor confidence in the stock market is shaken. Between these two extremes, many others may be affected: employees who suffer job loss or diminished pension fund value; depositors in financial institutions; the company's underwriters, auditors, attorneys, and insurers; and even honest competitors whose reputations suffer by association.

Risk of Occurrence. To assess the risk that fraudulent financial reporting may occur, the Commission analyzed its causes. We concluded that the causal factors, the forces and opportunities that were present in numerous SEC enforcement cases, are present to some extent in all companies. No company, regardless of size or business, is immune from the possibility that fraudulent financial reporting will occur. That possibility is inherent in doing business.

Realistic Potential for Reducing Risk. We believe a realistic potential exists for reducing the risk of fraudulent financial reporting, provided the problem is considered and addressed as multidimensional. The problem's multidimensional nature becomes clear when we merely consider the many participants who shape the financial reporting process: the company and its management, the independent public accountant, regulatory and law enforcement agencies, and even educators. Each one has the potential to influence the outcome of the financial reporting process. Thus we believe that a multidimensional approach that analyzes and addresses the role of each participant has the maximum potential for reducing the incidence of fraudulent financial reporting.

Participants in the Financial Reporting Process

The responsibility for reliable financial reporting resides first and foremost at the corporate level. Top management—starting with the chief executive officer—sets the tone and establishes the financial reporting environment. Therefore, reducing the risk of fraudulent financial reporting must start within the reporting company.

We have identified a number of practices already in place in many companies that can help all public companies meet their responsibilities and reduce the incidence of fraudulent financial reporting. One key practice is the board of directors' establishment of an informed, vigilant and effective audit committee to oversee the company's financial reporting process. Another is establishing and maintaining an internal audit function.

Prior efforts to reduce the risk of fraudulent financial reporting have tended to focus heavily on the independent public accountant and, as such, were inherently limited. Independent public accountants play a crucial, but secondary role. They are not guarantors of the accuracy or the reliability of financial statements. Their role, however, can be enhanced, particularly with respect to detecting fraudulent financial reporting, and financial statement preparers and users should be made to understand the enhanced role.

At the same time, however, management's primary responsibility for reliable financial reporting should be emphasized, so that public understanding of the relative and complementary obligations of corporate management and independent public accountants is improved.

Regulatory and law enforcement agencies provide the deterrence that is critical to reducing the incidence of fraudulent financial reporting. The SEC, through its financial fraud enforcement program, already has significantly raised corporate awareness of the problem and of the potential for detection and punishment. But improvements can and should be made, both at the state and the federal level.

Although educators are not generally considered participants in the financial reporting process, they have an important role in helping to reduce the risk of fraudulent financial reporting. Education can prepare business and accounting students to recognize the factors that can contribute to this type of fraud and the ethical values and good business practices necessary to guard against it.

Improvements Needed in All Areas

Our analysis of the role of each participant in the financial reporting process led us to conclude that no one answer to the problem of fraudulent financial reporting exists. Rather, improvement is needed in all areas. The Commission's recommendations can be implemented within the existing structure of corporate governance and regulation. As a consequence, the Commission's report presents a unified set of complementary recommendations to be carried out by a number of persons and entities. Fewer than one-third of the recommendations require regulatory or legislative action. In the Commission's estimation, alternatives to this approach would entail more drastic measures, requiring a restructuring of corporate governance and greater regulatory intrusion, with no evidence that greater results would obtain.

In referring to the recommendations in this report as a "unified set of complementary recommendations," the Commission emphasizes that the recommendations have been formulated to work together synergistically. Yet the Commission does not offer its recommendations as an "all or nothing" proposition to be accepted or rejected as a whole. Clearly, implementing some of the recommendations would be better than adopting none of them. Furthermore, success in implementing these recommendations does not hinge on the exclusive effort of a single participant or group of participants. Rather, success depends on a significant effort by all participants doing their part to make the financial reporting process work better.

In some cases, making the process work better requires the participants to initiate new practices; in others, it necessitates improving the present practices. In fact, some public companies and public accounting firms are already doing many of the things we recommend, as a matter of good business practice.

Legal, Financial, and Other Advisors

The professional and technical skills of several other groups within the business and professional community enable them to work closely with key participants in the financial reporting process. Among these groups are lawyers, investment bankers, financial analysts, business advisors, and those in charge of systems for securing company assets. Whether they operate from inside or outside the public company, these advisors are uniquely situated to influence the tone set by the top management of corporations. Through the advice and opinions they extend to top management or the board of directors, these advisors can affect the outcome of the financial reporting process.

In fact, past incidents of fraudulent financial reporting have revealed many patterns of behavior through which these types of advisors add to the pressures and the opportunities that may lead to this kind of wrongdoing. Lawyers who adopt a strictly legalistic approach may counsel clients to achieve desired ends through means that are too close to the fine line between what is legal and what is not. Investment bankers may exploit gaps or ambiguities in accounting standards to devise questionable financing techniques and transactions. Financial analysts, through myopic notions of profitability and other indicators of company financial health, may pressure top management to focus all their efforts on achieving short-term gains. Through such conduct, legal, financial, and other advisors become part of the problem of fraudulent financial reporting.

Although the Commission's recommendations do not specifically target them, these critical advisors should recognize the extent to which they contribute to and collaborate in activity that can lead to fraudulent financial reporting. If these advisors do not embrace the spirit behind the Commission's recommendations, they could hinder certain key participants in the financial reporting process from successfully implementing the recommendations directed to them. Accordingly, the Commission urges legal, financial, and other advisors to support its recommendations

and to consider them in forming their own response to the problem of fraudulent financial reporting.

The efforts of these advisors to form a response to the problem of fraudulent financial reporting will necessarily entail reassessing their legal and professional responsibilities and accountability, not only to their clients, but also to the public and to the system of which they are a part. Of remarkable relevance to this endeavor is a message that the late Supreme Court Chief Justice Harlan F. Stone delivered more than a half-century ago to members of the legal community:

Today antisocial business practices which have not yet met with our refusal to countenance them, are equally in the public thought. It is true that the parallel to the earlier era is not precise, for many of these practices are still within the law, and to stand against them it is necessary that we do more than defend legal rights; it is needful that we look beyond the club of the policeman as a civilizing agency to the sanctions of professional standards which condemn the doing of what the law has not yet forbidden. (*Harvard Law Review*, Volume 48, page 13, 1934)

Overall Benefits

In developing our recommendations, we weighed the costs and other burdens they would impose against the benefits they would achieve. We recognize that there are limits to the ability to prevent or detect fraud, no matter how much cost is incurred. We believe our recommendations are cost-effective.

Taken collectively, the recommendations can:

- Improve the financial reporting environment in the public company in several important respects and thus help to reduce the incidence of fraudulent financial reporting
- Improve auditing standards, the standard-setting process, and the system for ensuring audit quality, to detect fraudulent financial reporting earlier and perhaps thus deter it
- Enhance the regulatory and law enforcement environment to strengthen deterrence
- Enhance the education of future participants in the financial reporting process.

Inherent Limitations and Need for Continued Efforts

Our recommendations are by no means the final answers. Fraud is as complex as human nature, and as society changes, the financial reporting system will change. As fraudulent financial reporting likewise evolves, so must counter responses. The Commission urges all participants in the financial reporting system to implement these recommendations as the next step in the continuing process of responding to fraudulent financial reporting. Implementing our recommendations will require additional guidance in the form of rulemaking by regulators and through authoritative pronouncements by other interested and knowledgeable parties.

Yet, implementing all 49 of the Commission's recommendations would still not guarantee that fraudulent financial reporting will disappear. Similarly, failure to implement some or all of the recommendations should not automatically establish liability if fraudulent financial reporting occurs. Those who allege that fraud has occurred must still offer affirmative proof of any actual wrongdoing.

A further word of caution also is in order. While increased awareness of fraudulent financial reporting within the business and professional community and among the investing public generally is important, it is equally important that public expectations not be raised unduly because even full implementation of the Commission's recommendations will not completely eradicate

fraudulent financial reporting. Fraudulent financial reporting must not be assumed merely because a business fails. The public must recognize and understand the clear line that distinguishes the failure of top management to manage well from the intentional or reckless conduct that amounts to fraud. We hope that our report will serve as a framework for action now and as a springboard for future efforts to reduce fraudulent financial reporting.

SUMMARY OF RECOMMENDATIONS

This summary is a synopsis of the organization and content of the Commission's recommendations, which appear in Chapters Two through Five of the report. The Commission urges readers to consider the recommendations along with the accompanying text, which explains, adds guidance, and in certain cases makes ancillary recommendations.

I. Recommendations for the Public Company (Chapter Two)

Prevention and earlier detection of fraudulent financial reporting must start with the entity that prepares financial reports. Thus the first focus of the Commission's recommendations is the public company. These recommendations, taken together, will improve a company's overall financial reporting process and increase the likelihood of preventing fraudulent financial reporting and detecting it earlier when it occurs. For some companies, implementing these recommendations will require little or even no change from current practices; for other companies, it will mean adding or improving a recommended practice. Whether it means adding or improving a practice, the benefits justify the costs. The Commission's recommendations for the public company deal with (1) the tone set by top management, (2) the internal accounting and audit functions, (3) the audit committee, (4) management and audit committee reports, (5) the practice of seeking second opinions from independent public accountants, and (6) quarterly reporting.

The Tone at the Top

The first three recommendations focus on an element within the company of overriding importance in preventing fraudulent financial reporting: the tone set by top management that influences the corporate environment within which financial reporting occurs. To set the right tone, top management must identify and assess the factors that could lead to fraudulent financial reporting; all public companies should maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection—this is a broader concept than internal accounting controls—and all public companies should develop and enforce effective, written codes of corporate conduct. As a part of its ongoing assessment of the effectiveness of internal controls, a company's audit committee should annually review the program that management establishes to monitor compliance with the code. The Commission also recommends that its sponsoring organizations cooperate in developing additional, integrated guidance on internal controls.

Internal Accounting and Audit Functions

The Commission's recommendations turn next to the ability of the participants in the financial reporting process within the company to prevent or detect fraudulent financial reporting. The internal accounting function must be designed to fulfill the financial reporting responsibilities the corporation has undertaken as a public company. Moreover, all public companies must have an effective and objective internal audit function. The internal auditor's qualifications, staff, status within the company, reporting lines, and relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity. The internal auditor should consider his audit findings in the context of the company's financial

statements and should, to the extent appropriate, coordinate his activities with the activities of the independent public accountant.

The Audit Committee

The audit committee of the board of directors plays a role critical to the integrity of the company's financial reporting. The Commission recommends that all public companies be required to have audit committees composed entirely of independent directors. To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls. The board of directors should set forth the committee's duties and responsibilities in a written charter. Among other things, the audit committee should review management's evaluation of the independence of the public accountant and management's plans for engaging the company's independent public accountant to perform management advisory services. The Commission highlights additional important audit committee duties and responsibilities in the course of discussing other recommendations affecting public companies.

Management and Audit Committee Reports

Users of financial statements should be better informed about the roles management and the audit committee play in the company's financial reporting process. The Commission recommends a management report that acknowledges that the financial statements are the company's and that top management takes responsibility for the company's financial reporting process. The report should include management's opinion on the effectiveness of the company's internal controls. The Commission also recommends a letter from the chairman of the audit committee that describes the committee's activities. Both of these communications should appear in the annual report to stockholders.

Seeking a Second Opinion and Quarterly Reporting

Finally, the Commission's recommendations for the public company focus on two opportunities to strengthen the integrity of the financial reporting process. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue, explaining why the particular accounting treatment was chosen. The Commission also recommends additional public disclosure in the event of a change in independent public accountants. Furthermore, the Commission recommends audit committee oversight of the quarterly reporting process.

II. Recommendations for the Independent Public Accountant (Chapter Three)

The independent public accountant's role, while secondary to that of management and the board of directors, is crucial in detecting and deterring fraudulent financial reporting. To ensure and improve the effectiveness of the independent public accountant, the Commission recommends changes in auditing standards, in procedures that enhance audit quality, in the independent public accountant's communications about his role, and in the process of setting auditing standards. On February 14, 1987, the Auditing Standards Board (ASB) exposed for comment a series of proposed auditing standards that address many issues the Commission considered. The Commission commends the ASB for its efforts in these exposure drafts, some of which are responsive to Commission concerns.

Responsibility for Detection and Improved Detection Capabilities

Generally Accepted Auditing Standards (GAAS) should be changed to recognize better the independent public accountant's responsibility for detecting fraudulent financial reporting. The standards should restate this responsibility to require the independent public accountant to take affirmative steps to assess the potential for fraudulent financial reporting and design tests to provide reasonable assurance of detection. Among the affirmative steps recommended is assessment of the company's overall control environment along with improved guidance for identifying risks and designing audit tests. In addition, the independent public accountant should be required to make greater use of analytical review procedures, to identify areas with a high risk of fraudulent financial reporting. The independent public accountant also should be required to review quarterly financial data before its release, to improve the likelihood of timely detection of fraudulent financial reporting.

Audit Quality

Improved audit quality increases the likelihood of detecting fraudulent financial reporting. In this regard, the Commission makes three recommendations. The first two are designed to improve two aspects of the profession's existing quality assurance program. Peer review should be strengthened by adding reviews, in each office reviewed, of all first-year audits performed for public company clients that were new to the firm. Concurring, or second partner, review should be enhanced by adding more explicit guidance as to timing and qualifications. In the third recommendation, the Commission encourages greater sensitivity on the part of public accounting firms to pressures within the accounting firm that may adversely impact audit quality.

Communications by the Independent Public Accountant

Independent public accountants need to communicate better to those who rely on their work. The auditor's standard report can and should convey a clearer sense of the independent public accountant's role, which does not include guaranteeing the accuracy of the company's financial statements. The standard audit report should explain that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of fraud or error. It also should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. These two steps will promote a better appreciation of an audit and its purpose and limitations and underscore management's primary responsibility for financial reporting.

Change in the Process of Setting Auditing Standards

Finally, the Commission recommends that the process of setting auditing standards be improved by reorganizing the AICPA's Auditing Standards Board (ASB). The Commission believes that the setting of auditing standards should involve knowledgeable persons whose primary concern is with the use of auditing products as well as practicing independent public accountants. Such individuals would have particular sensitivity to the operating implications of auditing standards and to emerging policy issues concerning these standards. The recommendation contemplates a smaller ASB, composed of equal numbers of practitioners and qualified persons not presently engaged in public accounting and led by two full-time officers, that would look beyond the technical aspects of auditing and set an agenda reflecting a broad range of needs, serving public and private interests. The agenda would be implemented by auditing standards of continuing high technical quality, and the ASB would adopt these standards on the basis of their technical quality and their addressing these public and private needs.

III. Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment (Chapter Four)

Strong and effective deterrence is essential in reducing the incidence of fraudulent financial reporting. While acknowledging the SEC's significant efforts and achievements in deterring such fraud, the Commission concludes that the public- and private-sector bodies whose activities shape the regulatory and law enforcement environment can and should provide stronger deterrence. The Commission's recommendations for increased deterrence involve new SEC sanctions, greater criminal prosecution, improved regulation of the public accounting profession, adequate SEC resources, improved federal regulation of financial institutions, and improved oversight by state boards of accountancy. In addition, the Commission makes two final recommendations in connection with the perceived insurance and liability crises.

New SEC Sanctions and Greater Criminal Prosecution

The range of sanctions available to be imposed on those who violate the law through fraudulent financial reporting should be expanded. Congress should give the SEC additional enforcement tools so that it can impose fines, bring cease and desist proceedings, and bar or suspend individual perpetrators from serving as corporate officers or directors, while preserving the full range of due process protections traditionally accorded to targets of enforcement activities. Moreover, with SEC support and assistance, criminal prosecution for fraudulent financial reporting should be made a higher priority.

Improved Regulation of the Public Accounting Profession

Another regulatory function, the regulation of the public accounting profession, seeks to reduce the incidence of fraudulent financial reporting through ensuring audit quality and thereby enhancing early detection and prevention of such fraud. The Commission studied the existing regulation and oversight, which includes the profession's quality assurance program, and concluded that additional regulation—particularly a statutory self-regulatory organization—is not necessary, provided two key elements are added to the present system. The first element is mandatory membership: all public accounting firms that audit public companies must belong to a professional organization that has peer review and independent oversight functions and is approved by the SEC. The SEC should provide the second element: enforcement actions to impose meaningful sanctions when a firm fails to remedy deficiencies cited by a quality assurance program approved by the SEC.

Adequate SEC Resources

The Commission directs many recommendations to the SEC, the agency with primary responsibility to administer the federal securities laws. In that regard, the SEC must have adequate resources to perform its existing functions, as well as additional functions, that help prevent, detect, and deter fraudulent financial reporting.

Improved Federal Regulation of Financial Institutions

Federal regulatory agencies, other than the SEC, have responsibility for financial reporting by certain public companies that are banks and savings and loans. The Commission recommends that these other agencies adopt measures patterned on the Commission's recommendations for the SEC. To enhance efforts to detect fraudulent financial reporting within financial institutions, the

Commission also recommends that these federal agencies and the public accounting profession provide for the regulatory examiner and the independent public accountant to have access to each other's information about examined financial institutions.

Improved Oversight by State Boards of Accountancy

State boards of accountancy can and should play an enhanced role in their oversight of the independent public accountant. The Commission recommends that these boards implement positive enforcement programs to review on a periodic basis the quality of services rendered by the independent public accountants they license.

Insurance and Liability Crises

Finally, the Commission's study of fraudulent financial reporting unavoidably has led to certain topics beyond its charge or ability to address. The perceived liability and insurance crises and the tort reform movement have causes and implications far beyond the financial reporting system. They are truly national issues, touching every profession and business, affecting financial reporting as well. Those charged with responding to the various tort reform initiatives should consider the implications for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting. Moreover, the SEC should reconsider its long-standing position, insofar as it applies to independent directors, that corporate indemnification of officers and directors for securities law liabilities is against public policy and therefore unenforceable.

IV. Recommendations for Education (Chapter Five)

Education can influence present or future participants in the financial reporting system by providing knowledge, skills, and ethical values that potentially may help prevent, detect, and deter fraudulent financial reporting. To encourage educational initiatives toward this end, the Commission recommends changes in the business and accounting curricula as well as in professional certification examinations and continuing professional education.

Business and Accounting Curricula

The complexity and serious nature of fraudulent financial reporting led the Commission to conclude that any initiatives encouraged by its recommendations should permeate the undergraduate and graduate business and accounting curricula. The Commission first recommends that business and accounting students gain knowledge and understanding of the factors that cause fraudulent financial reporting and of the strategies that can lead to a reduction in its incidence. To enable students to deal with risks of such fraud in the future at public companies, the Commission recommends that business and accounting curricula convey a deeper understanding of the function and the importance of internal controls and the overall control environment within which financial reporting takes place. Students should realize that practices aimed at reducing fraudulent financial reporting are not simply defensive measures, but also make good business sense.

In addition, part of the knowledge students acquire about the financial reporting system should be an understanding of the complex regulatory and law enforcement framework that government and private-sector bodies provide to safeguard that system and to protect the public interest. As future participants in that system, students should gain a sense of what will be expected of them legally and professionally when they are accountable to the public interest.

The Commission recommends that the business and accounting curricula also foster the development of skills that can help prevent, detect, and deter such fraud. Analytical reasoning, problem solving, and the exercise of sound judgment are some of the skills that will enable students to grapple successfully in the future with warning signs or novel situations they will encounter in the financial reporting process.

Furthermore, the ethical dimension of financial reporting should receive more emphasis in the business and accounting curricula. The curricula should integrate the development of ethical values with the acquisition of knowledge and skills. Unfortunately, the lack of challenging case studies based on actual incidents of fraudulent financial reporting is a current obstacle to reform. The Commission therefore recommends that business schools give their faculty a variety of incentives and opportunities to develop personal competence and suitable classroom materials for teaching about fraudulent financial reporting. Business school faculty reward systems should acknowledge and reward faculty who develop such competence and materials.

Professional Certification Examinations and Continuing Professional Education

The Commission makes two additional recommendations relating to education. Both professional certification examinations and continuing professional education should emphasize the knowledge, skills, and ethical values that further the understanding of fraudulent financial reporting and promote a reduction in the incidence of such fraud.

Five-Year Accounting Programs and Corporate Initiatives

The Commission makes no recommendation with regard to the much-discussed proposal to expand the undergraduate accounting curriculum from 4 to 5 years. Rather, the Commission offers a number of observations based on its research and deliberations. Similarly, the Commission outlines some of the numerous opportunities for public companies to educate their directors, management, and employees about the problem of fraudulent financial reporting.

Chapter One

**OVERVIEW OF THE FINANCIAL
REPORTING SYSTEM AND
FRAUDULENT FINANCIAL REPORTING**

I. Background to the Report

Before developing recommendations responsive to fraudulent financial reporting, the Commission sought to understand how and why it occurs. The financial reporting system is so complex, however, that the Commission began by examining the many components and functions of the system itself. Having gained an understanding and appreciation of the complex system in which this type of fraud takes place, the Commission then could examine instances where the system broke down.

Similarly, this chapter provides background information to facilitate an understanding of the recommendations that appear in Chapters Two through Five. The chapter briefly explains the financial reporting system and illustrates its components and functions, then summarizes the Commission's analysis of fraudulent financial reporting's causes, perpetrators and means.

Finally, the chapter takes a more in-depth look at the extent and effect of fraudulent financial reporting, its evolutionary nature, and the need for cost-effective responses. These are among the fundamental conclusions that guided the Commission in developing its recommendations.

II. Financial Reporting System for Public Companies

The financial reporting system for public companies has many components, broadly organized into three major groups:

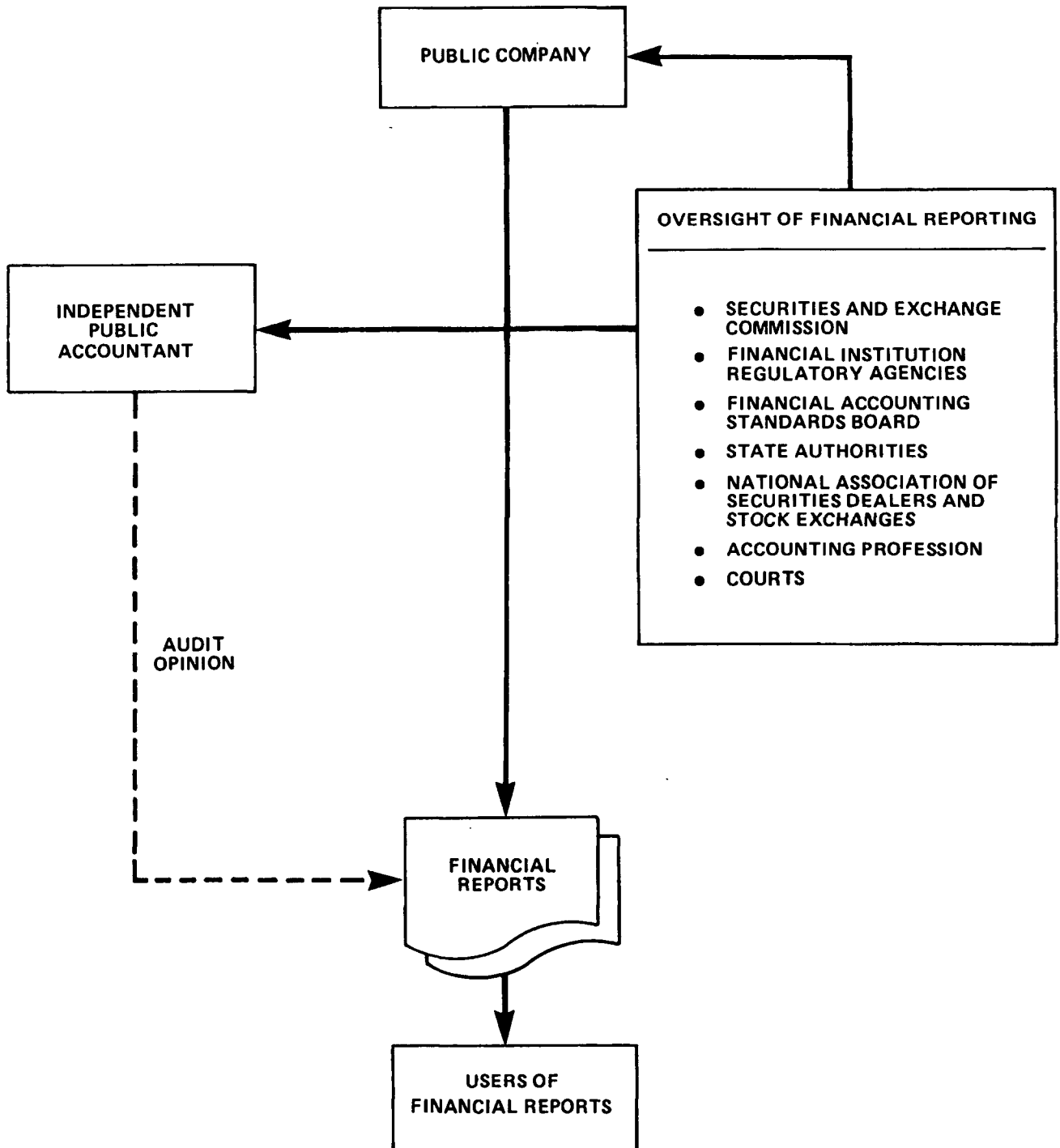
- Companies
- Independent public accountants
- Oversight bodies.

The following exhibits illustrate the functional relationships among these components.

Exhibit 1-1, page 18, illustrates the relationships of the three major groups in the financial reporting system to one another and to those who use publicly reported financial information.

The company and its management are the key players in the financial reporting system; they bear the primary responsibility for the preparation and content of the financial statements. Financial statements are management's representation as to the company's financial position and results of operations. Several oversight bodies that establish financial reporting standards and monitor compliance with those standards influence the reporting function. The company engages independent public accountants to render an opinion as to whether the financial reports fairly present the company's financial position and results of operations in conformity with established standards.

FINANCIAL REPORTING SYSTEM



THE PUBLIC COMPANY

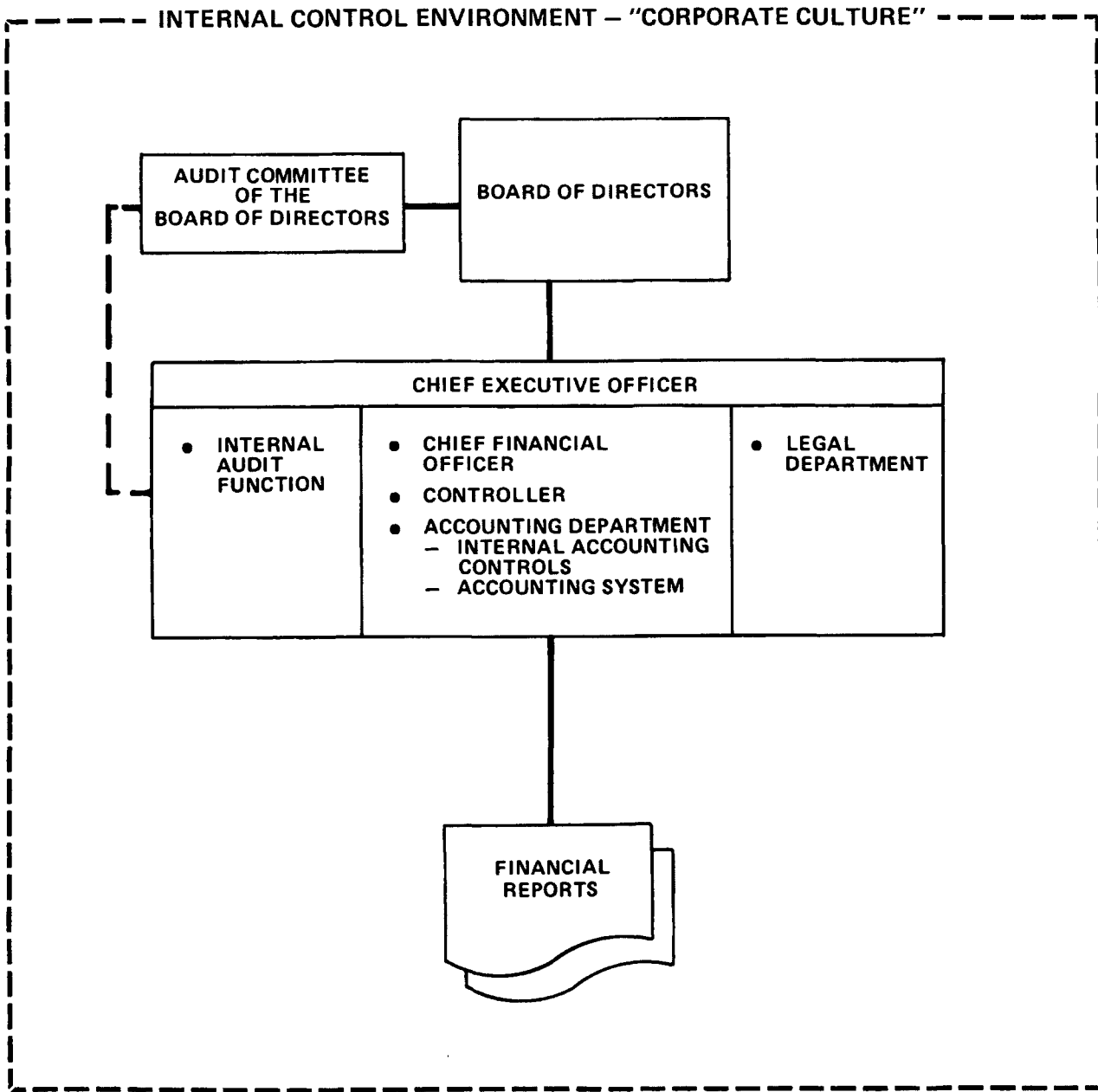


Exhibit 1-2, page 19, expands on Exhibit 1-1, illustrating the components within the company that play roles in preparing financial statements.

The company's accounting department actually prepares the financial statements. The chain of command supervising this function typically proceeds from the controller through the chief financial officer (CFO) to the chief executive officer (CEO). The legal department, or office of the general counsel, typically plays a key role in reviewing disclosure documents for compliance with applicable laws and regulations. The legal department also assists management in establishing and maintaining internal controls to prevent and detect noncompliance with other laws and regulations. The internal audit function, if present, performs an appraisal function within the company to examine, analyze, and make recommendations on matters affecting the company's internal controls. The board of directors has a responsibility to the company's shareholders to oversee management's performance. The board of directors generally delegates its responsibility to oversee the company's financial reporting process to an audit committee. All these participants and the functions they perform are part of the company's internal control environment for the financial reporting system.

Exhibit 1-3, page 21, illustrates the numerous organizations and agencies whose oversight, through standard-setting and compliance activities, affects the company's preparation of financial statements.

The SEC is the federal agency primarily responsible for administering the federal securities laws, and it establishes disclosure requirements for public companies. The SEC traditionally has delegated much of its responsibility for setting standards for financial reporting to the private sector, retaining a role largely of oversight. Accordingly, in preparing its financial statements, the public company looks to accounting principles set by the Financial Accounting Standards Board (FASB) as well as to SEC rules and pronouncements. If a federal banking or financial institution regulatory agency administers a public company's disclosure obligation under the securities laws, the company looks to that agency's pronouncements rather than to those of the SEC. In addition, the stock exchanges and the National Association of Securities Dealers (NASD) set certain disclosure and other standards as requirements for listing securities for trading. State securities or other commissions may impose regulations on financial reporting at certain times, such as in initial public offerings, or on companies in certain industries, such as insurance. With the exception of the FASB, each of these parties participates to varying degrees with the company's independent public accountant in overseeing the company's compliance with established standards. In addition, the courts participate when the adequacy of a company's financial reporting is the subject of a judicial proceeding.

EXHIBIT 1-3

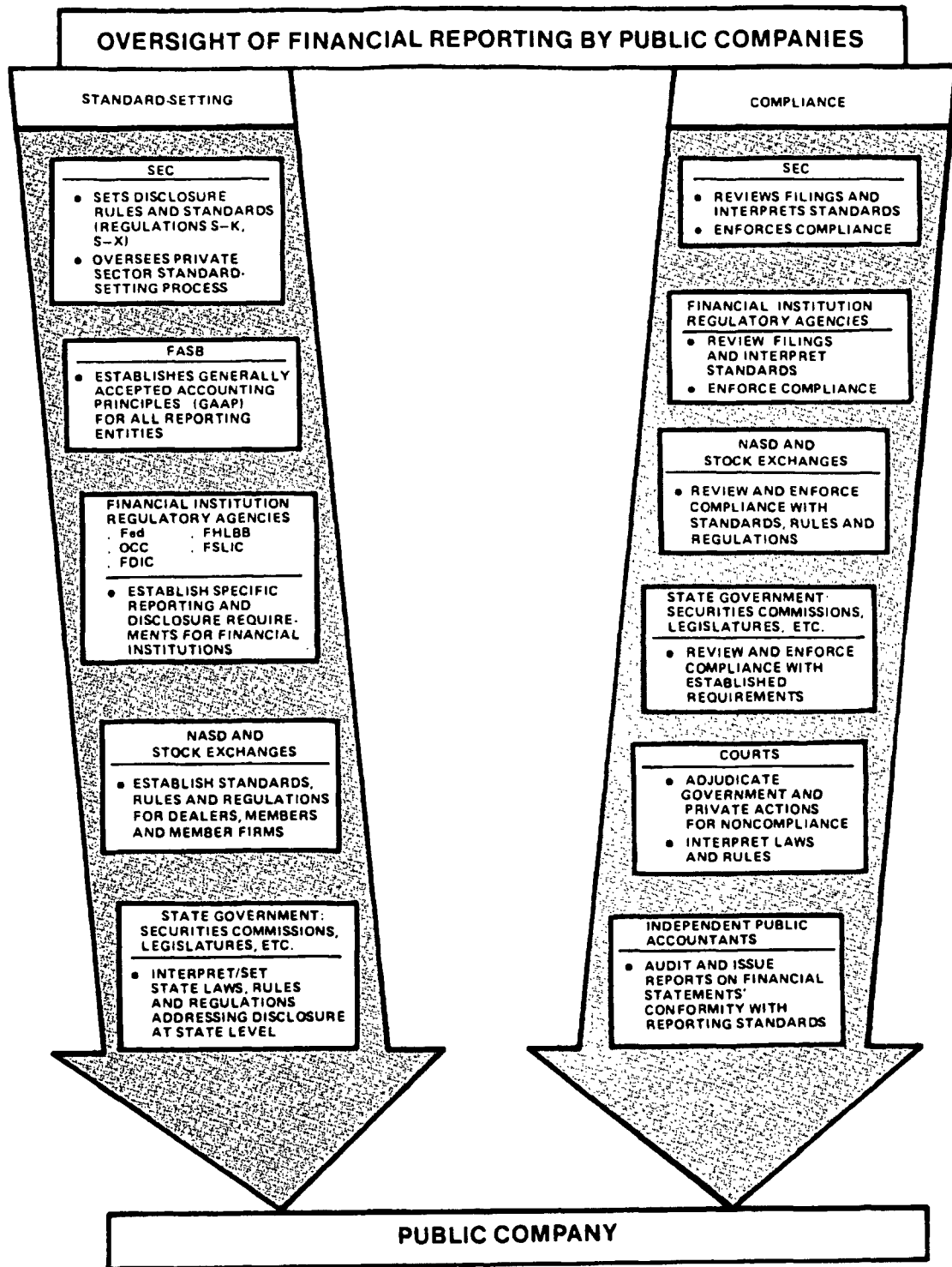


EXHIBIT 1-4

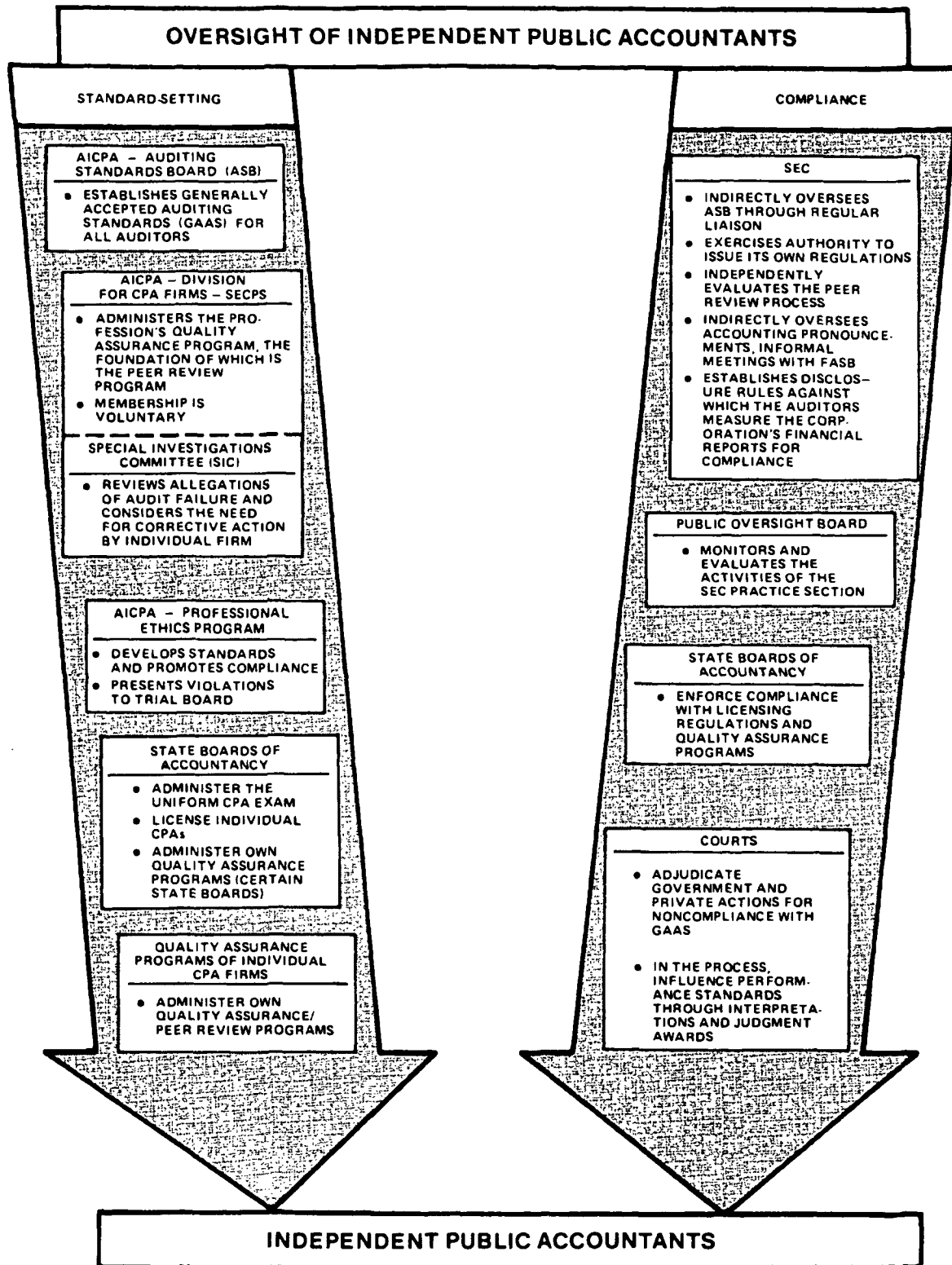


Exhibit 1-4, page 22, illustrates the various private and government organizations that oversee independent public accountants.

The organizations and the agencies that set standards for independent public accountants include the AICPA's Auditing Standards Board (ASB) and SEC Practice Section (SECPS) of its Division for CPA Firms, state boards of accountancy, and quality assurance programs of individual public accounting firms. The SEC, the Public Oversight Board (POB), state boards, and the courts monitor the compliance of the independent public accountants with established standards.

III. Breakdowns in the Financial Reporting System: Causes, Perpetrators, and Means

The financial reporting system functions remarkably well. Public companies generally live up to the public trust by disclosing timely, complete, and relevant financial information. In addition, organizations charged with overseeing the process of setting standards by and large do an admirable job of appropriately balancing the public interest and the burdens regulation imposes on business. Compliance and enforcement efforts are serious and generally effective.

Yet exceptions occur, and the system occasionally breaks down. The Commission studied those breakdowns to determine, if possible, how and why they happened.

Causes of Fraudulent Financial Reporting

The Commission reviewed both alleged and proven instances of fraudulent financial reporting, including 119 enforcement actions against public companies or associated individuals and 42 cases against independent public accountants or their firms brought by the SEC from 1981 to 1986. A number of the SEC cases are reflected in 2 composite case studies prepared by researchers at the Harvard Business School, included in Appendix E.

The Commission's studies revealed that fraudulent financial reporting usually occurs as the result of certain environmental, institutional, or individual forces and opportunities. These forces and opportunities add pressures and incentives that encourage individuals and companies to engage in fraudulent financial reporting and are present to some degree in all companies. If the right, combustible mixture of forces and opportunities is present, fraudulent financial reporting may occur.

A frequent incentive for fraudulent financial reporting that improves the company's financial appearance is the desire to obtain a higher price from a stock or debt offering or to meet the expectations of investors. Another incentive may be the desire to postpone dealing with financial difficulties and thus avoid, for example, violating a restrictive debt covenant. Other times the incentive is personal gain: additional compensation, promotion, or escape from penalty for poor performance.

Situational pressures on the company or an individual manager also may lead to fraudulent financial reporting. Examples of these situational pressures include:

- Sudden decreases in revenue or market share. A single company or an entire industry can experience these decreases.

- Unrealistic budget pressures, particularly for short-term results. These pressures may occur when headquarters arbitrarily determines profit objectives and budgets without taking actual conditions into account.
- Financial pressure resulting from bonus plans that depend on short-term economic performance. This pressure is particularly acute when the bonus is a significant component of the individual's total compensation.

Opportunities for fraudulent financial reporting are present when the fraud is easier to commit and when detection is less likely. Frequently these opportunities arise from:

- The absence of a board of directors or audit committee that vigilantly oversees the financial reporting process.
- Weak or nonexistent internal accounting controls. This situation can occur, for example, when a company's revenue system is overloaded from a rapid expansion of sales, an acquisition of a new division, or the entry into a new, unfamiliar line of business.
- Unusual or complex transactions. Examples include the consolidation of two companies, the divestiture or closing of a specific operation, and agreements to buy or sell government securities under a repurchase agreement.
- Accounting estimates requiring significant subjective judgment by company management. Examples include reserves for loan losses and the yearly provision for warranty expense.
- Ineffective internal audit staffs. This situation may result from inadequate staff size and severely limited audit scope.

A weak corporate ethical climate exacerbates these situations. Opportunities for fraudulent financial reporting also increase dramatically when the accounting principles for transactions are nonexistent, evolving, or subject to varying interpretations.

Perpetrators and the Means They Use

Individuals with many different roles within a company—sales representatives, operating managers, accountants, and executives—have perpetrated fraudulent financial reporting. In a large majority of the cases the Commission studied, however, the company's top management, such as the CEO, the president, and the CFO, were the perpetrators. In some cases, the company made deliberate misrepresentations to the independent public accountant, sometimes through falsified documents and records.

Furthermore, the Commission's studies revealed that, while the perpetrators of fraudulent financial reporting use many different means, the effect of their actions is almost always to inflate or "smooth" earnings or to overstate the company's assets. In addition, fraudulent financial reporting usually does not begin with an overt intentional act to distort the financial statements. In many cases, fraudulent financial reporting is the culmination of a series of acts designed to respond to operational difficulties. Initially, the activities may not be fraudulent, but in time they may become increasingly questionable. When the tone set by top management permits or encourages such activities, eventually the result may be fraudulent financial reporting.

This scenario illustrates how fraudulent financial reporting can occur: The CEO, under pressure to continue increasing sales, has the shipping department work longer hours in the days prior to the end of the quarter. As the pressure mounts, he compounds the situation by delaying the recognition of sales returns, instructing sales representatives to "make the sales stick." Finally, he commits a fraudulent act, by recognizing revenue from inventory shipped to a customer without

authorization or from inventory shipped to a public warehouse. He might also overstate sales by recognizing revenue from purported sales that were not consummated owing to materially unsatisfied conditions; recognizing revenue from purported fourth-quarter sales even though the shipments did not occur until after year-end; and improperly treating shipments consigned to salesmen as sales.

Methods used to defer current-period expenses or to overstate assets are equally diverse. They include issuing falsified purchase orders to vendors, who then submit false invoices that fraudulently decrease the cost of routine parts and increase the cost of capitalized equipment, failing to write off assets that had been scrapped or could not be located, improperly changing the lives of the company's depreciable assets, failing to create an adequate reserve for known losses on obsolete inventory or delinquent loans, and recording nonexistent assets by falsifying inventory count tags.

Independent Public Accountants

Almost all the SEC's fraudulent financial reporting cases against independent public accountants alleged a failure to conduct the audit in accordance with Generally Accepted Auditing Standards (GAAS). The most common alleged deviation from GAAS is the lack of sufficient competent evidential matter. Examples of this deficiency include failing to confirm account balances, neglecting to observe inventories, and placing undue reliance on uncorroborated management representations instead of obtaining outside verification from third parties.

In many cases, although indications of possible improprieties, or "red flags," existed, independent public accountants failed to recognize or pursue them with skepticism. The SEC believed that, if the independent public accountants had investigated these red flags, the fraudulent activity would have had a greater likelihood of being uncovered. Weak internal controls were the most commonly ignored red flag. In a number of cases, the independent public accountant knew or should have known that the company's internal controls were weak, but did nothing to investigate their potential impact.

Although national public accounting firms audit 84 percent of public companies, 75 percent of the SEC actions against independent public accountants and firms involved nonnational firms or sole practitioners. The alleged deficiencies in quality control included failure to train and supervise the audit staffs adequately and failure to tailor audit programs to particular specialized industries. These deficiencies correlate to the fact that a relatively high percentage of the SEC's cases against smaller, regional or local accounting firms and sole practitioners involved allegations of substandard audit work.

IV. Extent and Effect of Breakdowns

The Commission also considered the extent to which breakdowns occur in the financial reporting system and the effect such breakdowns have on affected parties. Both these inquiries, together with the Commission's analysis of the SEC cases, were critical to determining that the problem of fraudulent financial reporting should be addressed and to formulating recommendations to combat the problem.

Indeterminate Number of Incidents

The incidence of fraudulent financial reporting cannot be quantified with any degree of precision. No analysis yields a satisfactory result. The number of SEC proceedings against reporting com-

panies from 1981 to 1986 compared to the number of financial reports filed with the SEC during the same period, for example, gives an incidence of considerably less than 1 percent. But this figure takes no account of instances the SEC did not detect, or of known or suspected instances of fraudulent financial reporting that the SEC did not pursue because of the lack of sufficient evidence or resources. Moreover, it excludes financial reporting by financial institutions that report to regulators other than the SEC.

The Commission's reluctance to rely on the small number of SEC cases to quantify the extent of fraudulent financial reporting was influenced by the views of others. The Chairman of the FDIC, for example, contends that management fraud contributed to one-third of bank failures. Similarly, a Commission study of bankruptcies found that 20 percent of the bankruptcies studied involved litigation against the independent public accountant. Half of this 20 percent (10 percent of the total bankruptcies studied) also involved fraudulent financial reporting. All these findings indicate that any numerical estimate of the incidence of fraudulent financial reporting would be unsound.

Furthermore, the Commission has concluded that such an estimate is unnecessary for its purpose. Others have found the same to be true when considering other types of securities fraud. The magnitude of insider trading, for example, is equally difficult to quantify. SEC Chairman John Shad testified before Congress to that effect in June 1986 and roughly estimated that fraudulent securities activities, of which insider trading is only one type, amount to a fraction of 1 percent of the \$50 billion in U.S. corporate and government securities traded daily. At the same time, however, because insider trading has such a detrimental effect on public confidence in the fairness of the capital markets, Chairman Shad and the SEC recommended passage of the Insider Trading Sanctions Act of 1984 to increase deterrence of this type of fraud, and they have pursued a well publicized enforcement program against insider trading.

Although by available measures fraudulent financial reporting occurs infrequently, just as in the case of insider trading, when it does occur, its detrimental effects are serious and wide ranging.

Victims of Fraudulent Financial Reporting

Public investors in the company's equity or debt securities are, of course, victims of fraudulent financial reporting. But they are not the only ones who suffer immediate and direct harm. The victims also include others who rely on the company's reported financial information:

- Banks and other financial institutions that lend funds to the company
- Depositors and shareholders of such institutions whose assets and investments, respectively, are jeopardized
- Suppliers who extend credit
- Customers who look to the company to perform on its contracts
- Merger partners who may enter into agreements based on inflated values
- Underwriters who distribute securities
- Financial analysts who give investment advice about the issuer and its securities
- The company's independent public accountants, who may find themselves named defendants or the subject of an investigation
- Attorneys for the issuer, and perhaps for the underwriters
- Insurance companies that write directors' and officers' liability insurance and then experience large claims.

Some of these victims, particularly independent public accountants, underwriters, and attorneys, not only may suffer losses themselves and damage to their reputations, but also may be named as defendants in private litigation because they represent “deep pockets.” When shareholders and others seek to recover their losses, the company, whose top management actually perpetrates the fraudulent financial reporting, is often insolvent, leading the victims to look to the accountants, underwriters, and attorneys for damages.

When the wrongdoing comes to light, people within the company who reported fraudulent financial information are injured as well. These employees and other insiders include:

- The company’s management and directors, who may suffer loss of money as well as of reputation and standing
- Holders of large blocks of company stock, such as estates or family trusts, the value of whose holdings may drop dramatically
- Employee stockholders, who may have purchased the issuer’s securities directly or through employee benefit plans
- Employees, frequently at middle and lower levels, who become scapegoats for “toeing the company line”
- Honest employees and managers, whose careers may suffer from guilt by association.

Even if fraudulent financial reporting does not actually come to light, or even take place, the company with weak internal controls and other deficiencies does its employees a disservice by exposing them unduly to temptation.

Fraudulent financial reporting also has a more remote, potentially more damaging impact: loss of public confidence. Widespread media attention to even a single instance of fraudulent financial reporting can shake public confidence in the integrity of financial reporting by a whole industry or, worse, by all public companies. Public confidence in the fairness of financial reporting is critical to the effective functioning of the securities markets. The U.S. securities markets rely on full and fair disclosure, and financial information is an essential element of this disclosure. Also, loss of public confidence can increase the costs of capital for companies that have not been involved in fraudulent financial reporting. Consumers ultimately may bear these increased costs.

V. Evolutionary Nature of Fraudulent Financial Reporting

The forces and opportunities that can lead to fraudulent financial reporting evolve as society changes, as do the methods by which fraudulent financial reporting occurs. The Commission’s recommendations therefore cannot stand for all time as the most appropriate responses to the problem. Continued studies of fraudulent financial reporting and its prevention and detection will be necessary.

Two examples of societal changes that can affect fraudulent financial reporting are the Tax Reform Act of 1986 and developments in computers and information systems.

Tax Reform Act of 1986

The corporate alternative minimum tax provision of the Tax Reform Act of 1986 introduces new pressures that illustrate the evolutionary nature of fraudulent financial reporting. In the past, companies could report earnings to the SEC and their shareholders that did not necessarily relate

to earnings reported for tax purposes. The new tax law requires corporations to compute a minimum tax liability based on their financial statement income. This change may affect financial reporting to shareholders by introducing tax issues into the setting of Generally Accepted Accounting Principles (GAAP) and by giving corporations tax incentives to consider in connection with their publicly reported earnings.

Computers, Information Systems, and Audit Trails

The increasing power and sophistication of computers and computer-based information systems may contribute even more to the changing nature of fraudulent financial reporting. The last decade has seen the decentralization and the proliferation of computers and information systems into almost every part of the company. This development has enabled management to make decisions more quickly and on the basis of more timely and accurate information. Yet by doing what they do best—placing vast quantities of data within easy reach—computers multiply the potential for misusing or manipulating information, increasing the risk of fraudulent financial reporting.

On the other hand, advances in computers and information systems can improve the means of preventing and detecting fraudulent financial reporting. Auditors can use the computer's speed and power to test more transactions or calculations than otherwise possible. Management and internal auditors can identify unauthorized access attempts, unusual transactions, or deviations from normal processing more easily.

Using computer technology effectively to prevent, detect, and deter fraudulent financial reporting is a challenge that requires foresight, judgment, and cooperation among computer specialists, management, and internal auditors. For example, companies now can monitor financial transactions continuously by using auditing software modules embedded in the system. When an information system is developed, the company should build in an audit trail. To ensure that controls are in place and to integrate fraud prevention and detection methods in the system itself, internal auditors should be involved when a company develops computerized accounting applications.

Developments in computers and information systems have a fundamental and pervasive impact on all the participants in the financial reporting process. The Commission's conclusion that all participants in the financial reporting process need to understand computer-based information systems is fundamental to many of the recommendations in this report. Management needs to understand current computer technology to be able, for example, to make informed decisions about the required level of security. Internal auditors and independent public accountants need this knowledge to be able to review and evaluate the adequacy of internal controls for computerized accounting systems. Also, with a knowledge of information systems, they will be better equipped to audit using the computer rather than relying on user departments' manual controls and direct tests of ending balances. The audit committee needs sufficient understanding of computers and information systems to exercise its oversight responsibilities.

VI. Need for Cost-Effective Responses

The need for cost-effective responses has been paramount in the Commission's deliberations. Accordingly, the Commission has limited its responses to recommendations that are reasonable in the circumstances and that companies can implement realistically, with costs and burdens justified by the benefits to be achieved. This approach is particularly important because, although the

known number of fraudulent financial reporting cases is small, the number of companies that these recommendations may affect is large.

At the same time, the Commission agrees with a position the SEC noted in the cost-benefit analysis of a recent rulemaking action:

It is fundamental to the capital formation process that investors who fund new enterprises be treated fairly and be given reasonable information concerning the businesses in which they invest. Moreover, requiring small businesses to live with appropriate regulations as a *quid pro quo* for access to public markets will doubtless have the salutary side effect of accustoming their managers to an ordered approach to the conduct of their businesses, thus facilitating their future access to the capital markets. (From comment letter of American Bar Association, quoted in SEC Release No. 34 -23789, November 10, 1986.)

The Commission recognizes that the cost-benefit issue will be of concern to some people. The cost of implementing the Commission's recommendations will vary greatly because of the wide differences that exist in public company sizes as well as in current policies and practices. Many public companies and public accounting firms will incur little or no additional cost because they already have most of the recommendations in place as a matter of good business practice. Companies and firms that need to improve present practices to accomplish things the Commission recommends may incur some slight additional cost.

On the other hand, companies and firms that do not have a substantial number of the recommendations in place will face considerable short-term implementation costs. The Commission's studies indicate that for smaller, newly public companies and smaller public accounting firms, these costs may be especially significant. Yet, these entities may have a disproportionately greater risk of fraudulent financial reporting and thus may reap proportionately greater benefits. For these smaller entities and larger ones as well, the long-term benefits of implementing the Commission's set of recommendations include enhanced corporate control and ethical business conduct.

Costs must be viewed in two ways. The cost of implementation can be quantified. The other cost—the cost of failing to implement these recommendations—is impossible to quantify, yet it may be far larger and more important. This cost is the potential loss of confidence of investors and the public in corporate management and in the financial reporting system. Our capital markets and our private enterprise system cannot bear the loss of the public's trust and confidence in the integrity of the financial reporting system.

The Spirit of the Recommendations

The Commission urges all participants in the financial reporting process to implement both the substance and the spirit of its recommendations. The Commission nonetheless recognizes that the resources to implement its recommendations in smaller public companies and smaller public accounting firms may not always be available. In rare situations where implementation of the substance of a recommendation is not possible the Commission urges companies and firms to introduce procedures that respond to its spirit.

The next four chapters present the Commission's recommendations for the participants in the financial reporting process—the public company, the independent public accountant, and the SEC and other regulatory and legal bodies—as well as for educators of present and future participants.

Chapter Two

RECOMMENDATIONS FOR THE PUBLIC COMPANY

I. The Responsibility of the Public Company for Financial Reporting

The federal securities laws require public companies to disclose complete and accurate financial information regularly. The law imposes this obligation when a company begins the process of becoming a public company, and the obligation continues in effect as long as the company maintains public status. Implicit in this obligation is the requirement that the company's financial statements be complete and not misleading in any material respect.

Congress itself identified financial statements as an essential component of the disclosure system on which the U.S. securities markets are based. So important is financial statement disclosure, in fact, that Congress in enacting the Foreign Corrupt Practices Act (FCPA) in 1977 imposed direct regulation designed to ensure that public companies can meet their financial disclosure obligations. This added statutory obligation requires public companies to keep books and records that reflect their transactions and assets accurately and fairly and to maintain a system of internal accounting control that enables them to prepare financial statements in conformity with Generally Accepted Accounting Principles (GAAP).

The public company has the initial and the final responsibility for its financial statements. Within the company lies the greatest potential for reducing fraudulent financial reporting. Thus the Commission first looked to the public company when developing its recommendations, beginning by exploring the forces and opportunities that can lead to fraudulent financial reporting.

The Commission found that no company, regardless of size or line of business, is immune from the possibility that fraudulent financial reporting will occur; that possibility is inherent in doing business. The forces and opportunities that appeared in numerous SEC enforcement cases are present to some extent in all companies. The Commission also found that companies have a number of practices already in place to help them deal with these forces and opportunities. All companies would benefit from adopting similar practices to reduce the incidence of fraudulent financial reporting.

Addressing the Problem at Two Levels

The Commission's recommendations will reduce the incidence of fraudulent financial reporting by addressing the problem at two levels. Top management should:

- Level 1. Establish the appropriate tone, the overall control environment in which financial reporting occurs***
- Level 2. Maximize the effectiveness of the functions within the company that are critical to the integrity of financial reporting: the accounting function, the internal audit function, and the audit committee of the board of directors.***

The first three recommendations in this chapter are aimed at the first level, the tone set by top management. All the recommendations that follow depend on these recommendations. Top man-

agement first must establish the proper environment, one in which fraudulent financial reporting is less likely to occur and, if it does occur, is more likely to be detected.

The section of the chapter that addresses the tone at the top suggests a framework for improving the corporate environment or culture. The framework includes three steps: identifying and understanding the factors that can lead to fraudulent financial reporting, assessing the risk of this type of fraud, and designing and implementing internal controls. The Commission then recommends that every public company develop and enforce a written code of corporate conduct as a tangible embodiment of the tone at the top.

The chapter next turns to the second level, maximizing the effectiveness of the functions within the company that are critical to the integrity of financial reporting. The Commission first addresses two key functions within the company—the accounting function and the internal audit function. Next, the Commission’s recommendations concern the role of another critical component in the financial reporting process: the audit committee of the board of directors. This section discusses ways the audit committee can be more effective in preventing and detecting fraudulent financial reporting.

The chapter then concentrates on the need for top management and the audit committee to communicate their respective responsibilities to financial statement users. The Commission presents recommendations for a management report and an audit committee chairman’s letter, both as part of the annual report to stockholders. The chapter then looks at two specific areas for improvement: seeking a second opinion from another public accounting firm, and the role of the audit committee in quarterly reporting. The focus of the final section of the chapter is the Commission’s recommendation for its sponsoring organizations to cooperate in developing additional, integrated guidance on internal controls.

The Commission has distinguished fraudulent financial reporting from other corporate illegal acts that can cause a company’s financial statements to be misleading. The Commission’s primary objective was to identify causal factors that can lead to fraudulent financial reporting and to develop recommendations to reduce its incidence. While other kinds of corporate illegality, such as noncompliance with various laws and regulations, may have a material effect on financial statements, the misleading financial statements are a by-product or a result, rather than the objective, of the illegal acts. The Commission nonetheless believes that implementation of the recommendations this chapter presents will provide benefits to public companies beyond the increased prevention of fraudulent financial reporting, as it has defined that term. The appropriate tone set by top management should enhance a company’s compliance with laws and regulations as well as reduce the incidence of fraudulent financial reporting. Similarly, a properly designed system of internal control to reduce the incidence of fraudulent financial reporting will inherently increase the prevention and detection of noncompliance with laws and regulations.

II. Tone at the Top

The tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most important factor contributing to the integrity of the financial reporting process. Notwithstanding an impressive set of written rules and procedures, if the tone set by management is lax, fraudulent financial reporting is more likely to occur.

The measures a company can take to establish the right tone at the top include a wide range of options. But, to be effective, each option must include certain steps. The Commission suggests the

following framework to help public companies incorporate these steps into their efforts to prevent and detect fraudulent financial reporting.

Framework

The Commission's recommended framework includes three steps:

Step 1. *Identify and understand the factors that can lead to fraudulent financial reporting, including factors unique to the company*

Step 2. *Assess the risk of fraudulent financial reporting that these factors create within the company*

Step 3. *Design and implement internal controls that will provide reasonable assurance that fraudulent financial reporting will be prevented or detected.*

Steps 1 and 2. *Identifying, Understanding, and Assessing the Risk of Fraudulent Financial Reporting*

Recommendation: *For the top management of a public company to discharge its obligation to oversee the financial reporting process, it must identify, understand, and assess the factors that may cause the company's financial statements to be fraudulently misstated.*

The process of identifying, understanding, and assessing the factors that may create a risk of fraudulent financial reporting in a company is vital. This assessment enables a company to design and implement internal controls to minimize the risks it identifies.

The process of assessing the risk of fraudulent financial reporting requires judgment and insight. Rather than entailing a separate effort or project, this process entails bringing to regular management activities a heightened awareness of and sensitivity to the potential for fraudulent financial reporting. Accordingly, it is not intended that this process involve costly documentation, such as that which many companies have undertaken in response to the FCPA. Top management's judgment dictates the extent and the nature of the assessment appropriate to the particular company.

Individuals at all levels of the company, including operating management, attorneys, financial managers, and internal auditors, participate in the assessment, but top-level corporate management, such as the CEO and the CFO, must supervise the process. In addition, the audit committee of the board of directors should review periodically the company's risk assessment process and management's responses to significant identified risks.

The Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting, presented in Appendix F, illustrate some of the factors that can influence fraudulent financial reporting and can serve as a frame of reference for understanding and assessing the risk of fraudulent financial reporting.

Step 3. *Designing and Implementing Internal Controls*

Recommendation: *Public companies should maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection.*

The role of internal control in preventing and detecting fraud, well recognized in practice for many years, was recognized in federal legislation in 1977. The FCPA requires each SEC registrant to devise and maintain a system of internal *accounting* control sufficient to provide reasonable

assurance that (1) transactions are authorized by management, (2) transactions are recorded as necessary to permit preparation of the financial statements and to maintain accountability for assets, (3) access to assets is permitted only with management's authorization, and (4) existing assets are compared with recorded accountability, and appropriate action is taken with respect to any differences.

Internal accounting controls are generally interpreted to include the company's accounting system and specific control procedures. The accounting system consists of the methods and the records that the company uses to identify, assemble, classify, and record its transactions. The company's specific control procedures are its individual policies for processing transactions such as clerical checks, document comparisons, reconciliations, and independent assets counts. Internal accounting controls are directed primarily at systematically recorded transactions that lower-level employees generally perform.

Fraudulent financial reporting continues to occur despite the FCPA's statutory requirement that companies maintain adequate internal accounting controls. A Commission study of 119 fraudulent financial reporting actions brought by the SEC from 1981 to 1986 found that management in those companies repeatedly had been able to override systems of internal accounting control. Other instances of fraudulent financial reporting involved transactions under management's direct control and not part of the system of internal accounting controls, such as those requiring significant estimates and judgments. Therefore, internal controls broader than the internal accounting controls contemplated under the FCPA are necessary to reduce the incidence of fraudulent financial reporting.

The broad term *internal control* is often used to describe both controls over operational tasks like product quality assurance, production, and plant maintenance and controls over the financial reporting process. Although operational or administrative controls are an essential element of managing a company's affairs, some do not affect financial reporting directly and therefore are beyond the scope of this report.

Controls that affect financial reporting directly include more than internal accounting controls. They also include elements not generally considered part of internal accounting controls, such as the internal audit function and the audit committee of the board of directors. These control elements and all other components of the overall corporate control environment, together with the internal accounting controls, comprise the internal controls that can prevent and detect fraudulent financial reporting.

The corporate control environment is the atmosphere in which the internal accounting controls are applied and the financial statements are prepared. A company's control environment includes management philosophy and operating style, organizational structure, methods of communicating and enforcing the assignment of authority and responsibility, and personnel management methods. The control environment has a pervasive impact on the entire process by which a company's financial reports are prepared.

Well-run public companies have effective systems of internal control not just because internal control is the first line of defense against fraud, but because a strong system of internal control makes good business sense and is cost-effective.

Each company must design its internal controls according to its own unique circumstances, weighing the benefits of each control in relation to its cost. Every public company, however, should have a written code of corporate conduct as a prerequisite to an effective system of internal control, and to establish the appropriate tone at the top and throughout the company.

Code of Corporate Conduct

Recommendation: *Public companies should develop and enforce written codes of corporate conduct. Codes of conduct should foster a strong ethical climate and open channels of communication to help protect against fraudulent financial reporting. As a part of its ongoing oversight of the effectiveness of internal controls, a company's audit committee should review annually the program that management establishes to monitor compliance with the code.*

A strong corporate ethical climate at all levels is vital to the well-being of the corporation, all its constituencies, and the public at large. Such a climate contributes importantly to the effectiveness of company policies and control systems and helps influence behavior that is not subject to even the most elaborate system of controls. Consequently, a strong corporate ethical climate emphasizing accountability helps to protect a company against fraudulent financial reporting.

A written code of corporate conduct strengthens the corporate ethical climate by signaling to all employees standards for conducting the company's affairs. Well-defined ethical standards and guidelines for acceptable behavior promote ethical decision-making at all levels of the organization and help resolve ethical dilemmas that arise.

To succeed, a code of corporate conduct must have the full support of management and the board of directors. The most influential factors in determining the code's effectiveness are the attitude and the behavior of the top officers and directors, who set the example for the entire company. The CEO, in particular, has a special role; his attitude, behavior, and expectations of others strongly influence the actions of other upper-level managers.

The development of a corporate code is not an overnight task. A company must invest the necessary time, energy, and resources to ensure that the code is tailored to its circumstances. Since those circumstances will evolve to meet changing demands, the company must update the code periodically.

Finally, the full support of management and the board is needed to ensure that the code receives widespread understanding and support. Employees representing all levels of the corporation should be encouraged to participate in the code's development and evolution in an appropriate fashion. Such collaboration can minimize cases of noncompliance due to lack of understanding and can promote acceptance and adherence. In addition, the code and any amendments must be publicized throughout the corporation.

A code of corporate conduct also can help establish an environment where open communication is expected, accepted, and protected. Management needs a free flow of information to assist it in directing the company's operations, especially in a large, decentralized business. This need is critical in assessing the risk of fraudulent financial reporting. An atmosphere of open communication allows an employee, when confronted with suspected fraud, to bring the problem to the attention of those high enough in the corporation to solve it without fear of reprisal.

The code also must provide an accessible internal complaint and appeal mechanism. This mechanism should be designed to facilitate internal disclosures, particularly those involving allegations of fraudulent financial reporting or other misconduct. The mechanism could take a variety of forms, such as the use of an ombudsman.

Such internal procedures offer a number of advantages. They allow management to correct inadvertent mistakes and mistakes that may result from bad judgment or failure to recognize a problem. They also encourage employees to act in good faith and tend to ensure the validity of any

complaint. In addition, effective internal action may make external disclosures to government authorities or other third parties unnecessary.

The code of corporate conduct should protect employees who use these internal procedures against reprisal. Failure to adopt guarantees against reprisal as well as to provide an effective internal complaint procedure could undermine the vitality of codes of conduct, and encourage a call for antiretaliation legislation, for which there is ample precedent at the state and the federal level.

The Commission has observed a great deal of diversity in written codes of corporate conduct. Some are general, others specific in their content and direction. Corporate management should develop a code that fits the particular circumstances of their business. Nearly all codes of conduct, however, should include a conflict-of-interest policy, to prevent actual or apparent improprieties in connection with business transactions; a corporate policy of compliance with domestic and foreign laws affecting its business, including those laws relating to financial disclosures; and a policy of confidentiality relating to the company's proprietary information.

Yet another element is indispensable to the success of a code of conduct: adequate monitoring and enforcement mechanisms. Management is responsible for determining how best to establish adequate monitoring and enforcement mechanisms and for implementing these mechanisms. This responsibility is typically carried out through the legal department, internal audit department, or a separate ombudsman function. The board of directors should be responsible through its audit committee for reviewing the program that management establishes to monitor compliance with the code of conduct. Employees at all levels should understand that violation of the law or compromise of the company's code of conduct can result in serious disciplinary actions (including dismissal and criminal or civil proceedings where appropriate) and that no employee is exempt from the code.

Written codes of corporate conduct have further advantages. Such codes foster a strong ethical climate, helping to create a work environment that appeals to company personnel at all levels. With an effective code, a company's employees may be more highly motivated, and the company may be able to attract and retain better employees. In an era when loyalty between organizations and their customers seems less enduring, a company's concern for a strong ethical climate also may generate a positive image outside the organization, which can lead to increased business opportunities.

III. Two Key Functions: Accounting and Internal Audit

As the company acts to set an environment that is a strong deterrent to fraudulent financial reporting, it also must address fraudulent financial reporting at a second level by maximizing the effectiveness of two critical functions within the company: the accounting function and the internal audit function.

A. Accounting Function and Chief Accounting Officer

Recommendation: *Public companies should maintain accounting functions that are designed to meet their financial reporting obligations.*

A public company's accounting function is an important control in preventing and detecting fraudulent financial reporting. The accounting function must be designed to allow the company and its officers to fulfill their statutory financial disclosure obligations.

As a member of top management, the chief accounting officer helps set the tone of the organization's ethical conduct and thus is part of the control environment. Moreover, the chief accounting officer is directly responsible for the financial statements, and can and should take authoritative action to correct them if necessary. He generally has the primary responsibility for designing, implementing, and monitoring the company's financial reporting system and internal accounting controls. The controller may serve as the chief accounting officer, or the chief financial officer also may perform the functions of a chief accounting officer.

The chief accounting officer's actions especially influence employees who perform the accounting function. By establishing high standards for the company's financial disclosures, the chief accounting officer guides others in the company toward legitimate financial reporting.

Moreover, the chief accounting officer is in a unique position. In numerous cases, other members of top management, such as the chief executive officer, pressure the chief accounting officer into fraudulently manipulating the financial statements. An effective chief accounting officer is familiar with the company's financial position and operations and thus frequently is able to identify unusual situations caused by fraudulent financial reporting perpetrated at the divisional level.

The chief accounting officer has an obligation to the organization he serves, to the public, and to himself to maintain the highest standards of ethical conduct. He therefore must be prepared to take action necessary to prevent fraudulent financial reporting. His efforts may entail bringing matters to the attention of the CEO, the CFO, the chief internal auditor, the audit committee, or the entire board of directors.

The Financial Executives Institute (FEI) and the National Association of Accountants (NAA) play active roles in enhancing the financial reporting process by sponsoring research, technical professional guidance, and continuing professional education and by participating in the shaping of standards. Both organizations also have promulgated codes of conduct that strongly encourage reliable financial reporting. Public companies should encourage their accounting employees to support these organizations and adhere to their codes of conduct.

B. Internal Audit Function and Chief Internal Auditor

Recommendation: *Public companies should maintain an effective internal audit function staffed with an adequate number of qualified personnel appropriate to the size and the nature of the company.*

Properly organized and effectively operated, internal auditing gives management and the audit committee a way to monitor the reliability and the integrity of financial and operating information. The internal audit function thus is an important element in preventing and detecting fraudulent financial reporting.

Support of Top Management

To be effective, internal auditors must have the acknowledged support of top management and the board of directors through its audit committee. The company should set forth in writing the scope of responsibilities for the internal audit function. The scope of responsibilities as well as any change in role or function should be the subject of review by the audit committee. The optimal size of the internal audit function and the composition of its staff depend on the company's size and nature and the scope of responsibilities assigned to the function.

The education, experience, and professionalism of the internal auditors help determine the effectiveness of the internal audit function. The company should encourage the development of its internal auditors by providing continuing professional education programs and offering attractive career paths.

The Commission recognizes that some smaller companies could experience a significant hardship if compelled to employ persons to serve exclusively as internal auditors. Thus, the Commission's use of the term *internal auditor* includes, where appropriate, persons who do not function exclusively in that capacity.

IIA Standards

The professionalism of internal auditors has been enhanced in recent years by the efforts of the Institute of Internal Auditors (IIA), the professional organization for internal auditors. Standards of the IIA offer excellent guidance for effective internal auditing and reflect some of the most advanced thinking on fraud prevention and detection. The Commission encourages public companies who have not done so to consider adopting the IIA standards. These standards appear in Appendix G.

The IIA's standards call for a quality assurance program to evaluate the operations of the internal audit function. The standards provide guidelines that describe, as suitable means of meeting the quality assurance standard, a program that includes the following elements: supervision, internal reviews, and external reviews. The Commission endorses these concepts as ways to enhance the effectiveness of the internal audit function. Confidentiality and other issues associated with external reviews are important in management's decisions as to who should conduct such reviews, how they should be conducted, and with what frequency they should be conducted.

Objectivity of the Internal Audit Function

Recommendation: *Public companies should ensure that their internal audit functions are objective.*

The effectiveness of a company's internal audit function depends a great deal on the objectivity of the chief internal auditor and his staff. Public companies should ensure that their internal auditors are free to perform their functions in an objective manner, without interference and able to report findings to the appropriate parties for corrective action. Three principal factors contribute to independence and objectivity: the organizational positioning of the function, the corporate stature of the chief internal auditor, and the reporting relationship of the chief internal auditor to the audit committee.

For day-to-day operational purposes, the chief internal auditor should report administratively to a senior officer who is not directly responsible for preparing the company's financial statements. The Commission encourages an administrative reporting relationship in which the chief internal auditor reports directly to the CEO, but acknowledges that this organizational structure may be impractical in some corporations. At a minimum, however, the chief internal auditor should have direct and unrestricted access to the CEO and the Commission encourages the CEO to conduct regularly scheduled meetings with the chief internal auditor, no less frequently than every quarter.

The chief internal auditor should be an experienced executive, preferably with a background in auditing or a related field, and he should have the necessary business acumen to work effectively with fellow senior officers. The chief internal auditor should occupy a position of high stature within the organization.

In addition, the chief internal auditor should have direct and unrestricted access to the audit committee and he should meet privately with the committee on a regular basis. He also should attend all audit committee meetings, reporting to the committee at regular intervals on the activities of the internal audit function.

The internal audit function can be an important resource for the audit committee—a valuable in-house source of information and staff. The importance of the internal audit function to the audit committee leads the Commission to believe that the audit committee should review the appointment and the dismissal of the chief internal auditor.

Impact of Nonfinancial Audit Findings

Recommendation: *Internal auditors should consider the implications of their nonfinancial audit findings for the company's financial statements.*

Internal auditors also provide services to the organization broader than those relating to financial auditing. Operational auditing, acquisition reviews, and special investigations are a few examples. These services benefit the company substantially and give the internal auditor in-depth knowledge of many different aspects of the company's operations. This unique perspective enables internal auditors to be highly effective in detecting fraudulent financial reporting, particularly if internal auditors systematically consider the results and potential impact of the nonfinancial audits on the financial statements.

Involvement at the Corporate Level

Recommendation: *Management and the audit committee should ensure that the internal auditors' involvement in the audit of the entire financial reporting process is appropriate and properly coordinated with the independent public accountant.*

With their knowledge of the organization and its controls, internal auditors have considerable potential for preventing and detecting fraudulent financial reporting. But the full potential often is not realized, in part because the role the internal auditors have in the audit of financial statements at the consolidated level is often limited.

A Commission-sponsored study found that internal auditors often concentrate on the review of controls at the division, subsidiary, or other business component level, rather than at the corporate level. Independent public accountants, on the other hand, generally are responsible for the audit examination at the corporate level. Appropriate involvement by the internal auditors at the corporate level, effectively coordinated to avoid duplication of the independent public accountants' efforts, can help prevent and detect fraudulent financial reporting.

IV. Audit Committee of the Board of Directors

The audit committee of a company's board of directors can play an important role in preventing and detecting fraudulent financial reporting. The Commission highlights important aspects of the audit committee's oversight function throughout this chapter in the course of its discussions of other recommendations. In addition, the Commission offers six specific recommendations.

Mandatory Independent Audit Committee

Recommendation: *The board of directors of all public companies should be required by SEC rule to establish audit committees composed solely of independent directors.*

Primary responsibility for the company's financial reporting lies with top management, overseen by the board of directors. To help boards of directors carry out this oversight responsibility, the Commission recommends that all public companies establish audit committees consisting of independent directors. Establishment of such committees, of course, does not relieve the other directors of their responsibility with respect to the financial reporting process.

Most of the Commission's research studies emphasized the potentially positive influence of an effective audit committee. One study found that, for example, while 85 percent of all public companies have audit committees, a significantly smaller percentage (69 percent) of the public companies involved in the fraudulent financial reporting cases brought by the SEC from 1981 to 1986 had audit committees. [In fact, the 69 percent figure is high because, in 39 of 119 cases studied, the presence of an audit committee was unlikely but these cases were excluded because that fact could not be verified from available public sources. None of the 39 companies was listed on the NYSE (which requires audit committees) or filed proxy material with the SEC and many were involved in an initial public offering.]

To implement the Commission's recommendation that all public companies have independent audit committees, an SEC rule is necessary. The SEC has long recognized the importance of independent audit committees to the integrity of financial reporting. But the SEC has deferred to the policies and practices of the New York Stock Exchange (NYSE) and other Self-Regulatory Organizations (SROs). While all the SROs have considered the issue, only the NYSE requires that all its listed companies have audit committees composed solely of independent directors. The National Association of Securities Dealers (NASD) has recently required that all national market system companies establish and maintain audit committees that have a majority of independent directors. The Commission commends the SEC for not wishing to impose any unnecessary direct government regulation, but experience with independent audit committee requirements demonstrates that it is now time for direct action by the SEC.

The ultimate determination as to the SEC's authority to require independent audit committees under existing statutes is beyond the charge of this Commission. If the SEC lacks the requisite rulemaking authority, it should seek the legislation necessary to implement this recommendation. At the same time, the Commission notes that several potential sources of authority lie within the Securities Act of 1933 and the Securities Exchange Act of 1934. In particular, the SEC might predicate its rule on provisions of those Acts which (1) impose requirements for financial information certified by "independent" public accountants, (2) grant the SEC the express power to define terms used in the Acts, including "accounting" terms, (3) require public companies to devise and maintain systems of internal accounting controls, and (4) grant the SEC broad rulemaking authority to adopt rules and regulations necessary and appropriate to effectuate the purposes of the statutes.

With respect to the SEC's broad rulemaking authority, the Commission's study of fraudulent financial reporting cases may provide a factual predicate that a rule mandating audit committees is necessary and appropriate to implement the disclosure provisions of the federal securities laws. In this regard, the Commission believes that the audit committee's role is important to the financial reporting process. The audit committee's assessment of the independence of the public accountant and its review of the adequacy of, and compliance with, internal accounting controls contribute significantly, as does its role in the company's overall control environment.

Mandating audit committees is necessary but does not go far enough. The audit committee must be composed of independent directors to provide truly effective oversight of the company's financial reporting process. In considering "independence," the Commission noted that the NYSE audit committee policy defines an independent director, for the purpose of audit committee membership, as independent of management and free from any relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries are not "independent." A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership if, in the opinion of the board of directors, such person will exercise independent judgment and will assist materially the functions of the committee. A majority of the members, however, must be directors who are not former officers.

The Commission agrees with the concept underlying the NYSE definition of independent director. The NYSE developed this definition, including the supplementary material offering guidance on particular types of relationships, with the benefit of extensive public commentary, and the definition has been in place for almost a decade. The Commission believes that the NYSE definition and guidance are appropriate for inclusion in an SEC rule applicable to all public companies. (See Appendix H for the complete NYSE audit committee policy.) Members of senior management, particularly those with financial and legal responsibilities, would meet with the audit committee to provide the benefit of their expertise, whether or not they happen also to be directors of the company.

The Commission recognizes the difficulties today in encouraging a sufficient number of qualified persons to serve as independent directors, particularly in small, newly public companies. Accordingly, the SEC should be able to grant exceptions on a case-by-case basis, but the basic requirement should apply to all companies regardless of size. The SEC rules should provide an exception for companies unable to meet the requirement, if they can demonstrate that they have (1) attempted diligently to attract the necessary independent directors to comprise an audit committee and (2) instituted various procedures and controls that are functionally equivalent to an audit committee. Similarly, the SEC could provide an exception for other public companies, such as wholly owned subsidiaries for which the parent company's audit committee fulfills this function. Exceptions should be granted only in the most unusual cases, and should be reconsidered at appropriate intervals rather than granted on a permanent basis.

Informed, Vigilant, and Effective Audit Committees

Recommendation: *Audit committees should be informed, vigilant, and effective overseers of the financial reporting process and the company's internal controls.*

The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent, and probing in fulfilling its oversight responsibilities. The audit committee must, of course, avoid unnecessary or inappropriate interventions with the prerogatives of corporate management; but the oversight must be effective. As mentioned previously, 69 percent of the companies involved in SEC enforcement cases for fraudulent financial reporting had audit committees. That statistic raises doubts as to whether audit committees are meeting their potential for reducing the incidence of fraudulent financial reporting. The Commission's review showed great disparities in the probable effectiveness of audit committees, the functions they perform, and the manner in which they carry out their functions—all adding to the doubts.

The Commission therefore reinforces its general recommendation by delineating certain duties and responsibilities that it believes are essential for audit committee effectiveness. The recommenda-

tions in this section of the chapter reflect some of these specific recommendations. In addition, the Commission highlights other important audit committee functions throughout this chapter. These audit committee functions relate to the company's assessment of, and response to, the risk of fraudulent financial reporting, to management's program to monitor compliance with the code of corporate conduct, and to open lines of communication with the chief accounting officer and the chief internal auditor. In fact, the chief internal auditor's direct and unrestricted access to the audit committee is vital to his objective actions. Subsequent parts of this chapter outline the audit committee's role when management seeks a second opinion on a significant accounting issue and with respect to oversight of the quarterly reporting process. Finally, the Commission recommends that the chairman of the audit committee write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders.

The Commission developed this set of recommended audit committee duties and responsibilities after reviewing and considering the practices many well-managed companies follow today, the extensive guidance the public accounting and legal professions have published on the subject, and practices suggested by the results of the Commission's research projects and by presentations made to the Commission.

More detailed delineation and description of responsibilities are best left to the discretion of management and the board of directors to tailor to the needs and circumstances of each company. However, the Commission has identified additional, more specific practices and procedures that can help audit committees perform their oversight role effectively. The Commission is not prescribing these additional measures, and therefore has not included them as recommendations, but offers them instead in the form of the Good Practice Guidelines for the Audit Committee in Appendix I. Companies can consider these guidelines within the exercise of their judgment. To companies that already have audit committees, the guidelines will serve as a standard for review and assessment. Other companies—those just establishing audit committees or those seeking to improve their committees' effectiveness—may find the guidelines of assistance in suggesting practical ways for audit committees to discharge their responsibilities.

The Commission is aware of current difficulties in recruiting directors because of director liability and inadequate or unavailable insurance coverage. The Commission hopes that its recommendations, particularly those calling for an effective, independent audit committee, will ameliorate these concerns. The formal charter of the audit committee clarifies its duties and responsibilities, and the guidelines in Appendix I can assist audit committee members in meeting these responsibilities. Both can be helpful in the event of litigation and may offer insurers the degree of comfort they need to issue more favorable insurance coverage to directors.

Written Charter

Recommendation: *All public companies should develop a written charter setting forth the duties and responsibilities of the audit committee. The board of directors should approve the charter, review it periodically, and modify it as necessary.*

To enhance their effectiveness in carrying out their responsibilities for oversight of the financial reporting process on behalf of the board of directors, audit committees should have written charters that set forth their duties and responsibilities. The charter should be goal-oriented rather than taking a detailed "cookbook" approach. A charter can take the form of a by-law provision, a board resolution, or whatever other written document a board of directors chooses. The Commission's Good Practice Guidelines (Appendix I) can help in developing a charter, but each board of

directors should see that the charter responds to the particular needs of the company. As those needs change, the audit committee's charter should change.

Resources and Authority

Recommendation: *Audit committees should have adequate resources and authority to discharge their responsibilities.*

Audit committees must have resources commensurate with the duties and responsibilities assigned to them by their boards of directors. Public companies should give audit committees these necessary resources, including in-house staff and administrative support. Generally, support for an audit committee should come from existing employees. Only in the most unusual circumstances would an audit committee need a separate staff and then not on a continuing basis.

Audit committees should have the discretion to institute investigations of improprieties or suspected improprieties, including the standing authority to retain special counsel or experts.

Review of the Public Accountant's Independence

Recommendation: *The audit committee should review management's evaluation of factors related to the independence of the company's public accountant. Both the audit committee and management should assist the public accountant in preserving his independence.*

The credibility of the independent audit function is an integral element in the financial reporting process. Accordingly, SEC rules require public companies to have their financial statements audited annually by an independent public accountant.

Both the public company and the public accountant are responsible for ensuring that an independent audit has been performed. Independence is a cornerstone of the public accounting profession, and the public accountant must maintain his independence at all times. Management and the audit committee should carry out their responsibility by specifically asking the public accountant about factors affecting his independence and asking for his affirmation that he is in fact independent of the company. In this connection, management and the audit committee may wish to consider the economic significance of the client to the public accounting firm as a whole and to the engagement office.

Issue Related to the Public Accountant's Independence

Recommendation: *Before the beginning of each year, the audit committee should review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering both the types of services that may be rendered and the projected fees.*

One issue concerning public accountants' independence—the possible adverse effect of management advisory services performed for audit clients—has been debated continually over the past decade. Strong opinions have been expressed on both sides of the issue.

Some argue that the independent public accountant's performance of management advisory services improves the quality of audits. They claim that in the process of advising management the independent public accountant acquires a deeper understanding of the client's business. Many in

the public accounting profession also maintain that benefits accrue to the audit process when the independent public accountant is already familiar with the company's operations.

Others believe that some management advisory services place independent public accountants in the role of management, add commercial pressures to the audit examination and, as a result, impair independence. These individuals also argue that, at the very least, the public accountant's performance of management advisory services raises the perception of impaired independence.

The Commission reviewed previous studies of this issue and sponsored its own research study. None of the studies indicated any actual case where independence was compromised. This finding is reassuring. Nevertheless, two recent studies, a Harris survey sponsored by the AICPA and a research report prepared for the AICPA's Public Oversight Board (POB), showed that a substantial percentage of members of the key public groups involved in the financial reporting process believe that performing certain management advisory services can impair a public auditor's objectivity and independence. The existence of this perception cannot be ignored.

The Commission concluded that the audit committee should oversee management judgments relating to the independence of the public accountant. The rules of the AICPA's SEC Practice Section (SECPS) of its Division for CPA Firms require the independent public accountant to disclose to the audit committee or the board of directors the total fees received from the audit client for management advisory services during the past year and a description of the types of such services rendered. The Commission recommends that the audit committee, in its oversight capacity, also review management's plans to engage the independent public accountant to perform management advisory services during the coming year. This entails reviewing the types or categories of services that management may engage the independent public accountant to perform as well as the projected fees. The audit committee should weigh carefully the possible advantages of such use against the possible effects it may have on the independence—or even the perceived independence—of the public accountant, considering, among other factors, the type of service to be performed, helpful knowledge of the company that the independent public accountant may bring to the task because of its audit services, the extent to which audit and management advisory services staffs are positioned to take advantage of each other's knowledge, and the amount of the management advisory services fee relative to the audit fee.

V. Reporting to the Public on Management and Audit Committee Responsibilities

Top management and the audit committee should communicate explicitly their respective responsibilities for the company's financial reporting to those who use that information.

Management Report

Recommendation: *All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and the chief accounting officer and/or the chief financial officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.*

The investing public has a legitimate interest in the extent of management's responsibilities for the company's financial statements and internal control and the means by which management dis-

charges its responsibilities. Yet these responsibilities are not always communicated to the investing public.

Some public companies presently communicate such information in their annual reports to stockholders. A number of organizations concerned with financial reporting publicly embraced the concept of a management report in the late 1970s and early 1980s.

The FEI and the AICPA concluded that a management report can improve public understanding of the respective roles of management and the independent public accountant. Both of these groups issued guidelines on the content of management reports, including suggestions that management reports discuss management's responsibilities for the financial statements and assess the effectiveness of the company's internal controls.

In 1979, the SEC proposed requiring a management report that includes management's assessment of internal control. The SEC's proposed rule on management reports was criticized because of the close correlation of management's opinion on internal control with the internal accounting control provisions of the Foreign Corrupt Practices Act (FCPA). Many commentators viewed the proposal essentially as a requirement for a statement of compliance with the law. They suggested that the proposal was apparently intended not to give stockholders useful information, but rather to establish the existence of violations of the FCPA for enforcement purposes. These commentators questioned whether the proposal violated constitutional protections against self-incrimination.

The SEC withdrew its proposed release in 1980, acknowledging the criticisms but indicating that it continued to believe that management reports would give investors useful information and that private-sector initiatives in this area should continue.

Widespread implementation of management reports, tailored to fit individual company circumstances, would improve communication to financial statement users about the nature of financial information and the processes that surround its preparation and presentation. This report would be separate from, and thus in addition to, the usual letter from the CEO in the front of the annual report. Management's opinion on internal control is important because the internal control system provides the basis for the preparation of financial statements and, more broadly, the overall system of accountability. The CEO's signature on the management report would heighten his awareness of his responsibilities for the financial statements and internal control. Similarly, the chief accounting officer's and/or the chief financial officer's signatures would underscore their role in and responsibility for the financial reporting process. The controller may serve as the chief accounting officer, or the chief financial officer also may perform the functions of a chief accounting officer.

Despite the support of several influential private-sector organizations, after seven years a significant number of public companies still do not include management reports in their annual reports to stockholders. The time for voluntary compliance is past; the SEC again should take action to require management reports.

Criticisms of the SEC's earlier proposal are not relevant to this recommendation. First, the provisions of the FCPA are not limited by a standard of materiality. For the purposes of the management report, however, management's assessment should be limited to material matters about which stockholders reasonably should be informed; this aspect will limit the cost of the disclosure. Furthermore, the Commission is not suggesting that management compare its controls to some exact standard or express an opinion as to whether its internal controls are perfect or "fail safe." Management's assessment should recognize that the cost of controls should not exceed the expected benefits. Second, management's opinion on internal control would be included in a comprehensive management report. Many commentators on the SEC's proposal indicated that

management's assessment of the effectiveness of internal control would be more informative in that broader context. Finally, management's assessment of the effectiveness of internal controls should not parallel the definition of internal accounting control included in the FCPA. Management's opinion should encompass the entire system of internal control, a broader concept than the FCPA's internal accounting control.

Management, of course, should have a sound and adequate basis for expressing its opinion. Many CEOs will be able to rely to some extent on the establishment and communication of written policies and procedures and the selection and training of qualified personnel. Most CEOs also will review the company's assessment of the risk of fraudulent financial reporting and internal control evaluation with the CFO and the controller. Since the internal audit function evaluates the company's internal controls, the CEO normally also will discuss the effectiveness of the company's internal controls with his chief internal auditor as well as with the independent public accountant. The CEO should take whatever steps he considers necessary in the circumstances.

Good Practice Guidelines for Management's Report, including a sample management report, appear in Appendix J.

Audit Committee Chairman's Letter

Recommendation: *All public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the chairman of the audit committee describing the committee's responsibilities and activities during the year.*

The role of the audit committee is largely hidden from the investing public; it should be more visible and more effectively communicated. Moreover, the Commission's research indicated a need to reinforce the audit committee members' awareness and acceptance of the importance of their responsibilities. Accordingly, the Commission recommends that the SEC require the annual report to include a letter signed by the audit committee chairman discussing the audit committee's responsibilities and activities during the year.

Appendix K includes suggestions for the contents of the audit committee chairman's letter and a sample letter. Certain contents of the suggested audit committee letter duplicate existing proxy statement disclosures. Nonetheless, this recommendation should lead to more flexible and illuminating disclosure than most proxy statements presently provide. The Commission does not believe that simply expanding the proxy statement disclosure or including the information in the management report would accomplish the same purpose.

VI. Two Additional Areas

The Commission is offering recommendations in connection with two additional practices: seeking second opinions from public accounting firms and quarterly reporting. Both offer opportunities for strengthening the integrity of the financial reporting process.

Seeking a Second Opinion

Recommendation: *Management should advise the audit committee when it seeks a second opinion on a significant accounting issue.*

A difference of opinion over a significant financial reporting issue between a company and its independent public accountant may prompt management to seek an opinion from a second public accounting firm. On the one hand, the decision to do so may be management's legitimate attempt to obtain a technically correct opinion. On the other hand, it may be an attempt to obtain an opinion that coincides with management's interest in presenting the results in the most favorable light.

Bona fide differences of opinion arise in financial reporting, especially if complex or novel transactions are involved. Generally accepted accounting principles may not always be clear on the appropriate accounting treatment and the company and its independent public accountant must use judgment in making a decision. Under those circumstances, the company may wish another opinion and the Commission does not intend to undermine its ability to seek one. But when a company decides to seek an opinion from other than its existing firm, commercial pressures are introduced into the process of resolving the financial reporting issue. Recent cases have shown that these commercial pressures sometimes lead to fraudulent financial reporting.

Management has, and should have, the prerogative to seek second opinions. When such an opinion has been sought on a significant accounting issue, management should discuss the issue with the audit committee and explain why the particular accounting treatment was chosen.

Recommendation: *When a public company changes independent public accountants, it should be required by SEC rule to disclose the nature of any material accounting or auditing issue discussed with both its old and new auditor during the three-year period preceding the change.*

As a further deterrent to possible fraudulent financial reporting, when a change in independent public accountants occurs, public companies should be required to disclose promptly in an SEC filing the nature of any material accounting or auditing issue they discussed with both their old and new independent public accountant during the three-year period preceding the change. These requirements should apply with equal force to newly public companies.

Quarterly Reporting

Recommendation: *Audit committees should oversee the quarterly reporting process.*

Financial statement users rely heavily on quarterly financial statements. Quarterly reporting, however, is subject to fewer controls than annual reporting. The independent public accountant does not audit quarterly data. He is required to perform a limited review of the quarterly results disclosed in the annual report to stockholders, but he sometimes conducts this review after

year-end. Most audit committees play a limited role in the quarterly reporting process, even though quarterly information is an integral component of the financial reporting they oversee.

The audit committee's oversight responsibilities undertaken on behalf of the board of directors extend to the quarterly reporting process. The audit committee should review the controls that management has established to protect the integrity of the quarterly reporting process. This review should be ongoing. Timely communication between the board of directors or the audit committee and senior management, the chief internal auditor, and the independent public accountant is an important element of this ongoing process. Such discussions would normally take place during regular meetings of the audit committee or the board of directors.

Directors normally receive budgeted, projected, and actual financial data during the course of business throughout the year. If actual financial results for a quarter vary significantly from budgeted or projected results previously disclosed to the directors, management should advise the board or the audit committee before the actual financial results are released to the public. Management also should inform the board or the audit committee in advance of any proposed changes in accounting or financial reporting practices and of any other unusual events that could have a significant impact on the financial statements. Such communication does not require the audit committee to meet and can be handled by telephone if necessary. There is no reason why informing the audit committee of such unusual circumstances should interfere with the prompt release of quarterly results to the public.

In Chapter Three, which focuses on the independent public accountant's role, the Commission recommends that the independent public accountant perform a timely review of the quarterly financial statements. This recommendation works with the recommendation for increased audit committee oversight to improve the integrity of quarterly reporting.

VII. Guidance on Internal Control

Recommendation: *The Commission's sponsoring organizations should cooperate in developing additional, integrated guidance on internal control.*

Internal control is a complex, dynamic, constantly evolving concept, and one that many diverse organizations have studied. The Auditing Standards Board and the Institute of Internal Auditors have issued authoritative pronouncements on internal control. The AICPA Special Advisory Committee on Internal Accounting Control and the Research Foundation of the Financial Executives Institute also have studied the topic.

These groups have improved the overall understanding of internal control. Yet their studies also have resulted in varying interpretations and philosophies. As a result, independent public accountants, management, and internal auditors sometimes disagree about the adequacy of a given internal control system.

The Commission recommends that the organizations sponsoring the Commission work together to integrate the various internal control concepts and definitions and to develop a common reference point. This guidance would build on the Commission's recommendations, help public companies judge the effectiveness of their internal controls, and thus help public companies improve their internal control systems. The sponsoring organizations should determine the most appropriate means for providing this additional guidance.

Chapter Three

RECOMMENDATIONS FOR THE INDEPENDENT PUBLIC ACCOUNTANT

I. The Independent Public Accountant's Role in Detecting Fraudulent Financial Reporting

The financial statements are first and foremost the responsibility of the management of the reporting entity. But the independent public accountant plays a crucial role in the financial reporting process.

Users of financial statements expect auditors to bring to the reporting process technical competence, integrity, independence, and objectivity. Users also expect auditors to search for and detect material misstatements, whether intentional or unintentional, and to prevent the issuance of misleading financial statements. The Commission has identified a number of steps to improve the auditor's ability to detect fraudulent financial reporting and better serve users of the auditor's report.

First, the public accounting profession must recognize its responsibility to design the audit scope to consider the potential for fraudulent financial reporting and to design audit procedures to provide reasonable assurance of detecting such reporting. The first step should be a restatement of the auditor's responsibility for detecting fraudulent financial reporting.

Second, independent public accountants can and should do more to improve their detection capabilities. The Commission offers recommendations that would require greater use of analytical review procedures and timely review of quarterly financial data.

Third, the Commission makes three recommendations designed to improve audit quality. Two are designed to strengthen aspects of the profession's quality assurance program; the third highlights the need for public accounting firms to identify, assess, and manage pressures that may affect audit quality.

Fourth, because of the heavy reliance placed on the auditor's work and his opinion, users should clearly understand the nature, the scope, and the limitations of an audit. The Commission offers recommendations to strengthen communication with users of the independent public accountant's report.

Finally, the Commission considered the process of setting auditing standards. The work of the independent public accountant impacts a broad range of parties, both preparers and users. The Commission therefore is recommending that the auditing standard-setting process provide for more direct involvement of these constituencies. Specifically, the Commission recommends that the Auditing Standards Board (ASB) of the AICPA be reorganized to include equal representation and participation by knowledgeable representatives of the constituencies that have a significant interest in the financial reporting process.

On February 14, 1987, the ASB exposed for comment a series of proposed auditing standards that address many issues the Commission considered. The Commission commends the ASB for its efforts in these exposure drafts, some of which are responsive to Commission concerns.

II. Recognizing Responsibility for Detecting Fraudulent Financial Reporting

Recommendation: *The Auditing Standards Board should revise standards to restate the independent public accountant's responsibility for detection of fraudulent financial reporting, requiring the independent public accountant to (1) take affirmative steps in each audit to assess the potential for such reporting and (2) design tests to provide reasonable assurance of detection. Revised standards should include guidance for assessing risks and pursuing detection when risks are identified.*

The independent public accountant has accepted the responsibility to design his audit to detect material errors in financial statements. The degree of responsibility for designing the audit to detect fraudulent financial reporting, however, has been a source of continuing debate.

A review of past and current auditing literature illustrates the debate. Early auditing texts set forth three objectives for the audit: the detection of fraud, the detection of technical errors, and the detection of errors of principle. As the market for auditing services grew in the early 1900s and auditors increasingly experienced difficulty in detecting carefully concealed frauds, pressure built within the profession to modify auditing standards relating to the responsibility for detecting fraud. Auditing literature was subsequently rewritten, and auditors began to view the detection of fraud and similar irregularities as beyond the realm of their responsibilities.

By the 1960s the disavowal of responsibility on the part of many auditors became unacceptable to both financial statement users and the profession itself. Once again, auditing literature was modified, this time to acknowledge that, in performing the audit examination, the auditor must be aware of the possibility that fraud may exist. Even with this acknowledgment, the auditing literature made it clear that the auditor's responsibility for fraud detection was quite limited and that financial statement users should not rely on the audit for assurance of detection.

The next attempt to struggle with the auditor's responsibility for detecting fraud came in 1975. An AICPA committee was formed to determine whether the failure on the part of the auditors to detect massive fraud in the widely publicized Equity Funding case pointed to a need for revised standards. The committee concluded that no substantive change in the degree of responsibility was necessary, but that guidance describing the auditor's responsibility for detecting fraud should be improved.

This recommendation as well as Congressional pressure and the work of the Commission on Auditors' Responsibilities (widely known as the Cohen Commission, after its chairman, Manuel F. Cohen) led the AICPA in 1977 to issue Statement on Auditing Standards (SAS) No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*. That statement, which remains in effect today, contains the following description of the responsibility the auditor assumes:

Under generally accepted auditing standards the independent auditor has the responsibility, within the inherent limitations of the auditing process..., to plan his examination... to search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of that examination. The auditor's search for material errors or irregularities ordinarily is accomplished by the performance of those auditing procedures that in his judgment are appropriate in the circumstances to form an opinion on the financial statements; extended auditing procedures are required if the auditor's examination indicates that material errors or irregularities may exist.... An independent auditor's standard report implicitly indicates his belief that the financial statements taken as a whole are not materially misstated as a result of errors or irregularities.

Notwithstanding its specific requirement that the auditor has the obligation to plan his examination to search for irregularities, SAS No. 16 does not specify how such a search is to be conducted. Accordingly, the Commission recommends that the independent public accountant's responsibility for the detection of fraudulent financial reporting be restated. The auditing standards should include requirements to (1) assess the risk of fraudulent financial reporting and (2) design tests to provide reasonable assurance of detection.

The Commission appreciates the limitations inherent in the audit process. The auditor cannot and should not be held responsible for detecting all material frauds, particularly those involving careful concealment through forgery or collusion by members of management or management and third parties. Auditors nonetheless should be responsible for actively considering the potential for fraudulent financial reporting in a given audit engagement and for designing specific audit tests to recognize these risks.

Existing literature emphasizes the auditor's responsibility to assess the risk of error or irregularity at the specific account level. The existing literature does not require auditors to evaluate the control environment, and it allows the auditor to assume management integrity unless his examination reveals evidence to the contrary. The auditor's procedures thus do not focus at a sufficiently high level. Moreover, because the Commission has found that the majority of fraudulent financial reporting cases involve top management, the auditor should not assume management integrity but should apply professional skepticism to this determination.

As noted in Chapter Two, a strong control environment is essential. Without a strong corporate ethical climate, the risk of fraudulent financial reporting increases. The standards should require the auditor to assess the company's control environment, including its management, in planning the audit. The assumption of management integrity is one of the key areas where guidance should be changed.

Auditing guidance the profession develops should identify specific factors that may increase the likelihood of fraudulent financial reporting. To aid auditors in designing audit tests, the guidance should present illustrative audit objectives for factors identified, along with examples of audit tests that may achieve those audit objectives. Guidance also should recognize the difficulties in assessing risks, designing tests, and evaluating audit evidence and it should require substantial involvement by seasoned audit professionals.

The Commission has observed that fraudulent financial reporting usually follows a predictable path, normally in response to the presence of certain environmental, institutional, and individual pressures. This pattern differs from that of unintentional errors, which may occur randomly in the reporting process. Most SEC fraudulent financial reporting cases, for example, not only showed significant management involvement but also involved improper revenue recognition, overstatement of assets, or improper deferral of expenses. Frequently, these improprieties were accomplished through unusual transactions near the end of a reporting period or through accounting estimates and occurred most frequently in industries characterized by rapid change. In developing additional guidance, the profession should consider carefully the internal and external pressures that increase the likelihood of fraudulent financial reporting. The profession may find it helpful to consider the Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting, included as Appendix F.

The restated responsibility for detecting fraudulent financial reporting and the additional guidance described would recognize a responsibility that many in Congress and the courts already say exists. Moreover, the recognition would be in a positive vein, promote consistency in auditing practice,

enhance detection of fraudulent financial reporting, and reduce confusion among independent public accountants and the public as to the auditor's role.

III. Improving Detection Capabilities

The Commission does not wish to understate the significant role that audits presently play in detecting fraudulent financial reporting: audits can and very often do detect instances of fraudulent financial reporting. The audit process encompasses a wide range of procedures designed to detect material misstatements in the financial statements. Thus audits have a decidedly preventive and deterrent effect.

But independent public accountants can do more and the Commission is recommending two specific steps. The first, greater use of analytical review procedures, will, among other things, enhance the independent public accountant's ability to identify areas of high risk of fraudulent financial reporting. The second, timely review of quarterly financial data by independent public accountants, prior to public release, will improve the likelihood of early detection of fraudulent financial reporting.

Analytical Review Procedures

Recommendation: *The Auditing Standards Board should establish standards to require independent public accountants to perform analytical review procedures in all audit engagements and should provide improved guidance on the appropriate use of these procedures.*

The public accounting profession widely recognizes the usefulness of analytical review procedures, and auditors perform such procedures in many audits today. Analytical review procedures can encompass a broad range of audit steps. Usually involving comparisons of relationships among data, they range from relatively simple comparisons of ratios and trends to sophisticated statistical modeling techniques. Regardless of specific form, they focus on the overall reasonableness of a reported amount in relation to the surrounding circumstances.

The potential of analytical review procedures for detecting fraudulent financial reporting has not been realized fully. Unusual year-end transactions, deliberate manipulations of estimates or reserves, and misstatements of revenues and assets often introduce aberrations in otherwise predictable amounts, ratios, or trends that will stand out to a skeptical auditor. The Commission observed a number of cases where performing analytical review procedures would have increased the likelihood of the auditor's detecting fraudulent financial reporting.

Existing auditing standards allow, but do not require, analytical review procedures. The Commission recommends that auditing standards be revised to require the use of analytical review procedures on all audit engagements. The revised standards should require auditors to use analytical review procedures throughout the audit including at the planning phase. Further, the Commission recommends that the public accounting profession provide greater guidance on the application of analytical review procedures. Executive-level auditors should be required to participate in selecting the analytical review procedures to be performed and evaluating the results. Meaningful audit evidence from these procedures depends on the seasoned judgment of executive-level professionals who should have a greater understanding of the company's industry as well as the environmental, institutional, and individual factors that increase the risk of fraudulent financial reporting.

Timely Review of Quarterly Financial Data

Recommendation: *The SEC should require independent public accountants to review quarterly financial data of all public companies before release to the public.*

Investors and other financial statement users rely heavily on, and react quickly to, quarterly results. Yet under existing SEC disclosure rules, quarterly financial information is unaudited and does not require the independent auditor's review prior to its public release.

The Commission recommends that all public companies have their independent public accountants review, but not audit, quarterly data before releasing it to the public. The review should be a "limited" review, as described in existing ASB guidance.

SEC rules currently require larger, widely traded public companies to include summarized quarterly data in the annual reports to stockholders. The independent public accountant is required to review such data, but he may review them on a timely basis, prior to public release, or on a retrospective basis in connection with year-end audit work. The Commission does not recommend changing the scope of the independent public accountant's review for these larger, widely traded public companies, but it does recommend that the review be done on a quarterly basis, before public release of the data. In addition, the Commission recommends that companies not subject to the current SEC requirement for summarized quarterly data in an annual report engage their independent public accountants to perform a limited review of quarterly financial data prior to release to the public.

Current auditing standards provide guidance on the nature and extent of procedures that the auditor should apply when engaged to review interim financial information. These procedures, while not as comprehensive as an audit, nevertheless enhance the reliability of quarterly data. The procedures include, among other things, (1) applying analytical review procedures to identify unusual items, (2) making inquiries of management on a broad range of issues and events that may impact the quarterly data, and (3) obtaining written representations from management regarding events and transactions underlying the quarterly results and any other representations that the auditor deems appropriate.

A review differs from an audit in the degree of evidence the independent public accountant must obtain to support the financial information and also in the degree of assurance a user may place on such information. Because a review is not designed to express an opinion on the financial information, it requires significantly less supporting evidence than an audit requires. Existing standards for a review allow the independent public accountant to state that he is not aware of any material adjustments that should be made to the financial information for it to be in conformity with generally accepted accounting principles.

The timely involvement of the independent public accountant with quarterly financial data can improve the reliability of quarterly reporting and increase the likelihood of preventing or detecting fraudulent financial reporting. The review of quarterly financial data before public release assures the public of more frequent review of reporting practices of public companies by an independent and objective party. This in turn should improve the financial reporting discipline in many public companies.

The increased discipline that review by the independent public accountant contributes is particularly important in light of a study conducted for the Commission. A sample of 1,088 public companies revealed that nearly two-thirds of the dollar amount of writeoffs from 1980 to 1985 were concentrated in the fourth quarter. The study also found that fourth-quarter writeoffs have been

increasing, both in frequency and in dollar value, and noted that one possible contributing factor to the increasing level of writeoffs may be the ambiguity of accounting standards.

The Commission understands that various individuals and groups, including the Emerging Issues Task Force and the Accounting Standards Executive Committee of the AICPA, have raised the issue as to when to recognize the impairment of long-lived assets and that the Financial Accounting Standards Board is currently studying it. The Commission applauds these efforts and anticipates that more clearly defined accounting standards will contribute significantly to recording writeoffs on a timely basis and otherwise improving the reliability of quarterly financial information.

IV. Improving Audit Quality

The ability of the independent public accountant to detect fraudulent financial reporting is related directly to the quality of the audit. Thus efforts to improve overall audit quality are important elements of the financial reporting process.

In Chapter Four, the Commission examines the regulation of the public accounting profession, including the profession's quality assurance program, and presents conclusions and recommendations for improving regulation. One recommendation would close an existing regulatory gap by requiring all firms that audit SEC public companies to belong to a professional organization that has peer review and independent oversight and is approved by the SEC. The AICPA has such a program, the SEC Practice Section (SECPS) of its Division for CPA Firms. Another recommendation would add meaningful sanctions to the profession's quality assurance program through SEC enforcement action. As Chapter Four details, the Commission sees no need for separate or greater regulation, subject to adoption of these improvements to the existing framework.

The Commission has identified several steps that the profession can take to enhance audit quality within the existing framework. The first two steps, relating to peer review and second partner review, pertain to the profession's quality assurance program. The third step urges greater sensitivity in recognizing and controlling pressures within public accounting firms that may impact audit quality.

Peer Review

Recommendation: *The AICPA's SEC Practice Section should strengthen its peer review program by increasing review of audit engagements involving public company clients new to a firm. For each office selected for peer review, the first audit of all such new clients should be reviewed.*

A public accounting firm's procedures for accepting new clients, reviewing a new client's accounting policies, and resolving disagreements with clients are important parts of its quality assurance program. The Commission's review of fraud-related cases revealed that a significant number involved companies that had recently changed their independent public accountants, often because of disagreements over accounting policies. Accordingly, the profession's quality assurance program would be strengthened if, in each office selected for peer review, the program required the review of all first-year audits performed during the peer review period for public company clients that were new to the firm.

Concurring, or Second Partner, Review

Recommendation: *The AICPA's SEC Practice Section requirement for a concurring, or second partner, review of the audit report should be revised as part of an ongoing process of review of this requirement. Standards for the concurring review should, among other things, (1) require concurring review partner involvement in the planning stage of the audit in addition to the final review stage, (2) specify qualifications of the concurring review partner to require prior experience with audits of SEC registrants and familiarity with the client's industry, and (3) require the concurring review partner to consider himself a peer of the engagement partner for purposes of the review.*

The SECPS requires a concurring, or second partner, review in all audits of SEC registrants. A concurring review of the audit report and the financial statements, prior to issuance, is required by a partner other than the audit partner-in-charge of the engagement. The SECPS requires all member firms to establish policies and procedures that meet certain minimum standards as to the nature, the extent, and the timing of the review, the qualifications of the concurring review partner, and the documentation of the review.

In considering the SECPS's standards, the Commission noted the absence of a requirement to involve the concurring review partner in the planning stage of the audit. Audits must be carefully designed to address the risk of fraud and provide reasonable assurance of detection. An early concurring review of the audit plan would provide added assurance that the audit scope is appropriate for the detection of fraudulent financial reporting. Second partner review of the audit scope is consistent with the fundamental reasoning of quality assurance underlying the existing requirement for a second partner review. The same concurring review partner generally would be involved at both the planning and the final review stage, but if circumstances such as a partner transfer make that impractical, two different partners could conduct the concurring review.

The Commission examined the stated policies many of the largest public accounting firms have to ensure that the concurring review partner has sufficient technical expertise and experience. The Commission found a broad range of guidance offered, particularly with regard to qualifications required for the concurring review partner. While some of the policies require SEC and/or industry experience, more than one-third of them do not require any specific qualifications for the concurring review partner. A number of firms may, as a matter of practice, insist that concurring review partners have SEC and industry experience. Nevertheless, SECPS requirements should be explicit in requiring such background and experience.

The concurring review partner generally is, and considers himself to be, a peer of the engagement partner by virtue of his partnership in the firm. It is important, however, that the concurring review partner be free from any influence that could adversely affect his objectivity and independence. In practice, circumstances may cause one partner not to consider himself a peer of another partner, such as the partner in charge of the office to which he reports. Subordinate stature within a practice office, for example, could influence work as the concurring review partner. A different partner in similar circumstances, however, may feel free of any influence that could affect the objectivity of his review. Standards should explicitly require that the concurring review partner consider himself a peer of the partner whose engagement he is assigned to review.

In addition to these recommendations, the Commission notes and supports the present efforts of the Public Oversight Board (POB) to study the policies and practices of public accounting firms relating to concurring reviews. The objective of the POB's study is to determine whether the SECPS should make any further changes to clarify and enhance its membership requirements with regard to this important quality control measure.

Firm Pressures

Recommendation: *Public accounting firms should recognize and control the organizational and individual pressures that potentially reduce audit quality.*

The tone that the top managements of public accounting firms set is just as important in the firms as that set by top managements in public companies. Many public accounting firms are large organizations in which personnel face institutional and individual pressures not unlike those that personnel of public companies face. In public companies such pressures have the potential to contribute to fraudulent financial reporting. In both large and small public accounting firms, these pressures have the potential to compromise the skepticism and professional judgment that are critical to audit quality and the detection of fraudulent financial reporting.

Some of these organizational and situational pressures include:

- *Tight reporting deadlines.* Tight reporting deadlines imposed by companies and agreed to by the auditor are the norm. Proper planning of the audit, therefore, should anticipate tight deadlines when allocating personnel and other resources and thereby relieve deadline pressures that may encourage auditors prematurely to stop pursuing identified problems. These pressures are particularly troublesome because, as the Commission's studies indicate, activities that result in fraudulent financial reporting typically occur near the end of a reporting period.
- *Fee and budget pressures.* Intense competition among accounting firms contributes to significant pressure on audit fees, often with corresponding pressure to reduce staff, time budgets, and partner involvement in audit engagements. Such pressures may not be conducive to the thorough investigation of red flags indicating the potential for fraudulent financial reporting or to the thorough exercise of professional judgment and skepticism.
- *Broad accounting principles.* Accounting principles in some areas allow a broad range of acceptable practices. The Commission did not consider the advantages and disadvantages of broad-versus-specific accounting principles to be an issue within its scope, but nonetheless it noted that broad or vague accounting standards may lead auditors to accept overly aggressive accounting practices. Pressure to agree to the outer limit of acceptability of a number of accounting issues has an aggregating and undesirable impact on the financial statements that may make them unacceptable taken as a whole.

Public accounting firms must design their systems of quality control to recognize the organizational and individual pressures in today's audit environment and control them through such procedures as concurring, or second partner, reviews.

V. Communicating the Auditor's Role

Auditors can and should do a better job of communicating their role and responsibilities to those who rely on their work. Users of audited financial statements need to understand better the nature and the scope of an audit and the limitations of the audit process.

Communications With Users: Degree of Reliance

Recommendation: *The Auditing Standards Board should revise the auditor's standard report to state that the audit provides reasonable but not absolute assurance that the audited financial statements are free from material misstatements as a result of fraud or error.*

Users of financial statements need clarification of the role and responsibilities of the auditor, as outlined in this chapter. Since the independent public accountant's standard report is his primary communication with those who rely on his work, the report should be revised to communicate better the responsibilities the auditor assumes.

Accordingly, the Commission recommends that the standard report clearly explain the degree to which users can rely on the audit to ensure that audited financial statements are free from material misstatements. The report also should describe the limitations of the audit process: that an audit cannot and does not guarantee or provide absolute assurance that the financial statements are reliable or accurate. These clarifications will help to confirm to all concerned that management has primary responsibility for the financial statements and to prevent users of financial statements from placing more reliance on the audit process than is reasonable.

Communications With Users: Review of Internal Accounting Controls

Recommendation: *The Auditing Standards Board should revise the auditor's standard report to describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. The Auditing Standards Board also should provide explicit guidance to address the situation where, as a result of his knowledge of the company's internal accounting controls, the independent public accountant disagrees with management's assessment as stated in the proposed management's report.*

The Commission does not propose changing existing standards to increase the extent to which the independent public accountant must review and evaluate the system of internal accounting control. Rather, the Commission recommends disclosure, in the auditor's standard report, of the review of internal accounting controls that existing auditing standards require in connection with an audit of financial statements. This disclosure will reduce the likelihood that report users may misunderstand the extent of the independent public accountant's review, and the degree to which that review can vary under existing standards.

Generally accepted auditing standards require the independent public accountant to perform a preliminary review of the system of internal accounting control. This review is designed for the independent public accountant to gain sufficient understanding of the system to determine the degree of reliance he will place on it in determining the nature, the extent, and the timing of audit tests.

The extent of the independent public accountant's involvement with the system of internal accounting control subsequent to this preliminary review may vary widely. After completing his

preliminary review, the independent public accountant may decide not to rely on the company's internal accounting controls, and therefore he may not spend time to gain an in-depth understanding of the system or to test the system. On the other hand, the independent public accountant may choose to evaluate, test, and rely extensively on the system for purposes of the audit.

The independent public accountant decides whether he will test internal accounting controls on the basis of his preliminary review. This review assesses (1) whether the nature and the strength of the controls are likely to justify any restriction in audit tests and (2) whether the effort required to study and evaluate the controls is likely to exceed the reduction in audit effort that could be assumed by reliance on them. Thus in some circumstances adequately designed internal accounting controls may not be tested and evaluated because reliance on such controls is not cost justified. Further, the independent public accountant may decide to test and evaluate only those internal accounting controls on which he plans to rely; he need not evaluate or test other internal accounting controls in depth.

In the first recommendation in this chapter, the Commission proposed that the independent public accountant's study and evaluation of the control environment be among the affirmative steps required in each audit to assess the potential of fraudulent financial reporting. An in-depth study and evaluation of the system of internal accounting control, however, is not necessary on all audits. One of the primary functions of the internal auditor is to evaluate internal accounting controls and report thereon to management. The Commission defers to the public accounting profession on the determination of the appropriate extent of the independent public accountant's review of the system of internal accounting control.

Existing auditing literature allows the independent public accountant to render an affirmative opinion on internal accounting controls if the company so requests, and it provides guidance for that work. Some company managements may wish to request such an opinion to serve as part of their support for the assessment of internal controls they express in the management report in the annual report to stockholders.

The Commission is concerned, however, that users of the company's financial statements may not be aware of the extent of the independent public accountant's review of the system of internal accounting control because this review can vary so greatly. The independent public accountant's standard report should be revised to avoid possible misunderstanding of the report and mistaken reliance on it by describing the review of the system of internal accounting control that is required by auditing standards. Such standard language would make clear the degree to which the user can rely on the auditor having assessed the adequacy of the system of control. Further, the standard report should indicate that auditing standards require the independent public accountant to communicate to management and the board of directors, or to the audit committee, any significant material weaknesses that come to his attention during the course of his audit.

While the Commission is not recommending a special project for the independent public accountant to review and evaluate internal controls, it is recommending that auditing standards explicitly address the situation that could arise as a result of the Commission's recommendation calling for a management report in the annual report to stockholders. The report would include management's assessment of internal controls. Standards should provide explicit guidance for the independent public accountant if the knowledge he has gained about the company's internal accounting controls leads him to disagree with management's assessment of controls in its report.

Communication With Others Regarding Material Irregularities

The Commission also considered possible changes in the independent public accountant's current obligation to communicate to others outside the client any material irregularities and illegal acts

he discovers in the course of an audit. Current requirements obligate the auditor to report such events to parties other than the client's management and board of directors when the impact is so material as to affect his opinion on the financial statements. In such circumstances the auditor is required to modify his opinion, thus providing public disclosure of the impropriety, or to consider withdrawing from the audit engagement. The practical effect of this requirement is a withdrawal or termination of the relationship, which in turn triggers a public disclosure obligation under the provisions of Form 8-K, which public companies must file with the SEC in connection with changes in public accounting firms. Also, current auditing standards require that the auditor discuss his audit findings with the auditor who succeeds him. In the Commission's view, these existing requirements have promoted the appropriate reporting of material improprieties that might otherwise have resulted in fraudulent financial reporting. The Commission nevertheless urges the SEC and the public accounting profession to continue their efforts to improve the timing and the quality of such disclosures.

VI. The Auditing Standards Board

The Commission's study of the independent public accountant's role encompassed not only certain specific auditing standards but also the process by which standards are set. Among other things, auditing standards establish the independent public accountant's responsibility for detecting fraudulent financial reporting and guide him in fulfilling this responsibility. Auditing standards thus are a critical component of the financial reporting system.

Study of the independent public accountant's role in detecting fraudulent financial reporting must not limit itself to specific auditing standards existing at a point in time. It must recognize the constantly evolving nature of auditing and of the business and economic environment in which financial reporting takes place, and it must consider the standard-setting process itself.

Old and New Proposals for Change

Previous efforts to study and evaluate the role of the independent public accountant reached a similar conclusion. In the late 1970s the Cohen Commission, several Congressional studies, and a special AICPA committee considered the subject and recommended a number of changes. More recently, the heads of 7 major public accounting firms presented recommendations to the AICPA ("The Future Relevance, Reliability, and Credibility of Financial Information," April 1986) that included calls for enhancing the capacity of the Auditing Standards Board (ASB) to develop auditing standards.

The Commission reviewed the profession's responses to past suggestions for change and recent changes in the ASB's composition. The Cohen Commission believed the responsibility for setting standards should stay with the public accounting profession, but it recommended replacing the existing committee structure with a smaller, full-time, sufficiently compensated body. The Cohen Commission went on to suggest steps to support that body, such as improving the quality of supporting staff. The SEC reported to Congress in July 1978 that, while it did not necessarily agree with the profession's rejection of the Cohen Commission's recommendation of a small, full-time board, it believed that the newly adopted ASB would enhance the objectivity of the process and was an appropriate response at that time. The SEC observed that there was no need to go further at that time because, among other reasons, there was no backlog of urgent problems. The more recent recommendations by the seven major firms, however, reflected a conclusion within the

profession that the structure and the organization devised in 1978 may no longer strike the optimal balance.

After considering both old and new proposals for change, the Commission concluded that the process of setting auditing standards involves highly technical aspects but, further, that it also involves substantial policy aspects. The conduct of the audit impacts a broad range of parties, within both preparer and user groups. Consequently, the auditing standard-setting process should incorporate more direct involvement of all interested parties.

Reorganization of the Board

Recommendation: *The AICPA should reorganize the Auditing Standards Board to afford a full participatory role in the standard-setting process to knowledgeable persons who are affected by and interested in auditing standards but who either are not CPAs or are CPAs no longer in public practice.*

The Commission carefully reviewed the ASB's performance over the past decade and concluded that the process of setting auditing standards can be improved. The present arrangement provides highly competent preparation of technical documents and standards, to which the ASB's recent publication of 10 exposure drafts stands witness. The publication of these drafts as a group, however, serves to illustrate the need to recognize and address emerging policy issues on a more timely basis.

The Commission believes that the setting of auditing standards should involve knowledgeable persons whose primary concern is with the use of auditing products as well as practicing independent public accountants. Such individuals would have particular sensitivity to the operating implications of auditing standards and to emerging policy issues concerning these standards. The recommendations which follow contemplate a smaller ASB composed of equal numbers of practitioners and qualified persons not presently engaged in public accounting. The Commission believes that such a board, led by two full-time officers, would look beyond the technical aspects of auditing and set an agenda which reflects a broad range of needs, serving public and private interests. The agenda would be implemented by auditing standards of continuing high technical quality, and the ASB would adopt these standards on the basis of their technical quality and their addressing these public and private needs.

The Commission recognizes that implementing this recommendation will necessitate major changes in the existing organization of the ASB. Accordingly, the Commission offers the following suggestions for implementing its recommendation:

1. The ASB should continue to be under the auspices of, and to be supported by, the AICPA.

The Commission sees no need to remove auditing standard-setting from the domain of the public accounting profession. The Commission agrees with the conclusion of the Cohen Commission that the auditing standard-setting process has worked reasonably well and notes the profession's positive record of responsiveness to proposals for change. Moreover, as the Cohen Commission observed, removing standard-setting from the profession could have an adverse effect on professionalism and on auditors' motivation to accept and support auditing pronouncements. Establishing an independent body would involve substantial costs; these costs do not appear to be justified. The existing ASB, reorganized as recommended in this report, should be fully capable of setting standards as needed in the future.

2. The ASB should be significantly smaller than the present board and have an even number of members. Half should be practicing public accountants; half should be persons who are not engaged in public accounting practice but are qualified and knowledgeable about auditing.

Outside participation, to be meaningful and to attract highly qualified outside members, must be equal to the participation of the practicing profession. The Commission recognizes that the ASB currently receives the benefit of input from many sectors but believes actual participation on the ASB will enhance the value and the effectiveness of this input.

Nineteen of the 21 members of the ASB as currently organized are from the practicing public accounting profession. Thus, reaching 50 percent outside participation within the existing organizational structure would increase the board to an unwieldy size. The smaller size the Commission recommends — on the order of 8 to 12 members — would provide an improved forum for the members to focus on the policy aspects of auditing standards.

The outside members should come from sectors affected by or otherwise interested in auditing standards, such as companies, which are purchasers of audit services, and investors, financial analysts, and creditors, who use audited financial statements. Examples of qualified individuals are business persons, academicians, internal auditors, government auditors, and former independent public accountants who have since gained experience in management or other fields. Experience as a member of an audit committee would be particularly beneficial. In any event, the outside, or public, members must be able to appreciate and balance issues of concern to the public accounting profession, such as liability, issues of concern to public companies, such as cost, and issues of concern to users, namely the reliability of reported financial information.

3. The AICPA Board of Directors should select the ASB members. Selection should be based on personal expertise and qualifications, not on the basis of constituencies other than those discussed above for the outside members.
4. The chairman and vice chairman of the ASB should both serve full time. One should be from current professional auditing practice; the other should be from the ranks of knowledgeable persons not engaged in that practice. To attract qualified members, the ASB should sufficiently compensate all members, both full- and part-time.

Although the recent recommendations of the 7 major firms went further, including all full-time ASB members among the possible enhancements recommended, it may be more appropriate to start with a full-time chairman and vice chairman. Full-time service of at least those members is important to ensure the ASB's capacity to focus on the broad policy level and to provide timely guidance.

5. The reorganized ASB, in setting auditing standards, should perform a management role: (1) setting the agenda, priorities, and policy direction and (2) considering, approving, disapproving or changing technical auditing standards.

The ASB itself would not perform technical standards drafting but would look to its staff and other sources for this support.

6. The AICPA should ensure that the ASB has an adequate, technically qualified senior staff.

With the reduction in the size of the ASB, additional highly qualified staff may be necessary. To attract qualified individuals, the AICPA should consider asking partners, senior managers, or similar individuals from the public accounting firms to serve as practice fellows. The AICPA and

the accounting firms need to ensure that these positions have an enhanced career path, similar to that provided to practice fellows of the SEC and the FASB.

7. In addition to using the services of AICPA staff and rotating practice fellows, the ASB also should be able to continue to draw on the technical expertise of partners currently engaged in auditing practice, who now serve the ASB on a part-time basis, for difficult, technical matters that demand the partner's level of experience and judgment.

Reorganizing the ASB as outlined should ensure its technical capacity and at the same time broaden its policy-level capacity. With the addition of knowledgeable outside members and the other suggested organizational changes, the ASB will be in a better position to balance the needs and the interests of the profession, the public company, and the users of financial information.

Chapter Four

RECOMMENDATIONS FOR THE SEC AND OTHERS TO IMPROVE THE REGULATORY AND LEGAL ENVIRONMENT

I. Effectiveness of Regulatory and Law Enforcement Agencies and the Legal Environment Generally

A strong and effective regulatory and legal environment plays a critical role in preventing, detecting, and deterring fraudulent financial reporting. In Chapters Two and Three the Commission recommended several specific regulatory agency actions aimed at preventing and detecting fraudulent financial reporting. In addition, the regulatory and law enforcement environment can and should become a stronger deterrent.

The Commission recognizes the effectiveness of today's ongoing efforts, and those of the past, to strengthen the regulatory and legal environment. Indeed, the Commission congratulates the SEC for its financial fraud enforcement program and for its many contributions to improving the financial reporting process.

The SEC's recent enforcement program highlighted the existence and the seriousness of fraudulent financial reporting. The program is particularly commendable in view of the SEC's limited resources and the fact that financial disclosure cases usually are complex, often requiring more resources than other cases that involve violations of the federal securities laws.

The SEC has imposed many of the Commission's recommendations on a case-by-case basis, in the form of ancillary relief (additional remedies to support those allowed by statute) obtained when settling enforcement actions. These recommendations include requirements that public companies form audit committees and appoint independent directors and that public accounting firms become members of the AICPA's SEC Practice Section (SECPS).

Notwithstanding the SEC's positive actions, the Commission has concluded that a strengthened regulatory and legal environment is needed. Prosecution of, and sanctions imposed on, those who violate the law by their involvement in fraudulent financial reporting should be increased. The public accounting profession's quality assurance program, which generally functions well, should be extended to the independent public accountants of all SEC public companies and reinforced by meaningful sanctions. The effectiveness of the legal environment generally in deterring fraudulent financial reporting should be enhanced.

The Commission specifically recommends improvements in the following areas:

- Additional SEC enforcement remedies to provide more severe penalties and better tailoring of the sanctions to the case
- Increased criminal prosecution
- Improved regulation of the public accounting profession to include (1) mandatory membership in a quality assurance program with peer review and independent oversight functions approved and monitored by the SEC and (2) SEC enforcement to ensure adherence to that program

- SEC resources available to perform the functions recommended in addition to all traditional functions
- Financial institution regulatory action to (1) correspond to the Commission's recommendations relating to financial reporting that are directed to the SEC and (2) provide for staff examiners of the federal regulators and independent public accountants to have mutual access to information developed about examined financial institutions
- Enhanced enforcement by state boards of accountancy to monitor the quality of auditing services
- Acknowledgment of the relationship of the national liability crisis to fraudulent financial reporting.

II. Additional SEC Enforcement Remedies

The Commission applauds the SEC for seeking and obtaining enhanced enforcement authority from Congress in the context of the Insider Trading Sanctions Act of 1984 (ITSA). At that time, Congress authorized the SEC to bring administrative proceedings against individuals who "cause" a company's violation of the continuous reporting, proxy and tender offer sections of the Exchange Act. Prior to that time, while the SEC could bring either an injunctive action in court or an administrative agency proceeding against the company, it could only bring an injunctive action against the individuals.

This change closed a large gap in the SEC's enforcement authority. In the Commission's view several additional remedies are necessary to round out the SEC's enforcement options. The ability to tailor enforcement actions more precisely to particular facts will enable the SEC to maximize its enforcement effectiveness. The SEC would no longer be persuaded to drop an action because the available remedy is arguably too harsh. At the same time the SEC could impose harsher penalties than it now can or does.

Tougher sanctions clearly would inject a greater punitive aspect into the SEC's enforcement program. The Commission finds that the increased emphasis on punitive aspects in a program that has been primarily remedial is justified. So tremendous are today's pressures and opportunities to engage in fraudulent financial reporting that the existing array of penalties no longer provides a long-term recipe for achieving a satisfactory level of deterrence. The pressures and opportunities Chapter One details represent a set of circumstances that warrant a stronger and more flexible battery of disincentives.

The Commission's recommendations would give the SEC a broader range of penalties to apply to a securities law violation under existing law and legal standards. The Commission's intent is not to change the substantive law or the legal standards of what constitutes a violation but to ensure that no violation involving fraudulent financial reporting goes unpunished because it cannot be matched with an appropriate sanction.

The Commission's call for additional punitive tools is not an entirely new direction for SEC enforcement. The SEC has had three years' experience administering ITSA with its enhanced enforcement capabilities. And the possibility of criminal referrals in appropriate cases from the SEC to the Department of Justice or the United States Attorneys has long existed.

Naturally, before imposing any sanctions (existing or proposed), the SEC would continue to afford the due process protections that are available in its existing enforcement proceedings. And once

SEC administrative remedies have been exhausted and final agency action has been taken, parties who are adversely affected would be allowed to petition the appropriate federal appellate court for review of the SEC's final order.

A. Fines

Recommendation: *The SEC should have the authority to impose civil money penalties in administrative proceedings [including Rule 2(e) proceedings] and to seek civil money penalties from a court directly in an injunctive proceeding.*

The SEC lacks the ability to seek or impose civil money penalties on violators of the securities laws, except in one narrow area: insider trading. Not until 1984, with the passage of ITSA, did the SEC obtain the authority to seek a court-imposed civil money penalty. Under ITSA, the SEC can seek a penalty of up to three times the amount of profit gained or loss avoided because of the insider trading.

Even with this recent expansion of authority, the SEC does not have the flexibility or the breadth of response in seeking or imposing civil money damages that a fellow regulator, the Commodity Futures Trading Commission (CFTC), does. By statute, the CFTC can assess a penalty of up to \$100,000 for each violation in a broad range of violative conduct, including the filing of false or misleading reports with the agency.

In a similar vein, the SEC appears to be disadvantaged in its limited fining capacity in comparison with several of the Self-Regulatory Organizations (SROs) that it oversees. The New York Stock Exchange, the American Stock Exchange, and the National Association of Securities Dealers all have the authority to tailor fines to fit a host of objectionable activities, whether after formal or summary disciplinary proceedings or in the context of a negotiated settlement. The continued absence of express fining authority for the SEC is an impediment that ought to be rectified.

The SEC on occasion has settled enforcement actions involving ancillary relief that impose, in effect, a fine. This relief has come in the form of disgorgement of the value of compensation received based on fraudulently reported earnings or profits. Yet the propriety and the extent of the ancillary relief a court can impose in injunctive actions remains a topic of continuing debate. Ancillary relief theoretically has been limited to remedial sanctions and has not extended to punitive sanctions such as fines. To remove any doubt as to its capacity to seek or impose fines in enforcement actions, the SEC should ask Congress to amend the securities laws to provide express fining authority.

Express fining authority also would enable the SEC to distinguish better among perpetrators of fraudulent financial reporting, imposing heavy fines, in addition to other sanctions, at one end of the spectrum, and imposing smaller fines in lieu of excessively harsh sanctions at the other end of the spectrum. Depriving perpetrators of fraudulent financial reporting of any ill-gotten gains would help to maintain public confidence in the integrity of the financial reporting process and the securities markets, to the same extent as do civil monetary penalties imposed on inside traders.

B. Cease and Desist Orders

Recommendation: *The SEC should have the authority to issue a cease and desist order when it finds a securities law violation.*

Cease and desist authority would permit the SEC to issue an administrative order, once a securities law violation is found. By issuing the order, the SEC could direct a person to refrain, or cease and

desist, from engaging in such conduct. The power to impose a cease and desist remedy would increase the SEC's flexibility in tailoring remedies to the circumstances of a case.

In most cases, a cease and desist proceeding would afford a milder remedy than a civil injunctive action, avoiding the harsh side-effects of an injunction, such as the statutory disqualification from serving as an officer or director of an investment company. Although a more measured response than civil injunction, the cease and desist remedy nonetheless would provide increased deterrence in at least two kinds of financial reporting cases: (1) cases in which the SEC lacks sufficient evidence to demonstrate a reasonable likelihood of future violations and (2) those in which the SEC might hesitate to pursue injunctive relief because the side-effects may seem too harsh and therefore inappropriate. As a further benefit, the cease and desist remedy would improve the ability of the public to distinguish degrees of culpability.

For the cease and desist remedy to be the effective sanction the Commission envisions, the SEC must ask Congress not merely for the power to exercise the remedy, but also for the authority to make the remedy truly meaningful. If a cease and desist order is violated, the SEC should have the right (1) to seek an order in federal district court commanding compliance and (2) to assess and collect an adequate civil money penalty for each day during which the violation or any action contributing to the violation continues.

Some have argued that cease and desist authority could encourage the SEC, on the one hand, to settle cases for too light a sanction or, on the other hand, to bring cases that have not been thoroughly considered because of the ease of obtaining a cease and desist order. SEC procedures and practice as well as continuing Congressional oversight make both fears unjustified. These internal and external safeguards ensure that the SEC would not use cease and desist authority in cases that otherwise would merit a civil injunctive action, but would instead use the authority to provide a strong sanction in cases that otherwise might not be brought. The creation of this remedy would thus add to, not detract from, the SEC's repertoire of enforcement remedies.

C. Bars or Suspensions From Serving as Corporate Officer or Director

Recommendation: *The SEC should seek explicit statutory authority to bar or suspend corporate officers and directors involved in fraudulent financial reporting from future service in that capacity in a public company.*

A Commission-sponsored study of the SEC's role in combatting fraudulent financial reporting found a widespread belief that stiffer penalties for corporate officers and directors involved in fraudulent financial reporting would be an effective deterrent. In considering enforcement proceedings against individual corporate officers or directors who aid and abet, cause, or participate in fraudulent financial reporting, the SEC therefore should consider whether to bar those individuals from future service in that capacity in a public company. The bar, which the SEC could tailor as appropriate to the case, could be either temporary, like a suspension, or permanent. The permanent bar would be appropriate if the violation were particularly egregious or the violator were a repeat offender.

The authority to bar or suspend would give the SEC a sanction to use when the five-year proxy statement disclosure of SEC enforcement action and the side-effects of a civil injunction would not be sufficient deterrents to possible involvement in future fraudulent financial reporting. In addition to affording the SEC a greater degree of flexibility in its enforcement response, this recommendation would stiffen sanctions against individual offenders.

Under these circumstances, affording the usual due process protections and rights of appeal for enforcement targets becomes even more important. Equally important to those who are barred or suspended would be review within the SEC to allow these disciplinary sanctions to be removed or modified after a reasonable interval, when the barred or suspended officer or director may petition to serve again with a public company.

The use of bars or suspensions is by no means uncharted or extreme. Other individuals who participate in the financial reporting process, notably independent public accountants, are subject to bars or suspensions. The SEC has already barred or suspended individual corporate officers in a number of settled cases involving repeat violators. The SEC also has become familiar with bars or suspensions by hearing appeals from proceedings in which these sanctions have been imposed by SROs under its supervision.

Furthermore, in a number of litigated cases the SEC has obtained many forms of ancillary relief that amounted to a *de facto* partial bar without using the actual term *bar*. Whether involving the judicial appointment of a "special agent," a "limited receiver," or the like, this ancillary relief barred directors and officers from performing functions and exercising powers contemplated by state law (including some related to financial reporting and the disclosure process) as effectively as if the court decree were labelled a partial bar.

In addition, the British Insolvency Act, recently enacted by Her Majesty's Government, provides for the disqualification of directors of insolvent companies who have been determined by a court to be unfit. Among the many grounds supporting a determination of unfitness are any misfeasance or breach of any fiduciary or other duty by the director in relation to the company. Once issued, the disqualification order would prohibit the disqualified director from direct or indirect involvement in the promotion, formation, or management of any company for a period of not less than two years. Under certain circumstances a person who violates a disqualification order could even be held personally liable for the debts of the insolvent company.

The SEC's limited use of the bar nonetheless has taken place in the context of settled, rather than litigated, cases. And the issue of the SEC's statutory authority to impose bars or suspensions has been the subject of extensive legal debate. In view of (1) the absence of express statutory authority or judicial approval and (2) the need for legislative action to give the SEC cease and desist authority and the power to impose fines, the Commission believes that the SEC should seek explicit statutory authority to bar or suspend corporate officers and directors.

As a further advantage, the Commission believes that these additional remedies of bar and suspension provide some assurance of a lessened likelihood of repeat violators. The SEC would not be limited to the difficult task of successfully bringing a criminal contempt proceeding for the violation of a previously entered court order of injunction. And availability of bar and suspension may help the SEC maximize the use of its resources—no insignificant factor in a time of budgetary restraint.

III. Increased Criminal Prosecution

Recommendation: *Criminal prosecution of fraudulent financial reporting cases should become a higher priority. The SEC should conduct an affirmative program to promote increased criminal prosecution of fraudulent financial reporting cases by educating and assisting government officials with criminal prosecution powers.*

Criminal prosecution in appropriate cases of fraudulent financial reporting should become a higher priority. Underlying this recommendation is the premise, basic to the Commission's entire report,

that fraudulent financial reporting is a significant problem that requires more attention from many constituencies, including regulatory and law enforcement agencies. The majority of respondents in an informal Commission survey among the members of the White Collar Crime Committee of the American Bar Association's Criminal Justice Section share this point of view.

Furthermore, although the SEC should increase the number of administrative and civil proceedings it brings and the severity of the sanctions it seeks in cases involving fraudulent financial reporting, these measures alone cannot provide the degree of deterrence that is needed to protect against fraudulent financial reporting. The SEC has the primary responsibility for enforcing the federal securities laws, but it does not have the authority to bring criminal actions. The Department of Justice is the only body authorized to do so. The SEC is authorized, however, to transmit evidence to the United States Attorney General, who has the discretion to institute criminal proceedings. The SEC can and does assist the Department of Justice and the U.S. Attorneys by discussing with them cases that may be of interest, providing access to investigative files, and providing SEC personnel familiar with the case to assist in presenting it to a grand jury or at trial. The overwhelming majority of respondents in a study performed for the Commission found criminal referrals to the Justice Department or state prosecutors' offices to be an effective enforcement activity.

To increase criminal proceedings for fraudulent financial reporting, the SEC should undertake an organized, affirmative program to educate government officials who have criminal prosecution powers about the seriousness of the crime of fraudulent financial reporting, thus encouraging them to take a greater interest in fraudulent financial reporting cases. This program also should ensure coordination, cooperation, and whatever other assistance the SEC believes necessary to promote increased criminal prosecution.

IV. Improved Regulation of the Public Accounting Profession

Since the effectiveness of an audit in detecting fraudulent financial reporting is related directly to the quality of that audit, the importance of audit quality to the financial reporting process cannot be overstated. For this reason, the accounting profession is subject to extensive regulation to ensure that independent public accountants provide reliable accounting and auditing services. An important aspect of the Commission's deliberations has been to assess whether this regulation is sufficient or whether additional regulation, particularly in the form of a separate statutory SRO, is needed to ensure audit quality.

To answer these questions, the Commission applied a functional analysis to the issue of regulation and oversight of the public accounting profession. The Commission's conclusion after performing this analysis is that the existing framework of regulation and oversight is preferable to the establishment of a separate statutory SRO. This position is premised on the assumption that the Commission's recommendations for improvements in the existing framework—mandatory quality assurance and peer review and meaningful sanctions through SEC enforcement—will be implemented or that these necessary elements will otherwise be added to the present system.

In formulating its final recommendations, the Commission considered the SEC's recent proposal for a mandatory peer review requirement and public comment in response to that proposal. Although there are differences between the SEC's proposal and the Commission's recommendation, the Commission believes that it shares with the SEC a fundamental agreement in objectives. Peer review contributes to the improvement of the quality of audits, which in turn improves the reliability of financial statements prepared by public companies.

To set the context for the Commission's recommendations and analysis, a brief but more detailed overview of the existing framework than appeared earlier in Chapter One is in order.

A. Overview of Existing Regulatory Framework

The existing regulation of the accounting profession is complex. It is a process directed to independent public accountants as well as to the public accounting firms to which they may belong. Further, different parties carry the regulation out at different levels.

1. Regulation of Independent Public Accountants

Independent public accountants are licensed as individuals by state boards of accountancy and must meet minimum educational requirements and pass a rigorous qualifying examination developed by the AICPA to be eligible to practice. Applicants for the CPA license also are generally required to (1) have experience in the practice of accounting, (2) show evidence of moral character, and (3) undertake continuing professional education.

In addition, all 50 states and 4 other jurisdictions have accountancy laws governing the practice of independent public accountants in their jurisdictions. Among other requirements, these laws require adherence during the course of an audit engagement with Generally Accepted Auditing Standards (GAAS) as developed by the AICPA's Auditing Standards Board (ASB). State boards of accountancy established pursuant to these laws generally have authority to discipline independent public accountants who deviate from GAAS or otherwise fail to meet the legal requirements of practice. The sanctions imposed may include the suspension or revocation of a license to practice.

Over and above regulation by their respective states, independent public accountants face other government action addressed to audit quality. At the federal level the SEC is responsible for overseeing and then enforcing regulations that affect the independent public accountants of public companies. In addition, civil or criminal suits in federal and state courts help to ensure audit quality. Depending on the judicial forum and the factual context, independent public accountants who fail to comply with GAAS can face liability for damages, fines, or other civil or criminal sanctions. Court decisions also affect the duty of care independent public accountants owe to clients or third-party users of audited financial statements.

Furthermore, independent public accountants are subject as individuals to additional oversight outside of government. While the AICPA is a totally voluntary organization, most independent public accountants are members and, as such, must abide by its code of professional ethics, which imposes requirements relating to independence, integrity, and objectivity as well as to compliance with GAAS. The AICPA monitors and promotes adherence to the code and publicly identifies its members who violate the code.

Finally, many independent public accountants are subject to internal quality controls and other programs established by public accounting firms. These firms often are the first line of defense against unsatisfactory audit practice. Their internal systems of quality control ensure compliance with professional standards, SEC rules, and other legal requirements. As part of their quality control efforts, the firms conduct periodic inspections to monitor compliance with performance standards. They also may take disciplinary and remedial steps against partners and staff members who are found to perform substandard work.

2. Regulation of Public Accounting Firms

A system of regulation and oversight also exists at the firm level. A significant component in this system is the AICPA's Division for CPA Firms, which was created in 1977 in response to concerns by Congress and the SEC about regulation and oversight of the accounting profession. The Division consists of two sections, an SEC Practice Section (SECPS) and a Private Companies Practice Section. Membership in the Division and either, or both, of these two sections is voluntary. Firms that join commit themselves to the requirements set by each section, including peer review and continuing professional education, and to the quality control standards enunciated by the AICPA covering accounting and auditing practice.

In addition to the general quality control standards imposed by membership in the Division for CPA Firms, firms who join the SECPS agree to (1) perform concurring, or second partner, reviews of the audits of SEC registrants, (2) rotate partners in charge of such audits every 7 years, (3) file reports of key firm data annually with the AICPA, (4) report to the SECPS's Special Investigations Committee (SIC) any litigation (including criminal indictments) against the firm or its personnel or any proceeding or investigation publicly announced by a regulatory agency alleging audit failure with respect to a public company, (5) report serious disagreements with a client's management to the board of directors of the client, and (6) accept penalties imposed by the executive committee for noncompliance with membership requirements.

The thrust of the regulation and oversight by the AICPA's Division for CPA Firms is preventive and remedial rather than punitive. It focuses on strengthening systems of quality control and improving the performance of member firms through peer reviews that evaluate compliance with membership requirements.

The Public Oversight Board (POB) closely oversees all the activities of the SECPS, including the SIC process and peer review. Composed primarily of nonaccountants, the POB is a fully independent body that nominates its own successors, selects its own chairman, and sets its own compensation. Because it also has its own staff, the POB can systematically monitor all phases of the peer review program through observation of fieldwork, review of peer review workpapers, and attendance at exit conferences. This combination of independence and "hands on" oversight enables the POB to uphold the public interest and to make meaningful recommendations for improvements in the SECPS's operations.

The SEC, in turn, maintains liaisons with and monitors the POB. Moreover, the SEC independently evaluates the Division's peer review process as it affects the independent public accountants who audit SEC registrants. The SEC also receives certain information from the SIC concerning its closed investigations. The extent of access to the SIC's working papers and files, however, remains an open issue between the Division and the SEC.

In addition to the regulation provided by the Division, the government also directly oversees public accounting firms. The SEC and many state boards of accountancy have the authority to impose fines or other sanctions against firms when audit failure results from a systemic breakdown in quality control. Courts also impose significant damages against public accounting firms found negligent in professional liability lawsuits.

B. The Commission's Observations

To be effective, regulation of the public accounting profession must consist of four major components: (1) it must have the ability to set professional standards; (2) it must monitor compliance with those standards; (3) it must be applicable to all independent public accountants or all public

accounting firms that audit public companies; and (4) it must have the capacity to enforce its standards in a meaningful fashion.

The Commission finds that most of these components exist within the present regulatory framework and that they are functioning well and as intended. The Commission applauds, for example, the role the ASB plays in establishing professional standards. In addition, the Commission believes the role the Division for CPA Firms plays through its peer review process is directly responsible for a significant increase in the quality of audits. A recent example of the continuing effort to improve audit quality is the new SECPS membership requirement that significantly expanded required communications with a client's audit committee or board of directors. The Commission's recommendations in Chapter Three relating to the ASB and the SECPS simply are designed to make them more effective. The contributions of the SEC through its oversight of existing regulatory efforts by the private sector and its own standard-setting and enforcement activities have already been noted.

Nonetheless, the Commission's functional analysis reveals that several necessary components for effective regulation are missing under the existing system. To provide these missing components, the Commission considered but dismissed the possibility of replacing the existing private-sector regulation with direct government regulation of independent public accountants.

Because most of the necessary components for effective regulation already exist and are functioning well, a proposal for deeper, across-the-board involvement by government in the public accounting profession seems of doubtful merit. The efforts by the ASB and the AICPA's Division for CPA Firms demonstrate that the public accounting profession can work to protect the public interest and still be sensitive to the needs of independent public accountants and their firms. Taxpayers would bear the cost of any scheme of direct government regulation. Moreover, direct government regulation of the independent public accountants of public companies would not necessarily result in increased public protection or improved audit quality.

The Commission studied whether a statutory SRO should be established or whether the existing regulatory framework could be adjusted to achieve all the necessary components of effective regulation. The Commission found that in many areas an SRO would only duplicate functions that the present system performs quite well and that such duplication would not be cost-effective. Alternatively, the present system could be dismantled to provide for an SRO that executes all necessary regulatory functions. Against this alternative, however, is the risk that an SRO might not perform its regulatory functions as effectively.

The Commission believes that the present framework is flexible enough to accommodate all the components necessary for effective regulation, if the two recommendations that follow are implemented. The present framework, as modified by these recommendations, would be preferable to both direct governmental regulation and a statutory SRO. The Commission concluded that improving the existing framework offers the best alternative for effective regulation, because, among the three options considered, it is by far the least intrusive and least costly, without sacrificing audit quality assurance or protection of the public interest.

Professional Organization Membership

Recommendation: *The SEC should require all public accounting firms that audit public companies to be members of a professional organization that has peer review and independent oversight functions and is approved by the SEC, such as that specified by the SECPS of the AICPA's Division for CPA Firms.*

With respect to the first component needed for effective regulation—setting standards—the Commission has noted that both the ASB and the public accounting profession's existing quality

assurance program are executing this function effectively and should continue their activities in this area. Similarly, with respect to the second regulatory component—monitoring compliance with standards—the Commission has mentioned the effectiveness of the SECPS of the AICPA’s Division for CPA Firms, which is overseen by the POB and includes the SIC. The Commission concurs with the POB that the quality assurance program of the SECPS continues to be an important force in improving the quality of audit practice.

A significant deficiency exists, however, under the current regulatory framework with respect to the third component—applicability to all public accounting firms that audit public companies. Firms that do not want to comply with the public accounting profession’s quality assurance program are free to avoid it simply by not joining the SECPS. Accordingly, an SEC rule to mandate membership in a professional quality assurance program is required to achieve this missing component.

In addition, such a rule is necessary to implement the provisions of the federal securities laws. The quality of audit practice is related directly to the prevention, detection, and deterrence of fraudulent financial reporting. The Commission’s research demonstrated an unacceptably higher incidence of failure to detect fraudulent financial reporting by independent public accountants whose firms were not members of the SECPS. In view of the public trust placed in the independent public accountant, mandatory membership is essential to ensure that the independent public accountant has the requisite professional qualifications to represent a public company by auditing its financial statements and opining thereon in public disclosure documents.

The Commission’s study of a professional quality assurance program focused on the program sponsored by the AICPA’s Division for CPA Firms because it is the only established program with a substantial track record and experience. The Commission’s recommendation in support of mandatory membership in a quality assurance program nonetheless is not intended to preclude the development of other programs. As long as the functions vital to ensure audit quality are performed (that is, that the program has peer review and independent oversight functions and is approved by the SEC), the objective of the Commission’s recommendation would be met.

Enforcement

Recommendation: *The SEC should take enforcement action when a public accounting firm fails to remedy deficiencies cited by the public accounting profession’s quality assurance program.*

The fourth vital regulatory ingredient—enforcement with meaningful sanctions—exists under the current framework, but it should be broadened to include the threat of public sanctions. Under the current regulatory system, the AICPA’s Division for CPA Firms is geared toward remedial rather than punitive action. Members who fail to comply with membership requirements or to respond satisfactorily to peer review comments generally incur no substantive punitive measures for even the most egregious violations. The Division’s major punitive measure or threat of punishment, expulsion or threat of expulsion from a voluntary program, would no longer be available if membership is mandatory. Accordingly, if the public accounting profession’s quality assurance efforts are to work, credible enforcement must occur. The SEC can and should provide this function. SEC enforcement actions to reinforce the public accounting profession’s quality assurance program could take place within existing procedures, but any exercise of agency authority should be designed to preserve those fundamental safeguards which should be built into any system of mandatory peer review. Implicit in the notion of an SEC rule requiring membership in a

professional quality assurance program is compliance with that program's standards and requirements. Thus failure to remedy cited deficiencies would constitute violation of an SEC rule.

The SEC's long-standing rule for disciplining professionals who practice before the agency, Rule 2(e), includes as a basis for disciplinary action finding a person "not to possess the requisite qualifications to represent others." A finding of noncompliance with the requirements of the public accounting profession's quality assurance program, after the Rule's standard notice and opportunity for hearing, would mean a lack of "the requisite qualification to represent others" within the meaning of Rule 2(e).

The Rule 2(e) proceeding then would allow the SEC to impose a meaningful sanction: temporary or permanent denial of the privilege of performing audits of public companies for the inclusion of an audit report in public disclosure documents. Within this general sanction, the SEC has the ability to fashion appropriate sanctions not unlike those which the securities industry's independent SROs impose on broker-dealers.

For SEC enforcement of the public accounting profession's quality assurance program to take place within existing procedures, the SEC would have to be aware of any slippage in the quality of the peer review process. Accordingly, the SEC should continue to monitor and maintain liaisons with the public accounting profession's quality assurance program. In addition, the SECPS should inform the SEC of firms that fail to remedy deficiencies cited in a peer review pursuant to the quality assurance program.

V. SEC Resources

Recommendation: *The SEC must be given adequate resources to perform existing and additional functions that help prevent, detect, and deter fraudulent financial reporting.*

The SEC's resources should be adequate to enable the SEC to perform effectively the further functions the Commission recommends, in addition to its existing functions. In particular, the SEC should have adequate resources to enforce the public accounting profession's quality assurance standards, an additional function that would obviate the need for a separate, ultimately more costly, SRO.

The SEC's existing functions include not only enforcement, but also oversight and surveillance of financial reporting through the interpretation of standards and rules and the review of filings. The sheer volume of new issues and other pressures has inevitably led to a reduction in the review function.

Adequate resources should extend beyond funding to salary and grade-level mechanisms that would enable the SEC to attract and retain highly qualified personnel. The Commission is encouraged that the SEC has requested a budget increase of approximately \$30 million, a rise in excess of 26 percent.

VI. Financial Institution Regulatory Agencies

Recommendation: *The Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (including the Federal Savings and Loan Insurance Corporation) should adopt measures patterned on the Commission's recommendations directed to the SEC to carry out their own regulatory responsibility relating to financial reporting under the federal securities laws.*

The primary focus of the Commission's recommendations for federal regulatory agency action is the SEC. That agency has primary responsibility for administering and enforcing the federal securities laws. Where the public entity is a bank, savings and loan, or other financial institution, this responsibility belongs to, or may be divided among, a number of other federal agencies.

Because fraudulent financial reporting has occurred in public companies that report to regulators other than the SEC, all regulatory agencies with responsibility for the federal securities laws should adopt regulatory measures patterned on the Commission's recommendations calling for SEC action. Thus the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board (including the Federal Savings and Loan Insurance Corporation) should:

- Adopt rules, or if necessary seek legislation, to implement the recommendations for public companies that appear in Chapter Two.
- Enhance enforcement efforts to provide a stronger deterrent to fraudulent financial reporting, including, if necessary, seeking additional sanctions and powers from Congress.
- Join the SEC and the Department of Justice in their program to increase criminal prosecutions for fraudulent financial reporting.

The Commission concludes that the financial institution regulatory agencies need not duplicate its recommendations to the SEC regarding regulation of the public accounting profession, namely required membership in a professional quality assurance program and SEC enforcement of the program's quality assurance standards. This part of the regulatory system would be missing only in the case of a public accounting firm whose public company audit clients are exclusively financial institutions that do not report to the SEC. Accordingly, the other regulatory agencies and the accounting profession should monitor this area and make adjustments in the future if this gap begins to become serious.

Access to Information

Recommendation: *The financial institution regulatory agencies and the public accounting profession should provide for the regulatory examiner and the independent public accountant to have mutual access to information they develop about examined financial institutions.*

If regulatory examiners of financial institutions and independent public accountants provide each other access to information they develop about financial institutions, they will improve the ability of both parties to perform their duties, thus helping to prevent and detect fraudulent financial reporting. A financial institution, for example, should give its independent public accountant access to the regulatory examiner's report; the independent public accountant should give bank examiners access to his letter to management and management's response.

When the regulatory examiner's and the independent public accountant's examinations of the financial institution are concurrent, each should provide the other with relevant information during the examination. This information may include information, for example, about questionable loans and policies that may indicate the likelihood of fraudulent financial reporting.

The Commission is confident that the public accounting profession and the financial institution regulatory agencies can make arrangements for information access that satisfactorily address any issues raised, such as client confidentiality. The Commission commends the public accounting profession and the financial institution regulatory agencies for their efforts to date to provide access to information after completion of examinations. The Commission encourages the public accounting profession and the financial institution regulatory agencies to broaden these efforts, by providing each other access to information during concurrent examinations and by otherwise continuing to explore ways that mutual access to information can help to reduce the likelihood of fraudulent financial reporting.

The concept of sharing information should be applied throughout government, wherever there are regulated industries and the regulatory examiners normally conduct examinations of financial information.

VII. Enhanced Enforcement by State Boards of Accountancy

Recommendation: *State boards of accountancy should implement positive enforcement programs that periodically would review the quality of services that the independent public accountants they license render.*

To a significant degree, as this chapter noted earlier, state laws and state government agencies govern the regulation of public accountancy. State boards of accountancy (or equivalent government agencies) have been established by statute in all 50 states (as well as in four other jurisdictions) to administer state laws governing various aspects of the public accounting profession, such as certification, licensing, professional conduct, and continuing professional education. State boards are in fact the only entities that, taken together, have jurisdiction over all who are licensed to practice public accountancy in the United States. Because of this unique jurisdictional mandate and the ultimate sanctioning authority that goes with it, state boards can play a critical role in assuring the public that the independent public accountants whom they have licensed are continuing to provide competent service.

Some states have taken genuine strides to meet this challenge. A growing number of states are experimenting with positive enforcement programs, in addition to maintaining the complaint-based system of enforcement and discipline under which state boards traditionally have operated. Positive enforcement programs require state boards to adopt a regulatory approach that is proactive. These programs periodically monitor the work of all licensees on a uniform or random basis, and a concerted effort is made to uncover substandard practice that has not been the subject of formal complaint. The aim of positive enforcement programs appears to be primarily preventive and rehabilitative, but a broad range of disciplinary measures also must be available and imposed, if warranted.

By contrast, in the jurisdictions that still adhere exclusively to a complaint-based system, state boards of accountancy remain reactive bodies; their disciplinary and enforcement machinery can be set into motion only through formal complaints about audit quality. Relatively few complaints about substandard work ever surface, and cases involving substandard work tend not to draw the strongest sanctions.

Because a majority of all state boards has not adopted positive enforcement programs, much more remains to be done to promote and develop these programs. The commendable campaign by the National Association of the State Boards of Accountancy, a voluntary federation of state boards, is in the right direction. In the final analysis, however, the creation and the support of such programs require a state-by-state commitment by governors, legislatures, and boards of accountancy in jurisdictions that lack positive enforcement programs.

Jurisdictions that have successfully implemented positive enforcement programs demonstrate that state regulatory systems can work if they receive the appropriate levels of authority and direction from government and support from the public accounting profession and the public at large. Effective state regulation would give added assurance that all independent public accountants are fulfilling their public trust to render accounting and auditing services that are truly professional. That assurance could in turn go a long way toward deterring fraudulent financial reporting.

VIII. Current Legal Climate

The national crisis of liability and insurance, and the various tort reform initiatives to address this perceived crisis, go beyond the mandate and the ability of this Commission to resolve. At the same time, however, the Commission is aware of the legal climate in which the participants in the financial reporting process operate today. The liability to which individuals, particularly officers and directors and independent public accountants, are subject is related to fraudulent financial reporting, and this relationship may need to be reexamined.

Traditionally, individual liability for violations of the disclosure provisions of the federal securities laws has been viewed as being a discipline that is necessary to the integrity of the disclosure process which those laws mandate. In fact, potential legal liability for negligence to private parties who suffer damages has long been considered the most effective mechanism for assuring that independent public accountants perform their public responsibilities competently and diligently. By supplementing the government's limited law enforcement resources, private parties who bring lawsuits as "private attorneys-general" provide an incentive for independent public accountants and corporate officers and directors to serve responsibly.

In recent years, however, concerns have been expressed that potential private liability under the current tort system has become excessive. While this argument has been made in the past, it may bear heeding now. The Commission is concerned that private liability may have reached a level at which it no longer adds to the quality of financial reporting and corporate disclosure generally.

Considering the Implications of Liability on Audit Quality

Recommendation: *Parties charged with responding to various tort reform initiatives should consider the implications that the perceived liability crisis holds for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting.*

The expansion of the independent public accountant's liability in recent years has promoted a dramatic increase in the number and the size of legal claims, which in turn have contributed to an increasingly unstable insurance market. These developments are jeopardizing the public accounting profession's ability to attract and retain high-caliber professionals and its future economic viability. To the extent that the perceived liability and insurance crisis makes recruiting and retaining professionals more difficult, it may have a long-term detrimental effect on audit quality. In addition, liability concerns have a direct relationship with the public accounting profession's willingness to assume greater responsibility for detecting fraudulent financial reporting.

Accordingly, while the Commission would be concerned if shareholders' rights were unduly restricted and takes no position on any of the public accounting profession's specific proposals for legislative reform of the tort system, it urges those who do so to consider the implications for long-term audit quality and the detection by the independent public accountant of fraudulent financial reporting.

Reconsidering Corporate Indemnification

Recommendation: *The SEC should reconsider its long-standing position, insofar as it applies to independent directors, that the corporate indemnification of officers and directors for liabilities that arise under the Securities Act of 1933 is against public policy and therefore unenforceable.*

The perceived crisis of liability and the difficulties in obtaining directors' and officers' ("D&O") insurance have been widely reported from the perspective of corporate management and well-documented in the press. This aspect of the perceived liability crisis also could affect financial reporting adversely.

The implications of the liability crisis for recruiting qualified independent directors, particularly those who are to serve on audit committees of public companies, concern the Commission greatly. As the Commission stressed in Chapter Two, independent directors are necessary components of an effective audit committee, which in turn is a key to preventing fraudulent financial reporting. Since the factors are interrelated, balance is essential. If concerns about personal liability exceed their traditional role as a necessary discipline and begin to jeopardize the essential contribution of independent directors, the SEC should reconsider its long-standing position that the corporate indemnification of directors for liabilities arising under the Securities Act of 1933 is against public policy and therefore unenforceable. If certain limited indemnification, particularly of independent directors, helps companies recruit and retain highly qualified directors, its benefits may well outweigh the public policy issue underlying the SEC's traditional stand.

More than a half-dozen states have responded with legislation to reduce the pressures corporations face as a result of the D&O liability crisis. The legislative initiatives include measures, for example, to limit the liability of directors and to broaden the indemnification that a corporation may offer its directors and officers.

One state, Delaware, now permits companies to limit or even eliminate their directors' financial liability for a breach of the duty of care but leaves director liability intact in cases of disloyalty, bad faith, or misconduct. In derivative actions (a suit by a shareholder to enforce a corporate cause of action), Delaware has chosen to limit indemnification to expenses, taking a somewhat more conservative approach than that of many recent initiatives. On the other hand, in the nonderivative area, most of the new legislation mirrors Delaware's recent statute that allows a corporation to indemnify its directors and officers for expenses, judgments, fines and settlement, if certain criteria are met. States that have not acted face pressures similar to those faced by states that have acted, and so the Commission expects the initiatives mentioned here to be part of a continuing trend.

To help address both the liability that exists and the difficulties in obtaining D&O insurance, the Commission offers Good Practice Guidelines for the Audit Committee, which appear in Appendix I.

Chapter Five

RECOMMENDATIONS FOR EDUCATION

I. The Role of Education in Preparing Participants in the Financial Reporting System

Participants in the financial reporting system must first understand the multidimensional nature of fraudulent financial reporting to be able to address it with appropriate responses. Their knowledge, skills, and ethical values—gained through education—must be commensurate with this challenge.

The process of educating present and future participants in the financial reporting system can take place in the undergraduate and graduate business school classroom, in continuing education programs, or through on-the-job training or experience. In all these settings the participants should be exposed to the knowledge, the skills, and the ethical values that potentially may help them prevent, detect, and deter fraudulent financial reporting. Through this process, education and educators can have an especially important positive influence on the financial reporting system.

This chapter presents the Commission's recommendations that are designed to help make present and future participants in the financial reporting process better informed about fraudulent financial reporting and better prepared to prevent, detect, and deter it. The next section presents recommendations for improving today's business and accounting curricula. Because the American Assembly of Collegiate Schools of Business (AACSB), which accredits these academic programs, is one of the most important influences on the content and the structure of business and accounting curricula, it should consider how best to reflect these recommendations in its accreditation standards. Although the recommendations presented here are targeted to the undergraduate and graduate school curricula, educators can and should adapt them to appropriate aspects of the law school curriculum.

The Commission then offers its observations about recent calls for expanding the accounting curriculum. The following section presents the Commission's recommendations for professional certification examinations for accountants. In the subsequent section the Commission recommends improvements in continuing professional education for accountants. Finally, the last section discusses opportunities within the public company for educating management and other employees about the risk of fraudulent financial reporting and measures required to reduce its incidence.

II. Business and Accounting Curricula

The Commission endorses recent calls for additional liberal arts requirements in the business and accounting curricula, to serve as a strong foundation on which to build additional knowledge, skills, and values. The National Institute of Education, the Association of American Colleges, and the American Accounting Association each have recommended increasing the curricula's emphasis on analytical and problem-solving skills, ethical values, and historical and cultural awareness—all benefits of liberal arts studies and useful groundwork for future participants in the financial reporting process.

As tomorrow's top corporate managers and partners of public accounting firms, today's business and accounting students will be responsible and accountable for the financial reporting process on which the capital and credit markets depend. The Commission's recommendations in this chapter are designed to reinforce and supplement the foundation of liberal arts studies and thereby help students deal with the forces and the opportunities they will encounter in business that may contribute to fraudulent financial reporting. Rigorous and thorough academic preparation will not only help today's students advance to leadership positions in companies and public accounting firms, it also will help them face the challenge of preventing, detecting, and deterring fraudulent financial reporting more successfully.

Accordingly, the business and accounting curricula should examine fraudulent financial reporting in depth, highlighting ethical, analytical, and judgmental considerations. Because of the complex nature of this type of fraud and of every strategy aimed at its reduction, faculty should teach its nature and possible solutions throughout such curricula. Limiting students' exposure to the problem of fraudulent financial reporting to a single course on ethics is simply not enough.

Curriculum-wide Exposure to Fraudulent Financial Reporting

Recommendation: *Throughout the business and accounting curricula, educators should foster knowledge and understanding of the factors that may cause fraudulent financial reporting and the strategies that can lead to a reduction in its incidence.*

When a Commission-sponsored survey sampled accounting and auditing textbooks, it found little to no discussion of fraudulent financial reporting. The fact that students lack an adequate understanding of this fraudulent activity and a sensitivity to the forces and opportunities that may contribute to it is therefore not surprising. The serious nature of fraudulent financial reporting warrants a change in this situation.

Throughout their studies, business and accounting students should receive sufficient exposure to the problem of fraudulent financial reporting, including its causes, its widespread impact, and the practical, cost-effective responses that participants in the financial reporting system can and should undertake. In addition, these students should examine the complex management and professional issues that surround fraudulent financial reporting.

Many opportunities for discussing the topic of fraudulent financial reporting occur throughout the entire curricula. Management courses, for example, are a natural setting for examining the oversight functions of the audit committee and the critical importance of the ethical tone set by top management. To show management's effect on the corporate environment, these courses also should look at how management sets company goals and how it uses reward, feedback, and support systems to motivate personnel to achieve those goals. Finance classes should stress the ethical and the economic underpinnings of full and fair disclosure that govern access to public funds through capital and credit markets. The risks of fraud that management by objectives, decentralized operations, incentive compensation plans, and top-down profit planning may pose are appropriate topics for cost and managerial accounting classes to discuss. Business law courses should include securities law, demonstrating how fraudulent financial reporting violates the law and how the regulatory and law enforcement system operates to prevent, detect, and deter reporting violations.

Elsewhere in the curricula, systems classes should address risks of fraudulent financial reporting introduced by complex information systems, and such classes should, for example, cover internal controls. Auditing classes should emphasize the use of analytical review techniques and the need for healthy skepticism. In addition, behavioral courses should analyze how forces and opportu-

nities at various levels of the organization encourage misleading financial reporting and how the corporation can help individuals cope with them.

Their academic training should give business and accounting students a solid understanding of fraudulent financial reporting and the awareness that the problem has no quick, simple, or final solution. Since the complex nature of fraudulent financial reporting will continue to evolve, the problem will require periodic, if not continual, reexamination. Educators should encourage students to make this reexamination part of their continuing education.

Better Understanding of Internal Controls

Recommendation: *The business and accounting curricula should promote a better understanding of the function and the importance of internal controls, including the control environment, in preventing, detecting, and deterring fraudulent financial reporting.*

In Chapter Two and throughout this report, the Commission has stressed the importance of strong internal controls, broader than internal *accounting* controls. In addition to providing a first line of defense against fraudulent financial reporting, internal controls make good business sense. Nevertheless, many business and accounting curricula do not highlight internal controls. In particular, they pass lightly over the broad controls that constitute the control environment, such as the code of corporate conduct, the internal audit function, and the audit committee of the board of directors. Coverage of the powerful influence that top management exerts on the control environment has been especially inadequate.

Furthermore, advances in computer technology, systems development, and data processing have heightened the need for teaching students about internal controls, including the control environment. These advances rapidly have transformed the financial reporting process. Accordingly, students majoring in accounting or business, who will graduate with a greater understanding of data processing concepts than that of their predecessors, also require an understanding of the heightened internal controls and security required in computer-based environments. Curricula that emphasize the importance of internal controls will help students become better prepared participants in the financial reporting process.

Knowledge of Regulation and Law Enforcement

Recommendation: *Business and accounting students should be well-informed about the regulation and enforcement activities by which government and private bodies safeguard the financial reporting system and thereby protect the public interest.*

The business and accounting curricula should inform students about the regulatory and law enforcement framework so that students develop a clear understanding of the responsibilities and the functions of federal and state agencies, courts, Self-Regulatory Organizations (SROs), other private bodies, and professional organizations and of how they interact. Students also should develop an appreciation of how the public trust is invoked when a company solicits and operates with funds from public investors or when an independent public accountant audits a public company. They must understand their own legal and professional obligations to maintain this public trust as well as the consequences of failing to do so.

Developing the Necessary Skills

Recommendation: *The business and accounting curricula should help students develop stronger analytical, problem solving, and judgment skills to help prevent, detect, and deter fraudulent financial reporting when they become participants in the financial reporting process.*

Managing a corporation well and serving as a chief financial officer, internal auditor, or independent public accountant requires good judgment, the ability to reason analytically, and the ability to solve problems. Preventing, detecting, and deterring fraudulent financial reporting require similar skills. The lack of these skills can contribute to fraudulent financial reporting. In fact, many instances of fraudulent financial reporting that the Commission reviewed went undetected for some time because of faulty judgment or inadequate analytical reasoning on the part of the participants in the financial reporting process.

Also, fraudulent financial reporting and its cover-up generally involve an unusual set of circumstances: a unique combination of forces and opportunities conducive to such fraud, whether the fraudulent scheme involves inappropriate revenue recognition, overstatement of assets, override of controls, or collusion. Frequently, those who are in a position to prevent, detect, or deter the fraudulent action do not contemplate or foresee the risks of the specific set of circumstances.

Overemphasizing course content and exposing students only to simple factual case histories, which can prevent them from developing the ability to use analytical and problem-solving skills and to make sound judgments in unusual, demanding circumstances, are some of the pitfalls to which educators are prone in their attempts to improve students' thinking and judgment skills. Educators should recognize these obstacles and attempt to redress the imbalance by stressing analysis and judgment as well as problem solving. The business and accounting curricula should help students develop good judgment and analytical thinking skills and the ability to confront novel situations in a company's financial reporting process, especially if those situations involve warning signs or red flags.

Emphasizing Ethics

Recommendation: *The business and accounting curricula should emphasize ethical values by integrating their development with the acquisition of knowledge and skills to help prevent, detect, and deter fraudulent financial reporting.*

The business and accounting curricula have given too little attention to the ethics of financial reporting. Restricting coverage of ethics issues to an elective course near the end of the formal education process is too little and too late. The Commission recommends that the curricula emphasize ethics issues, integrating them with the coverage of technical information and the development of skills to help prevent, detect, and deter fraudulent financial reporting.

This goal is difficult to accomplish. It requires the interest and involvement of business school faculty from all areas of concentration. Attention to ethics issues must permeate the curricula, with ethical inquiry an expected part of any analysis of a business or accounting case study. Current business events also can offer opportunities for classroom discussions of ethics issues.

In the typical accounting curriculum, however, the only ethics study takes place in the auditing course, where it usually amounts to no more than a procedure-based, one-class discussion of the AICPA's Rules of Conduct. Because the AICPA's Rules form the basis for disciplinary action, discussions of them tend to be narrowly focused. Unfortunately, the level of ethical inquiry is also

minimal in the business curriculum and again frequently limited to a single course. Such inadequate coverage of ethics issues can send an unintended message to students that ethics is of secondary importance.

The independent public accountant's responsibility and accountability to the public requires a much broader exposure to ethics. Business schools should include ethics discussions in every accounting course. Students should study codes of corporate conduct and other ethics codes such as those promulgated by the National Association of Accountants, the Institute of Internal Auditors, and the Financial Executives Institute, in addition to the AICPA's Rules of Conduct. At a minimum, because all business majors are required to take some accounting, treatment of ethics issues throughout the accounting curriculum would expose every business graduate to at least some ethical inquiry concerning the financial reporting process. Yet ethics ideally should be a part of all business courses.

Faculty Development and Classroom Materials

Recommendation: *Business schools should encourage business and accounting faculty to develop their own personal competence as well as classroom materials for conveying information, skills, and ethical values that can help prevent, detect, and deter fraudulent financial reporting. Business school faculty reward systems should recognize and reward the contribution of faculty who develop such competence and materials.*

The most serious deficiency in attempts to improve the business curriculum along the lines the Commission recommends is the lack of relevant classroom discussions of real situations and of challenging classroom materials. The Commission recommends that business schools encourage faculty members to develop their own competence and to produce classroom materials that help students understand fraudulent financial reporting.

There is no substitute for business and professional experience in contributing insight and information to classroom analyses and discussions of cases of fraudulent financial reporting. Business faculty members should therefore—with the business schools' support—gain actual work experience in a corporate setting directly relating to their area of academic expertise. Furthermore, business schools should bring executives and professional accountants into the classroom through guest lectures, part-time residence programs, and part- and full-time faculty appointments on a permanent or temporary basis. Interaction between academia and the marketplace would bridge the gap between the academic and commercial worlds and add more reality to case studies of fraudulent financial reporting.

Support for developing materials based on actual incidents of fraudulent financial reporting can come in several forms. Case-writing workshops, such as those the Decision Sciences Institute sponsors, and a central registry or clearinghouse for existing case studies would foster support within academia for writing cases. Financial support from companies, private institutions and foundations, professional organizations, and public accounting firms would enable faculty to develop new materials.

Educators need access to information on actual incidents of fraudulent financial reporting to be able to help their students understand why and how this type of fraud occurs. Corporate executives, internal auditors, independent public accountants, and regulatory and law enforcement officials therefore should make every effort to grant this access and support the dissemination of information about these incidents.

Appendix E presents, as examples of the kinds of cases that business school faculty should develop, two cases developed as part of the Commission's research effort. Each case is based on knowledge of actual situations involving public companies, although the facts have been altered and any resemblance to real people or events is unintentional. These cases have been tested successfully with mixed groups of corporate executives and other professionals, including independent public accountants, attorneys, and securities analysts as well as students.

Developing materials like these would have many benefits. Students respond favorably to learning situations that reflect real life. Their enthusiasm in turn would inspire the faculty to increase their efforts to help students understand fraudulent financial reporting and the appropriate responses to it. In sum, business schools should create a learning environment in which the importance of effective controls, high ethical standards, good judgment and analytical skills, and a concern for the public interest are communicated effectively.

Encouraging faculty to develop improved classroom materials and their own personal competence will require additional incentives in business school faculty reward systems. The faculty reward system should be flexible, recognizing relevant practical work experience, case writing, and professional service that ultimately enhances the education of future participants in the financial reporting process.

III. Five-Year Accounting Programs

The need to expand undergraduate accounting curricula from 4 to 5 years has been a frequent topic of discussion in recent years. The American Accounting Association (AAA) and the American Institute of Certified Public Accountants (AICPA) have supported this expansion, and some universities now require 5 years of study for accounting majors. While discussion about this proposed curriculum change is best left to these and other professional groups, such as the Financial Executives Institute (FEI), the Institute of Internal Auditors (IIA), and the National Association of Accountants (NAA), the Commission offers the following observations based on its research and deliberations:

- Since liberal arts courses offer a strong framework for evaluating and adjusting to rapid changes in business during a time of continuing economic and technological development and evolution of the accounting profession, expanding accounting curricula to deal with fraudulent financial reporting, as the Commission recommends, should not be at the expense of the liberal arts component of business and accounting education.
- A significant explosion of information related to accounting, systems, and related fields has been taking place, and studying this information may require more time in course work.
- Entry-level positions for corporate accountants, internal auditors, and independent public accountants require increasing levels of competence and therefore more educational preparation.
- Developing ethical inquiry, analytical reasoning, sound judgment, and problem-solving skills requires more time than developing simpler cognitive skills such as memorization requires.
- Just as the Masters of Business Administration degree has become increasingly important for corporate advancement in areas like management, marketing, finance, and internal audit, a comparable accounting degree may become more necessary for advancement as a corporate accountant and as an independent public accountant.

IV. Professional Certification Examinations

Recommendation: *Professional certification examinations should test students on the information, skills, and ethical values that further the understanding of fraudulent financial reporting and that promote its reduction.*

Professional certification examinations influence business and accounting education. Textbooks and course syllabi quickly reflect changes in the subject matter that these examinations cover.

The AICPA examination for accountants (the CPA examination), the Certified Internal Auditor Examination, and the Certified Management Accountant Examination are designed to measure the professional competence of candidates in public accounting, internal auditing, and management accounting. All three professional certification examinations, especially the CPA examination, influence business and accounting education. Accordingly, the AICPA's Board of Examiners as well as the Boards of Regents of the IIA and the NAA should modify future professional certification examinations in light of the recommendations in this report, testing students on the information, skills, and ethical values that will determine their responses to the problem of fraudulent financial reporting.

V. Continuing Professional Education

Recommendation: *As part of their continuing professional education, independent public accountants, internal auditors, and corporate accountants should study the forces and opportunities that contribute to fraudulent financial reporting, the risk factors that may indicate its occurrence, and the relevant ethical and technical standards.*

Continuing professional education influences the quality of work performed by independent public accountants, internal auditors, or corporate accountants. Continuing professional education is available to these professionals in a variety of forms, such as in-house training programs, education programs of professional organizations, correspondence courses, and business school courses, and helps them adjust to change and keep current on new developments.

Moreover, professionals in public accounting, internal auditing, and corporate accounting who have been certified as CPAs, Certified Internal Auditors (CIAs), or Certified Management Accountants (CMAs) are expected to maintain their professional competence through a regular program of continuing professional education. Requirements for CPAs are set by the state board of accountancy of the jurisdiction licensing the individual professional as well as indirectly through membership in the SEC Practice Section of the AICPA's Division for CPA Firms. CIAs report progress each year toward completing 100 hours of activity in each 3-year rolling period. To remain in good standing, CMAs must complete 90 hours of continuing education activity in each 3-year period subsequent to passing the examination.

Most of the recommendations in this chapter for the business and accounting curricula generally apply to continuing professional education as well. The professional education process that continues throughout these professionals' careers should further their knowledge of fraudulent financial reporting, refine the skills required to combat such fraud, and sensitize these professionals to the related ethics issues.

VI. Educational Initiatives by Public Companies

A public company has many opportunities to educate its directors, management, and employees about fraudulent financial reporting. The audit committee of the board of directors has an important responsibility to be alert to the risk of such fraud and to educate its members and the rest of the board members about the forces and the opportunities within the company's financial reporting system that could lead to its occurrence. Chapter Two and the Good Practice Guidelines for the Audit Committee in Appendix I suggest some of the educational resources that are available to assist the audit committee in this task.

In addition, continuing managerial education, whether performed in-house or by outside consultants, should focus on the information, the skills, and the ethical values required to safeguard against fraudulent financial reporting. Familiarity with the Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting in Appendix F, for example, could help raise management's awareness about the possibility of fraudulent financial reporting occurring in its own company.

Finally, the process of developing and publicizing a code of corporate conduct is an opportunity to let employees at all levels of the company know what they can do if they encounter actual or suspected instances of fraudulent financial reporting. Training in the meaning and the application of the code is one means of alerting employees about such fraud and enlisting their support as part of the company's system of internal control.

APPENDICES

APPENDICES

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Appendix A
BIOGRAPHIES OF COMMISSIONERS
AND EXECUTIVE STAFF

WILLIAM M. BATTEN

William Milfred Batten was elected Chairman and Chief Executive Officer of the New York Stock Exchange in May 1976 and retired from that position in May 1984. He first became associated with the Exchange in 1972 as a public member of the Board of Directors. He came to the New York Stock Exchange from J.C. Penney Co., from which he retired as Chairman and Chief Executive Officer in October 1974.

Mr. Batten currently serves as Chairman of the Board Advisory Council, Texas Instruments, as director of the Zweig Fund, and as a director of the Managerial Economics Research Center, William E. Simon Graduate School of Business Administration, University of Rochester. He is a Fellow of the faculty of the Kennedy School of Government at Harvard University. He served on the Boards of AT&T, Boeing, Citibank, J.C. Penney, and Texas Instruments.

Active in civic and governmental affairs, Mr. Batten served as a member of the Board of the White House Preservation Fund and the President's Commission on Executive Exchange. He was President of the Economic Club of New York in 1967-68, and in 1973 served as the National Chairman of the U.S. Industrial Payroll Savings Committee and was Chairman of the Business Council in 1971-72. He also was inducted into the National Business Hall of Fame in 1980.

Mr. Batten received a B.S. degree in economics from Ohio State University, Columbus, in 1932, and did graduate work at the University of Chicago. He served in the U.S. Army from 1942 to 1945, where he attained the rank of Lieutenant Colonel.

WILLIAM S. KANAGA

William S. Kanaga is Chairman of the Advisory Board of Arthur Young & Company, an international accounting, tax, and consulting firm. He served as Chairman of that firm from 1977 through 1985 and was Managing Partner from 1972 through 1977.

Long active in the American Institute of Certified Public Accountants, Mr. Kanaga served as Chairman of its Board of Directors for the 1980-81 term and is currently serving as the Chairman of the profession's centennial celebration in 1987.

In addition to his professional activities, he is a member of the Boards of Trustees or Advisory Councils to the Presbyterian Hospital in the City of New York, Babson College, U.C.L.A. Graduate School of Management, Stanford University Graduate School of Business, and the Consortium of Christian Colleges. He is Vice Chairman of the Board of Directors of the Chamber of Commerce of the United States, and also serves on the Board of Directors of the Business Council for the United Nations, Value Line, Inc., and McDonnell Douglas Corporation.

Mr. Kanaga received his B.S. degree in metallurgical engineering in 1947 from the University of Kansas and was elected to Tau Beta Pi and Sigma Tau. He did postgraduate work at Babson College and Columbia University and in 1968 completed the Advanced Management Program of the Harvard Business School.

HUGH L. MARSH

Hugh L. Marsh is Director-Internal Audit for Aluminum Company of America and is responsible for its worldwide audit activities. He served as 1984-85 Chairman of the Board of the Institute of Internal Auditors.

Previously, Mr. Marsh held various financial positions with Aluminum Company of America and its subsidiaries, including an assignment in Australia. He has served in several international positions with the Institute of Internal Auditors, including International Treasurer and Chairman of the Budget and Finance Committee. In 1983-84 he was Senior Vice Chairman of the Board.

Mr. Marsh has been a frequent lecturer and conference chairman on accounting and auditing subjects. A former National Director for the National Association of Accountants, he is also a member of the Financial Executives Institute, the Institute of Certified Management Accountants, the American Accounting Association, and the Stuart Cameron McLeod Society. He has served on the Advisory Council for the Paton Accounting Center at the University of Michigan and presently serves on the National Advisory Forum of Beta Alpha Psi, the national accounting fraternity, and the Executive Committee of the Institute of Internal Auditors.

In 1984, the government of the People's Republic of China invited Mr. Marsh to consult on the establishment of, and training programs for, their new audit agency, which is expected to have 60,000 member auditors within 5 years.

Mr. Marsh, a Certified Management Accountant and a Certified Internal Auditor, is a graduate of the University of Tennessee, with a B.S. degree in industrial management. He has also attended special courses in accounting and finance at the University of Alabama, Evansville University, and Geelong Technical College in Australia.

THOMAS I. STORRS

Thomas I. Storrs retired in 1983 as Chairman and Chief Executive Officer of NCNB Corporation and its subsidiary banks. He continues to serve as a director of the corporation.

Born in 1918 in Nashville, Tennessee, he began his banking career in 1934 at the Federal Reserve Bank of Richmond, Virginia. He graduated from the University of Virginia in 1940, and later received M.A. and Ph.D. degrees in economics from Harvard University.

In 1960, he joined NCNB National Bank as Executive Vice President. He was named President in 1969 and Chief Executive Officer in January 1973. He was named Chairman and Chief Executive Officer of NCNB Corporation in January 1974.

Mr. Storrs served as President of the Association of Reserve City Bankers in 1980-81. He was President of the Federal Advisory Council of the Federal Reserve System in 1975 and 1976. He is a Director of Black and Decker Manufacturing Company and Royal Insurance Group. Mr. Storrs also serves as Chairman of the Board of Trustees of the University of North Carolina at Charlotte and as a Trustee of Davidson College.

He served on active duty as a Naval Officer from 1941 through 1945 and from 1951 through 1952, retiring as a Commander USNR.

DONALD H. TRAUTLEIN

Donald H. Trautlein retired in 1986 as Chairman and Chief Executive Officer of Bethlehem Steel Corporation, a position he assumed in 1980.

Prior to joining Bethlehem in 1977, he was with the international accounting firm of Price Waterhouse in New York, where he was named a Partner in 1964. While with Price Waterhouse, his responsibilities included supervision of the annual independent audit of several major companies, including Bethlehem. After joining Bethlehem, he served successively as Comptroller, Senior Vice President, Accounting and Executive Vice President. He was a Director from November 1977 until August 31, 1986.

Mr. Trautlein is a member of the Board of Directors of The Chase Manhattan Bank, N.A. and the Chase Manhattan Corporation. He served as Chairman of the American Iron and Steel Institute from 1984 through 1986 and was a member of the Board of Directors and the Executive Committees of both the American Iron and Steel Institute and the International Iron and Steel Institute from 1980 through 1986. He is a member of the Business Council and a former member of the Policy Committee of The Business Roundtable and the Labor-Industry Coalition for International Trade.

A native of Sandusky, Ohio, Mr. Trautlein served in the U.S. Navy in 1945 and 1946. He graduated in 1950 from Miami University *cum laude*, with a B.S. degree and was elected to Phi Beta Kappa, Beta Gamma Sigma, and Beta Alpha Psi. He is a Dean's Associate of Miami University. In 1981 he received an Honorary Doctor of Law degree from Lehigh University.

JAMES C. TREADWAY, JR.

James C. Treadway, Jr., is Executive Vice President, General Counsel, member of the Executive Group, and a Director of Paine Webber Incorporated. Until June 1, 1987, he was a Partner in the Washington, D.C., office of the law firm of Baker & Botts. Mr. Treadway served as a Commissioner of the United States Securities and Exchange Commission from 1982 through 1985.

Mr. Treadway is a frequent writer and speaker on matters involving corporate, securities, and banking laws, with special emphasis on accounting and financial disclosure issues. He currently is a member of the Planning Committee of the Northwestern University Ray Garrett, Jr., Corporate and Securities Law Institute, and the Advisory Board of the University of Southern California SEC and Financial Reporting Institute. He is a member of the District of Columbia, Massachusetts, Georgia, New York, American, and Federal bar associations.

Mr. Treadway received his undergraduate education at Rollins College and the University of Georgia. He received his legal education at Washington & Lee University, where he was conferred a LL.B. degree, *summa cum laude*, in 1967. He served as Editor-in-Chief, Washington & Lee University Law Review, and is a member of Phi Beta Kappa, Order of the Coif, Omicron Delta Kappa, and Omicron Delta Epsilon.

G. DEWEY ARNOLD—Executive Director

G. Dewey Arnold was a partner in the accounting firm of Price Waterhouse until his retirement in June 1985. He became partner-in-charge of Price Waterhouse's Washington office in 1966, was elected to their Policy Committee in 1975, and was appointed Regional Managing Partner in 1976. At the time of his retirement, he was a member of the firm's Management Committee and Operating Committee.

Mr. Arnold is a member of the American Arbitration Association, was a member of the Audit Advisory Committee to the Secretary of the Navy and served as Vice Chairman of the Bicentennial Commission. He is a member of the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants and Beta Alpha Psi. He was formerly an accounting instructor at the Robert Morris School of Accounting in Pittsburgh and a lecturer and course director at the Instituto Mexicano de Administracion de Negocias, A.C.

JACK L. KROGSTAD—Research Director

Dr. Jack L. Krogstad is the John P. Begley Professor of Accounting at Creighton University in Omaha, Nebraska. Prior to joining the faculty at Creighton, he taught at the University of Texas at Austin, Kansas State University, and the University of Michigan at Ann Arbor. Dr. Krogstad is the author of numerous scholarly articles, including works published in journals of four of the Commission's five sponsoring organizations. He is active in many professional and academic organizations, most recently serving as Editor of *Auditing: A Journal of Practice & Theory*, a publication of the Auditing Section of the American Accounting Association. He also has been Chairman of the Auditing Section and a Regional Vice President of the American Accounting Association.

Dr. Krogstad received his Ph.D. from the University of Nebraska at Lincoln. He also holds a B.S. degree, *summa cum laude*, from Union College, and an M.B.A. from the University of Nebraska.

**CATHERINE COLLINS McCOY—Deputy Executive Director and
General Counsel**

Catherine Collins McCoy served on the staff of the Securities and Exchange Commission from 1975 until 1986, most recently as Associate Director—Legal of the Division of Corporation Finance. As the Division's chief legal officer, she had responsibility for the Office of Chief Counsel, as well as for rulemaking through the Office of Disclosure Policy and liaison with respect to the Division of Enforcement's recommendations for Commission enforcement action. Her extensive rulemaking experience while at the SEC included all phases of the Integrated Disclosure System and Rule 415, the "shelf" registration rule.

Mrs. McCoy has been a frequent speaker and panelist for continuing legal education and industry programs. She received her J.D. degree from the American University Washington College of Law in August 1977 and her B.A. degree from Manhattanville College in Purchase, New York in 1969.

Appendix B
SUMMARY OF EXTERNAL RESEARCH
PROGRAM

This appendix presents descriptions of the Commission's external research studies and brief summaries of the results. The Commission used these studies in developing its conclusions and recommendations. The views, conclusions, and recommendations expressed in the various research studies, however, are those of the researchers. The projects are as follows:

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RESEARCH STUDY: Computer Fraud**PRIMARY RESEARCHER: Stephen M. Paroby, Partner
Ernst & Whinney****STUDY SPONSOR: Ernst & Whinney**

ABSTRACT

This study documents the growing exposure to fraud that computer systems are creating and explores the implications of these systems for the prevention and detection of fraudulent financial reporting. It points out that it is difficult to segregate frauds aimed at manipulation of financial statement information from those with other primary objectives, such as the misappropriation of assets, since, in many cases, the latter also will materially misstate the financial statements. Nevertheless, the study recognizes an increasing potential to use the computer to automate perpetration of fraudulent financial reporting.

The study concludes that computer fraud is likely to continue to increase in frequency and sophistication in the future unless (1) corporate managements, with oversight from boards of directors and audit committees, establish and maintain adequate systems of internal control over their computerized data processing environment and (2) internal auditors and independent public accountants regularly review, monitor, and report on these systems. Other observations and conclusions include the following:

- Since audit trails in many sophisticated environments exist for only a short period of time, if at all, the audit process (both internal and external) must move closer to the accounting transaction at its entry point into the system.
- Internal auditors need to be involved in the systems development process to ensure that controls are considered and to integrate fraud prevention and detection measures into the system itself.
- Since sophisticated systems create a need for increased reliance on internal controls, internal auditors or independent public accountants need periodically to perform comprehensive reviews of internal controls that extend beyond those normally performed during the course of an audit, including reviews of controls over computerized systems.
- Professional auditing standards should clarify the minimum procedures independent public accountants should perform to evaluate the computerized portions of the accounting system in connection with the examination of an organization's financial statements.
- Independent public accountants can no longer take a functional approach to audits (e.g., accounts receivable, inventory, accounts payable) because of the interdependence of data among various functional areas created by computer systems. They should understand the overall business environment and how the various accounting systems relate to one another.
- In the not-so-distant future, organizations possibly will report their financial results by establishing a data base of information that can be accessed by interested parties.
- Management, internal auditors, and independent public accountants all face an urgent need to become more computer literate, to be better able to make and evaluate decisions about the desired level of security, and to take measures to prevent, detect, and limit the potential for computer fraud.
- Companies need to adopt formal codes of conduct that include policies related to computer resources.
- Internal auditors and independent public accountants need to make greater use of computer technology in performing audits.
- Colleges and universities, as well as professional organizations such as the American Institute of Certified Public Accountants, the Institute of Internal Auditors, the National Association of Accountants, the Financial Executives Institute, and the EDP Auditors Association, need to do all they can to increase the computer literacy of professionals. For example, a heavier emphasis needs to be given to EDP issues on professional certification examinations.

**RESEARCH STUDY: Fraudulent and Questionable Financial Reporting:
A Corporate Perspective**

**PRIMARY RESEARCHER: Dr. Kenneth A. Merchant, Associate Professor
Harvard University**

STUDY SPONSOR: Financial Executives Research Foundation

ABSTRACT

The purpose of this study was to gain an understanding of (1) fraudulent and questionable financial reporting practices that may occur in public corporations, (2) organizational and individual factors that may contribute to the occurrence of these practices, and (3) alternative solutions to help prevent or detect such practices. The findings of the study are based on a review of relevant literature; an analysis of recent cases of fraudulent financial reporting; interviews with over 100 general managers, controllers, and internal auditors; and discussions of two fictional, but realistic, cases by panels comprised of preparers of financial statements, audit committee members, internal auditors, independent public accountants, and financial statement users.

The study identifies a broad range of deceptive financial reporting practices. While some of these practices clearly are fraudulent, many, although deceptive, are considered acceptable by some proportion of interested parties. This acceptability-judgment problem creates difficulty in dealing with deceptive financial reporting. Nevertheless, the study cautions that allowing even slightly deceptive reporting practices creates an environment that is conducive to more serious deceptions. The study concludes that in the vast majority of fraudulent financial reporting cases, the people involved were good people who got involved in small, nonmaterial manipulations, perhaps even with good intentions. Then, over time, the magnitude of the manipulations grew, and eventually laws were broken.

Some of the organizational factors that may contribute to the incidence of deceptive financial reporting practices include:

- Lack of leadership and moral guidance
- Complexity in rules, regulations, and policies
- Unrealistic budget targets, particularly when these emphasize short-term results
- High incentives for financial performance
- Inadequate internal controls, especially in the presence of organizational change
- High divisional autonomy
- Inadequate internal audit function
- Ineffective board of directors and audit committee.

These organizational factors interact with individual factors in producing deceptive financial reporting practices. People within the organization are sensitive to its ethical culture, its incentives and punishments, and its social affirmation. Over time, an individual's judgment of right and wrong can be greatly affected by the atmosphere in the work place. For example, individuals are frequently motivated to participate in deceptive financial reporting practices because they believe or rationalize that they are acting in the organization's best interests or they have developed a corporate "team spirit" of deception.

Sometimes individuals may get drawn into deceptive financial reporting practices through ignorance. Accounting and reporting rules and SEC requirements are technical, extensive, and subject to continuing change. Individuals in the marketing or sales areas of the organization, for example, simply may not know when they have been asked to violate generally accepted accounting principles in recording undelivered goods as a sale.

Consideration of organizational and individual factors together points to the importance of establishing an ethical conscience, an effective audit committee, strong internal controls, clear financial reporting responsibilities and practices, an effective internal audit function, meaningful organizational sanctions, and appropriate budget targets and compensation schemes. Furthermore, open lines of communication between the audit committee and both the controller and the internal auditor are critical.

RESEARCH STUDY: Control and Internal Auditing

**PRIMARY RESEARCHERS: Dr. Michael J. Barrett, Professor
University of Illinois at Chicago
Roger N. Carolus, Senior Vice President—
Deputy General Auditor, NCNB Corporation**

STUDY SPONSOR: Institute of Internal Auditors

ABSTRACT

This study builds on prior pronouncements of the Institute of Internal Auditors (IIA) in describing the concept of control and how the internal audit function can help a public company to achieve a positive control result through assessments of the control culture. The study describes the control culture as flowing from the following four interrelated components:

- The attitudes and behavior of the board of directors and executive management set the tone of the organization and signal to all parties the way that business affairs will be conducted.
- The business plan, formulated by the board of directors and executive management, states what the company desires to be, identifies and ranks the business exposures expected to be encountered, and specifies the network of business fundamentals needed to address the business exposures identified.
- The network of business fundamentals establishes the elements and linkages needed to inform individuals about how to perform their work. This network includes policy statements, operating procedures, performance standards, budgets, and performance monitoring systems.
- Controlling activates the network of business fundamentals through board, management, employee, customer, supplier, and regulator activities such as supervising, comparing, reconciling, monitoring, confirming, and reporting.

This characterization of control led to the following selected observations or conclusions:

- A relevant concept of control incorporates the activities and actions of the board of directors and executive management.
- The single most important control component is the attitude and behavior of the chief executive officer, followed closely by that of the audit committee.
- Although achieving a positive control result begins with the chief executive officer and the board of directors, responsibility for its accomplishment rests with every employee as well as with entities closely related to the company such as suppliers, customers, and regulators.
- Meaningful evaluation of control should extend to every level affected in the organization and to closely related external entities. A positive control result can be achieved at one or more levels in a company (e.g., headquarters, divisions, subsidiaries, departments) while a negative result is achieved at other levels.
- To expand assessment and reporting responsibilities in regard to the adequacy of the design and effectiveness of control, internal auditors need:
 - The support and encouragement of the board of directors and executive management to adopt and adhere to professional (IIA) internal auditing standards and practices
 - Organizational status and objectivity
 - Enhanced internal auditing career incentives
 - The support of the public accounting profession.

RESEARCH STUDY: The Role of the Internal Auditor in the Deterrence, Detection, and Reporting of Fraudulent Financial Reporting

**PRIMARY RESEARCHERS: William G. Bishop, III, Executive Vice President—
Corporate Audit, Shearson Lehman Bros., Inc.
Richard Allan White, Manager of Standards
Institute of Internal Auditors**

STUDY SPONSOR: Institute of Internal Auditors

ABSTRACT

This research study provides a comprehensive analysis of how the internal auditor can play an effective role in the deterrence, detection, and reporting of fraudulent financial reporting. The analysis draws on professional internal auditing standards, a number of other related research studies, current proposals of public accounting firms, proposed federal legislation, an informal survey of 20 leaders in the internal auditing profession, and interviews with members of the SEC Enforcement Division and the Auditing Standards Board. The following selected observations and conclusions result from the study:

- The audit committee has the potential for playing the most critical role in assuring that mechanisms are in place to deter, detect, and report fraudulent financial reporting.
- Internal audit coverage focuses primarily on the evaluation of controls at the division, subsidiary, or other operating unit level and allocates much less effort to auditing the financial reporting process and its controls at the corporate or seniormost level of consolidation.
- There is a trend toward increased reliance by independent public accountants on the work of the internal auditor, particularly in the areas of control evaluation and computer systems.
- There is a need for improved auditing coordination between internal auditors and independent public accountants.
- Internal auditors administratively report most frequently to the chief financial officer who also may have responsibility for financial statement preparation.
- In most cases, internal auditors have a well-defined, formal reporting responsibility to the audit committee or the board of directors.
- Internal auditing is viewed by many as a transient profession rather than a long-term career.
- Organizational status and independence are essential in insulating internal auditors from compromising organizational influence and pressure.
- When the code of corporate conduct receives top management's support, it is instrumental in establishing a positive ethical environment and is an important control.

Internal auditors are anxious to play an effective role in the deterrence, detection, and reporting of fraudulent financial reporting. To do this, they need the support of the audit committee and top management. They believe that their work should be carefully coordinated with the work of the independent public accountant and that they should be more involved with the financial reporting process and its controls at the corporate level of consolidation. Furthermore, there must be appropriate incentives to attract and retain competent career internal auditors, and organizational status and independence must insulate them from compromising organizational pressures.

**RESEARCH STUDY: Impact of Professionalism and Codes of Corporate
Conduct on Financial Reporting**

**PRIMARY RESEARCHER: Stephen Landekich, Research Executive
National Association of Accountants**

STUDY SPONSOR: National Association of Accountants

ABSTRACT

This study describes and analyzes two predominant ethical forces that come to bear on the financial reporting process—the corporate ethical climate and professional codes of ethics. With respect to the corporate ethical climate, in-house documentation of ethically related policies and procedures was requested from 103 chief executives of 48 industrial and 55 nonindustrial companies selected randomly from *Fortune* 500 listings. Fifty-one usable responses were received (19 industrial and 32 nonindustrial) from companies headquartered in 20 states and the District of Columbia. The 32 nonindustrial participants included banks (9), utilities (6), retail merchandising (6), transportation (5), insurance (3), and other services (3).

Responses to the request for documentation of ethically related policies and procedures indicated widespread awareness of the effective role that ethical guidance can play in corporate administration. Although the views and policies of the participants differed considerably, the ethical climate did not seem to be correlated with respective management styles. Rather, the basic aim of ethical guidance generally was to achieve a corporate ethical climate consistent with the professed corporate self-image. Areas specifically covered usually were those requiring extra diligence, those offering opportunities for undesirable behavior, those involving ethical dilemmas, or areas where any below-standard actions or attitudes might be especially harmful.

The study also examines professional codes of ethics of the American Institute of Certified Public Accountants (AICPA), the Financial Executives Institute, the Institute of Internal Auditors, and the National Association of Accountants. Both standards of competence and integrity are incorporated into these codes as expressions of professionalism. However, due in part to the absence of strong enforcement clauses in these codes, organizational and situational forces tend to be dominant when on-the-job ethical dilemmas arise. This finding points once again to the critical role that a positive corporate ethical climate plays in enhancing the reliability of the financial reporting process.

The study also cautions that while improved accounting and auditing standards may help independent public accountants prevent and detect fraudulent financial reporting, these are not substitutes for a willingness to place professional ethics above the pressures of the accounting marketplace. The AICPA's code of ethics presently endorses several levels of independence to accommodate a variety of services performed by its members. The study suggests that the AICPA consider linking the ethical concept of independence more directly to the auditor's public trust. This linkage may result in a different interpretation of what constitutes undesirable conflicts of interest in the independent public accountant's unique role.

RESEARCH STUDY: Expansion of Nonaudit Services and Auditor Independence

**PRIMARY RESEARCHER: Dr. James B. Edwards, Professor
University of South Carolina**

STUDY SPONSOR: National Association of Accountants

ABSTRACT

This study analyzes the concerns about the actual and potential impact of management advisory services on the quality of audits in general and on the effectiveness of the audit process in deterring and detecting fraudulent financial reporting in particular. The concept of independence is the pivotal link between management advisory services and the auditor's ability to deter and detect fraudulent financial reporting. Independence has long been the cornerstone of the audit process, and any erosion of it may create potential dangers to audit quality and reduce the likelihood that the auditor will detect fraudulent financial reporting.

One objective of the study was to analyze and condense available information with relevance to this issue. Since much has been written on this topic, substantial effort was devoted to a review of publicly available information such as the 1979 Report of the Public Oversight Board and supporting files, the 1978 Report of the Commission on Auditors' Responsibilities (Cohen Commission), transcripts and video tapes of Congressional hearings, SEC documents, published articles, and the book recently written by Dr. Gary John Previts entitled *The Scope of CPA Services* (John Wiley & Sons, Inc., 1985).

A second objective was to update the 1979 Report of the Public Oversight Board (POB) as called for by Arthur M. Wood, then Chairman of the POB. This portion of the study had two separate phases. One phase involved a review of firm literature that lists and describes the management advisory services offered by a sample of large public accounting firms. A second phase consisted of obtaining questionnaire responses and interviews from a sample comprised of management, financial executives, financial analysts, management consultants, regulators, and independent public accountants.

The study concludes that the nature and the scope of the services that many public accounting firms provide have expanded at an unprecedented rate over the past 10 years. However, as with the findings of the Cohen Commission in 1978 and the POB in 1979, this study found no established evidence that independence had been impaired or fraudulent financial reporting abetted where an audit firm also performed management advisory services. Nevertheless, the study cautions that the historical precepts of independence are giving way to modern vanguards of professionalism, namely concurrent "savvy" and "commitment" to quality service and the public interest.

The study classifies management advisory services into three groups: (1) services that have a direct impact on the financial statements, (2) services that have only an indirect impact on the financial statements, and (3) services that are not related to the financial statements. The study argues that services in the first group (e.g., actuarial determinations or appraisals upon which the allocation of acquisition cost is based) create an inherent conflict with independence because they result in the public accounting firm auditing its own work.

The second group of services (e.g., information systems design) generally does not impair independence and may actually contribute to the prevention and detection of fraudulent financial reporting. Moreover, these services and the audit may need to be coordinated to take full advantage of the separate efforts. Services in the third group are not related to fraudulent financial reporting except to the extent that they may place the audit in a subordinate role (e.g., as a loss-leader) or involve independent public accountants making decisions for their clients.

RESEARCH STUDY: Surprise Writeoffs—Financial Reporting, Disclosure and Analysis

PRIMARY RESEARCHERS: Dr. Dov Fried, Associate Professor
Dr. Michael Schiff, Professor
Dr. Ashwinpaul Sondhi, Assistant Professor
New York University

STUDY SPONSOR: National Association of Accountants

ABSTRACT

The objective of this study was to provide accounting regulatory bodies and other interested parties with a descriptive and limited analytical report on the nature and characteristics of writeoffs that have occurred in business during the years 1980-1985. The data used in the study were developed from press reports of announcements by publicly traded companies, as compiled by the Dow Jones News Service. All announcements relating to writeoffs, writedowns, restructurings, and plant closings over the period from January 1, 1980 to March 31, 1986 were analyzed. After omitting irrelevant data, the study examines the final database, consisting of 1,088 companies that reported a total of 1,354 writeoffs, and categorizes it into four different classifications:

- Asset impairments including writedowns and writeoffs
- Plant closings and restructurings
- Writedowns and writeoffs of investments
- Writedowns and writeoffs of goodwill.

The study reviews the current status of reporting and accounting standards for writeoffs and writedowns and then analyzes the data by classifying it along several dimensions: frequency, type, industry, timing, and dollar value. Finally, some preliminary analysis was performed to assess the financial impact of the writeoffs on a sample of the companies in the database. Some of the primary observations and conclusions include the following:

- The accounting standards address “permanent” writedowns or writeoffs to a much greater extent than “partial” writedowns.
- The frequency of reported writeoffs increased rapidly over the 6-year period (1980-85). Also, 10 companies reported writeoffs in 4 of the 6 years while 41 companies reported writeoffs 3 times during the same 6-year period, indicating that writeoffs may not necessarily be nonrecurring in nature.
- The oil and gas industry reported the largest number of writeoffs, accounting for more than 16 percent of the total for the 6-year period.
- Forty-seven percent of the writeoffs related to asset impairments.
- Over the 6-year period, 52 percent of the writeoffs were reported in the fourth quarter and this pattern of reporting occurs in each of the years under study and across all industries.
- Some of the significant findings related to the dollar amount of the writeoffs were:
 - The dollar amount of writeoffs increased significantly over the 6-year period.
 - Asset impairments accounted for 51.3 percent of the dollar value over the 6 years, while plant closings accounted for 36 percent.
 - In dollar value, 64 percent of the writeoffs were reported in the fourth quarter.
- Writeoffs tend to be large relative to income reported and frequently occur in years when annual income is negative.

In a sample of 109 companies from the original population, the study examines the behavior of financial ratios over time. Both turnover and profitability ratios indicated a deteriorating situation in the years prior to the writeoff, a stabilizing subsequent to the writeoff, and then a gradual improvement. Stock market reaction to the writeoffs was consistent; following the writeoffs, stock performance rebounded in anticipation, perhaps, of the reversal in the reported financial results of the companies during the next 2 to 3 years.

The study concludes that, in a climate of vague accounting standards, reported writeoffs have increased dramatically in frequency and in dollar value, the reporting of the writeoffs is concentrated heavily in the fourth quarter, and the writeoffs have significant impact on financial performance.

RESEARCH STUDY: The Independent Public Accountant's Responsibility for the Detection of Fraudulent Financial Reporting

**PRIMARY RESEARCHER: Dr. Zoe-Vonna Palmrose, Assistant Professor
University of California–Berkeley**

**STUDY SPONSORS: American Accounting Association and the
University of California–Berkeley,
Professional Accounting Program**

ABSTRACT

This study summarizes how the independent public accountant's responsibility for the detection of fraudulent financial reporting has developed since the early 1900s and analyzes a sample of 472 cases of litigation against independent public accountants from 1960 through 1985 to determine the role of management fraud and business failures in litigation against external auditors.

Interpreting the historical literature is not easy because a clear distinction between types of irregularities or fraud has not been maintained. It is clear, however, that professional standards have always lacked a clear statement affirming auditors' responsibility for detecting and reporting material irregularities when conducting an audit. On the other hand, evidence exists that detection of intentional material misstatements by management has been a legitimate objective of audits at least since the late 1930s.

The analysis of litigation against independent public accountants confirms the historical summary. Current professional standards with their emphasis on the inherent limitations of the audit process have not prevented litigation against the independent public accountant or significant payments in settlement where fraudulent financial reporting is involved. Nearly one-half of the 472 cases involve fraudulent financial reporting by management. Furthermore, cases involving fraudulent financial reporting generally lead to larger damage settlements by the independent public accountant than do other types of cases.

The study also challenges the common notion that business failure automatically leads to allegations of audit failure. Although increases in litigation against independent public accountants do appear to be correlated with economic downturns, only about 20 percent of the sample of bankruptcies studied (458) led to litigation against auditors. Moreover, over one-half of the bankruptcies involving litigation against independent public accountants also involved fraudulent financial reporting. Accordingly, the study concludes that proposals to focus increased auditor attention on a company's financial and business difficulties are useful primarily because they direct the auditor's attention to conditions that may increase the likelihood of fraudulent financial statements.

RESEARCH STUDY: Reducing the Incidence of Fraudulent Financial Reporting: The Role of the SEC

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STUDY SPONSOR: National Commission on Fraudulent Financial Reporting

ABSTRACT

This study addresses the adequacy of existing and proposed SEC methods and rules for combatting fraudulent financial reporting. The study provides a perspective on the historical role of the SEC in reducing the incidence of fraudulent financial reporting based on a comprehensive review of the literature, including books, periodicals, and Congressional and SEC documents. The review identified approximately 20 existing SEC activities and 25 proposed activities that have potential for being effective in the prevention or detection of fraudulent financial reporting. The results of the review provided the foundation for the mail survey and personal interviews conducted in connection with this project.

The researchers surveyed approximately 1,150 persons and received 515 replies (45 percent response rate). The survey dealt with questions regarding participants' views on the magnitude of the problem of fraudulent financial reporting, the effectiveness of current SEC policies and activities, and the potential effectiveness of possible changes to the current system. The survey population included attendees at the 1986 University of Southern California SEC and Financial Reporting Institute Conference, a sample of members of the American Society of Corporate Secretaries which represents corporate officers and directors (65 percent NYSE companies, 19 percent AMEX companies, and 16 percent OTC companies), a sample of members of the Financial Executives Institute, and a sample of members of the Institute of Internal Auditors.

The researchers also conducted in-depth interviews with 20 individuals who have a high degree of knowledge about some aspects of the securities laws and the functioning of the SEC. These interviews addressed the same issues as the mail survey. The interviewees included two executives of publicly held companies, five independent public accountants, seven high-level employees of the SEC, four attorneys, a financial analyst, and a representative of users of financial information.

Approximately 50 percent of the 515 questionnaire respondents believed that fraudulent financial reporting is a problem of moderate to serious proportions. While the primary focus of the study was on the role and effectiveness of the SEC in addressing this problem, a number of closely related findings and conclusions also emerged. A few selected findings and conclusions where both survey respondents and interviewees generally agree follow.

- The SEC's fraudulent financial reporting prevention and detection activities are somewhat effective.
- Creation of "red flag" profiles would be useful in identifying cases for SEC investigation.
- Stiffer sanctions for registrant companies and members of their management found to be involved in cases of fraudulent financial reporting would be an effective deterrent. Effective sanctions would include barring the individual from high office in a publicly held company, stiffer penalties, and longer prison terms.
- There is a need for better clarification/definition of the independent public accountant's fraud detection responsibilities.
- There should be a mandatory requirement that all publicly held companies have an audit committee. The audit committee was thought to be potentially effective for both fraud prevention and detection. The

committee should be composed of members who are capable, independent, and protected from exposure to liability when acting in good faith.

One area where general agreement was not shared by survey respondents and interviewees concerned internal accounting controls. The survey respondents did not view mandatory disclosure of internal accounting control weaknesses or mandatory auditor examination of internal accounting control as promising changes. Most interviewees believed that changes were probably desirable in current standards and practices concerning the evaluation of and reporting on internal control.

RESEARCH STUDY: Fraudulent Financial Reporting: The Potential for Educational Impact

**PRIMARY RESEARCHER: Dr. Jean C. Wyer, Associate Professor
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STUDY SPONSOR: American Accounting Association

ABSTRACT

This study addresses the question of how education can have an impact on the way in which corporate management and independent public accountants confront instances of fraudulent financial reporting. The study draws on the accounting and auditing educational literature as well as some selected works from higher education. A limited survey also was conducted of the way in which ethical, situational, and technical aspects of fraudulent financial reporting are covered in accounting and auditing textbooks. While the study's observations and conclusions largely generalize to the entire business curriculum, the discussion focuses primarily on accounting and auditing education.

The study concentrated on two areas: (1) the way in which accounting knowledge is imparted to students and (2) the way in which accounting students receive instruction on ethical values. The following selected observations and conclusions resulted from the study:

- Being able to record a transaction correctly often has two components. The first is an understanding of the mechanics of the accounting model, the attendant disclosure requirements, and the operations of the specific accounting systems generating the financial statements. The second, which is much harder to teach, is the ability to work above a simple programmed level in the application of concepts to anomalous data.
- Many accounting textbooks rely very heavily on a procedural approach concentrating on individual problems—an approach that may not be sufficient for facing the challenges of the real world. Accordingly, there should be more emphasis on cognitive and conceptual issues in accounting education.
- Auditors require technical skills in addition to those required for proper accounting. Auditors must be conversant with the principles of logic, they must be adept at gathering information, and they must be shrewd evaluators of risk. Acquiring these skills requires a broad educational experience.
- The results of a survey of accounting and auditing textbooks indicate that coverage of fraudulent financial reporting is minimal to nonexistent.
- The treatment of ethics is usually limited to a procedure-based examination of the AICPA's Rules of Conduct during the auditing course.
- Coverage of fraudulent financial reporting and ethics should be included throughout the accounting curriculum. Confining such coverage to a single course (e.g., auditing) implies that these areas are not important to other subject matter such as financial and managerial accounting.
- Faculty must be exposed to fraudulent financial reporting and ethical reasoning in Ph.D. and post-doctoral training. Faculty cannot be expected to teach what they have not learned.
- A robust case literature is critical to bringing the complexity, challenge, and realism of fraudulent financial reporting and ethical issues into the classroom.
- Improvements in the accounting curriculum depend heavily on the cooperation and support of the public accounting firms and business corporations that hire graduates as well as the professional organizations that administer the uniform certified public accountant and other professional certification examinations.

Appendix C
SUMMARY OF RESEARCH REPORTS
AND BRIEFING PAPERS
PREPARED BY COMMISSION STAFF

In addition to the 10 external research studies summarized in Appendix B, the Commission's staff conducted additional research studies, literature reviews, and comparative analyses which resulted in reports and briefing papers for the Commission. This Appendix describes the scope of these activities and summarizes selected findings and positions.

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The Public Company

Fraud Risk Assessment

This research study summarizes risk factors that may contribute to fraudulent financial reporting. In addition to risk factors identified by the Commission's other research activities, this summary draws on the following sources:

- A survey of the risk assessment and client acceptance and retention policies of 10 of the 14 largest public accounting firms in the United States
- The AICPA's "Warning Signals of the Possible Existence of Fraud," published in the March 12, 1979, *CPA Letter*
- The following books on business fraud:
 - *Corporate Fraud*, 2nd ed., by Michael J. Commer [McGraw-Hill (United Kingdom), 1985]
 - *How to Detect and Prevent Business Fraud*, by W. Steve Albrecht, Marshall B. Romney, David J. Cherrington, I. Reed Payne, and Allan V. Roe (Prentice-Hall, 1982)
 - *Management Fraud: Detection and Deterrence*, by Robert K. Elliott and John J. Willingham (Petrocelli Books, 1980)
 - *Corporate Fraud: The Basis of Prevention and Detection*, by Jack Bologna (Butterworth Publishers, 1984).

The results of this study are presented in Appendix H as Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting.

Management and Audit Committee Reports

This study analyzes the positions taken by the SEC, the Cohen Commission, and the Financial Executives Institute regarding management reports to be included in corporate annual reports to stockholders. The study also reviews the contents of a limited number of actual management and audit committee reports included in corporate annual reports during the last 5 years and examines Statement on Auditing Standards No. 19, *Client Representations*. Drawing on these sources, illustrative management and audit committee reports are developed.

Need for Uniform Authoritative Internal Control Standards

This briefing paper summarizes the current internal control practices and standards in the United States. The paper is based primarily on current literature describing the nature of internal control practices, focusing particularly on two research studies sponsored by the Financial Executives Research Foundation: *Internal Control in U.S. Corporations: The State of the Art* (1980) and *Criteria for Management Control* (1981). Both books were authored by a research team from the University of Michigan Graduate School of Business Administration under the direction of Dr. Robert K. Mautz.

The paper notes that many different groups, including Congress, corporate management, and accountants, are becoming increasingly interested in the concepts of internal control and accountability and how to implement these concepts effectively. There is, however, diversity in internal control practices among public companies and in the definitions and terminology used to discuss internal control among the various groups who have studied it. As a result, management, internal auditors, and independent public accountants often disagree as to whether a public company's internal control is adequate. The definition of internal accounting control developed by independent public accountants and adopted by the Foreign Corrupt Practices Act is the most widely used. Since this definition was developed primarily to guide independent public accountants

in conducting an audit, however, it is deliberately the most narrow and may not provide the best guidance for other purposes.

Opinion Shopping

This briefing paper discusses the issues surrounding the practice of “opinion shopping,” the practice of consulting various independent public accountants to find one that will accept an inappropriate or questionable accounting treatment. The paper summarizes the existing guidance to independent public accountants concerning this issue, principally Statement on Auditing Standards (SAS) No. 50, *Reports on the Application of Accounting Principles*. It also summarizes current disclosure requirements concerning changes in independent public accountants and the SEC’s July 1, 1985, concept release requesting comments on opinion shopping (Release No. 33-6594; File No. S7-33-85), which proposes several modifications to these requirements.

The paper notes that differences of opinion do arise in financial reporting, especially when complex or novel transactions are involved. Consultation with another independent public accountant often is a legitimate method of resolving these differences. Opinion shopping occurs when management introduces commercial pressure into the process of resolving the financial reporting issue to obtain an opinion based on its desires rather than sound reporting principles. The briefing paper concludes that neither SAS No. 50 nor current SEC regulations adequately addresses the problems associated with opinion shopping and the paper presents some additional procedures for consideration.

Review of Recent SEC Cases Involving Fraudulent Financial Reporting

This research study analyzes all accounting and financial disclosure cases brought by the SEC against public companies, individuals associated with these companies, and independent public accountants between July 1, 1981, and August 6, 1986. The analysis was conducted by reviewing public documents for each case. After omitting duplications and cases with insufficient information for analysis, 119 cases against public companies and 42 cases against independent public accountants were analyzed.

The following are the major findings:

- Forty-four percent of the cases against public companies occurred in industries that were experiencing, or about to experience, a general economic decline.
- Eighty-seven percent of the cases against public companies involved manipulation of the financial disclosures, as opposed to misappropriation of assets for personal gain (13 percent). Frequently used techniques were improper revenue recognition methods (47 percent), deliberate overstatements of company assets (38 percent), and improper deferral of current period expenses (16 percent). In 27 percent of the cases against public companies, the SEC alleged that other information disseminated to the public was inadequate or otherwise contained false and misleading statements.
- In 45 percent of the cases against public companies, the SEC alleged that the fraud occurred because of a breakdown of the company’s internal controls. In many of these instances, the company had adequate internal accounting controls; these controls, however, were overridden by management.
- In 17 percent of the cases against public companies, misrepresentations were made to the company’s independent public accountants.
- The SEC cited a member of upper-level corporate management (chief executive officer, president, or chief financial officer) as being involved in 66 percent of the cases against public companies. In 5 percent of the cases, nonmanagement personnel were cited by the SEC. The personnel involved could not be determined in the remaining 29 percent of the cases.
- In contrast to SEC and professional studies showing that 85-90 percent of public companies have audit committees, in only 69 percent of the cases against public companies was an audit committee maintained. This percentage excludes 39 cases where the staff could not determine whether or not the company had an audit committee. The 69 percent appears generous because it is likely the percentage would drop if

the 39 unknown cases were determined since these companies were not listed on the NYSE, filed no proxy material with the SEC, and many were involved in an initial public offering.

- In 67 percent of the cases against independent public accountants, the auditor failed to obtain sufficient competent evidential matter.
- In 36 percent of the cases against independent public accountants, the auditor failed to recognize or pursue with sufficient skepticism certain warning signs or “red flags” that existed at the time the audit was conducted.
- Although 84 percent of all public companies are audited by national public accounting firms, 74 percent of the actions brought against independent public accountants were against smaller, regional, or local firms or sole practitioners. Moreover, 64 percent of the actions were brought against firms that were not members of the AICPA’s SEC Practice Section.

Review of Recent Cases Involving Fraudulent Financial Reporting by Non-SEC Reporting Organizations

This briefing paper summarizes the circumstances involved in the following alleged cases of fraudulent financial reporting:

- E.S.M. Government Securities, Inc.
- Home State Savings and Loan of Ohio
- American Savings and Loan Association of Florida
- Penn Square Bank
- Continental Illinois Bank
- Beverly Hills Savings and Loan Association
- United American Bank
- Drysdale Government Securities.

While these organizations are not under the SEC’s jurisdiction, they were reviewed because they have been cited in Congressional hearings as examples of fraudulent financial reporting and/or audit failure.

The material for the paper was obtained primarily from the transcripts of the 1985 and 1986 hearings of the Oversight and Investigations Subcommittee of the House Energy and Commerce Committee, chaired by Congressman John Dingell. Additional material was obtained from business periodicals and the transcripts of other Congressional hearings.

Role of the Audit Committee—Prevention and Detection of Fraudulent Financial Reporting

This research study analyzes the role of audit committees in preventing and detecting fraudulent financial reporting. The study involved reviewing previous research on audit committees and brochures discussing audit committee duties published by public accounting firms.

The study notes that over 85 percent of all public companies maintained audit committees during 1981. The wide adoption of audit committees appears to be due to the NYSE’s requirement that its listed companies have such committees, the SEC’s strong advocacy of them, recognition of the benefits of such bodies, and the liability to which board members may be exposed if the board has no audit committee.

The study also notes that there is general agreement that a key ingredient in having an effective audit committee is the independence of its members. Various bodies have, however, different definitions of independence and different requirements as to the number of independent members. Some of these alternative definitions are contrasted with the NYSE definition of independence.

The study concludes by describing customary audit committee functions and alternative functions proposed by several bodies. It also presents suggested audit committee guidelines tailored to the prevention and detection of fraudulent financial reporting. Some of these guidelines are incorporated into Chapter Two in the discussion of audit committee functions while others are included in Appendix I.

Whistleblowing

This briefing paper is based on a review of current cases, statutes, and legal research on the subject of whistleblowing. The paper discusses both internal whistleblowing (within the structure of the public company) and external whistleblowing (to government authorities or other third parties).

As to internal whistleblowing, the paper notes that courts universally have found a duty of loyalty to be an obligation of employment. Such duty extends to the firm's operating rules and procedures, its reputation, and its commercial opportunities. The duty of loyalty also means that a company has the right to know about its problems first before any disclosure to outsiders is made. If this proposition is to operate successfully, a company must have a widely known and accessible internal complaint and appeal mechanism for receiving complaints, conducting impartial investigations, applying clearly defined standards of judgment, and, if necessary, providing a fair hearing.

While the duty of loyalty suggests that a potential whistleblower should exhaust all internal procedures provided to ensure the accuracy and appropriateness of his disclosure, there are recognized exceptions where external whistleblowing is appropriate. Once an employee decides to go outside the company, he can seek protection against reprisal from three sources: common law as interpreted by the courts, federal statutes, and state statutes. The actual protection against reprisal afforded by the law, however, is often not predictable and many times inadequate.

The paper concludes that, for the most part, those making disclosures of alleged wrongdoing or illegality find little or no protection. Whistleblowers almost inevitably pay a heavy price. With few exceptions, they are driven out of not only their jobs, but also their professions.

Independent Public Accountants

Analytical Review

This research study analyzes the independent public accountant's use of analytical review procedures and the effectiveness of these procedures in detecting fraudulent financial reporting. The study included reviewing (1) authoritative auditing standards, (2) the auditing policies concerning analytical review of several of the larger public accounting firms, and (3) several published academic studies on the use of analytical review. The researcher also held discussions on how analytical review procedures can be improved with a limited group of experienced independent public accountants.

The resulting briefing paper first analyzes the existing authoritative auditing guidance concerning the use of analytical review procedures contained in Statement on Auditing Standards No. 23, *Analytical Review Procedures*. The paper observes that SAS No. 23 does not require the use of analytical review procedures in an audit and includes little specific procedural guidance on how and when analytical review procedures can be used, who on the audit team should perform them, and why specific analytical review procedures may prove more fruitful than others in specific circumstances.

The paper observes that there is considerable diversity in the use of analytical review procedures among the larger public accounting firms in the United States and that there exists a perception that these procedures have a relatively low degree of precision. It also notes that instead of being used as a planning tool, analytical review procedures are often mechanically applied by less experienced staff at the completion of the engagement.

The paper concludes by discussing two recent studies that demonstrate the potential effectiveness of analytical review procedures. The first, an empirical study of financial statement errors conducted by Robert E. Hylas and Robert H. Ashton and entitled "Audit Detection of Financial Statement Errors" (*The Accounting Review*, October 1982), found that more errors were initially signaled by analytical review procedures than by any other single category of event or procedure. The second, a study of several well-publicized cases of fraudulent financial reporting conducted by Frank Coglitore and entitled "Analytical Review: A Defensive Necessity," points out how timely application of analytical review procedures could have highlighted the materially misleading financial information.

Changes in the Independent Public Accountant's Responsibilities Concerning Audit Committee Communications

This briefing paper summarizes the proposed Statement on Auditing Standards entitled, *Communication With Audit Committees or Others With Equivalent Authority and Responsibility*. The paper notes that current auditing standards require that independent public accountants communicate to management and audit committees only material weaknesses in internal accounting control and information relating to errors and possible irregularities. The proposed standard requires independent public accountants to discuss with audit committees many other items involving the audit or management, including the following: significant accounting policies, management's judgment and accounting estimates, implications of audit adjustments, the independent public accountant's responsibility under GAAS, disagreements with management, the independent public accountant's responsibility for other information in the financial statements, difficulties encountered in performing the audit, and issues discussed with management prior to retention.

Changes in the Independent Public Accountant's Responsibility to Detect and Report Errors and Irregularities

This briefing paper summarizes the proposed Statement on Auditing Standards entitled, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*. The proposed standard would supersede Statement of Auditing Standards No. 16, *The Independent Auditor's Responsibility for the Detection of Errors and Irregularities*.

The paper notes that the proposed standard includes (1) an explicit statement that the audit should be designed to detect material misstatements, (2) a list of specific factors that could heighten or mitigate the independent public accountant's concern about the risk of material irregularities, (3) a discussion of the independent public accountant's use of professional skepticism in planning and performing the audit, and (4) a description of the characteristics of errors and irregularities that influence the independent public accountant's ability to detect such misstatements. The proposed standard also includes a clearer and more comprehensive discussion of the independent public accountant's responsibility to report errors and irregularities than is included in current auditing literature.

Comparison of the Commission's Recommendations with the Auditing Standards Board's February 1987 Proposed Standards

On February 14, 1987, the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants released for comment 10 proposed statements on auditing standards. This briefing paper compares these standards with the recommendations in the Commission's April 1987 Exposure Draft, and identifies the differences and similarities. The paper points out that the majority of the similarities exists in the following ASB proposed standards: (1) the auditor's responsibility to detect and report errors and irregularities and (2) the auditor's responsibility for assessing control risk. The paper notes that most of the differences are not generally contrary to the Commission's recommendations. Some of the differences are a result of issues the ASB addressed in a different manner than the Commission did (e.g., communication with audit committees or others with equivalent authority and responsibility). Other differences are a result of issues the ASB addressed that the Commission considered beyond its scope, for example, (1) illegal acts by clients and (2) the auditor's consideration of an entity's ability to continue in existence.

Comparison of the Internal Auditor's and the Auditing Standards Board's Definition and Concept of Control

This briefing paper contrasts (1) the definitions of internal control, (2) the control objectives analyzed, and (3) the required control assessments that are developed in the research study, "Control and Internal Auditing," prepared for the Commission (see Appendix B) under the sponsorship of the Institute of Internal Auditors (IIA) with those developed in the Auditing Standards Board's (ASB) proposed Statement on Auditing Standards, *The Auditor's Responsibility for Assessing Control Risk*.

The briefing paper notes that the IIA paper's definition of control and control objectives is broader than that of the ASB's. The former's definition includes the company's business plan and the way in which the company plans to conduct business and relates to both the corporate entity and the individuals within the corporation. The ASB's definition centers on the financial reporting processes and activities and relates more to the corporation as a reporting entity and less to individuals within the company.

The IIA paper's control assessment also is broader. While the ASB's assessment is concerned primarily with testing controls that indicate that the company can adequately and effectively prepare reliable financial reports, the IIA paper's assessment is concerned with the company's controls in both operational and financial areas.

Independent Public Accountant's Standard Report

This briefing paper discusses the history of the independent public accountant's standard report and recent attempts to change it. The paper notes that the current independent public accountant's standard report has remained substantially the same since 1948. This version of the report has been criticized as being hard to understand and defensive. Two attempts by the public accounting profession to revise the report failed largely because of concerns that a report that better describes the audit process would be seen as an attempt to dilute the profession's responsibilities.

The paper concludes by discussing the costs and benefits of potential changes to the auditor's standard report that the Auditing Standards Board and other parties have suggested. These changes fall into two general categories: (1) those that involve a better description of the audit process and its limitations but do not involve any change in the scope of the independent public accountant's work or in the extent of his responsibilities, and (2) those that would result in a change in the independent public accountant's responsibilities and a corresponding change to the independent public accountant's report to communicate such new responsibilities.

Individual and Situational Forces and Pressures Within Public Accounting Firms

This research study explored some of the individual and situational forces and pressures that can affect independent public accountants. A review of the literature dealing with this subject was conducted and independent public accountants from a national public accounting firm were interviewed.

The study identifies the following external factors that can affect audit quality:

- The ambiguity of Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS), to which management can appeal in attempts to influence the independent public accountant's interpretation of GAAP and GAAS
- The intense level of competition among public accounting firms which may lead to audit budget pressure, reduced audit scopes, and increased leveraging of partner and manager time on individual audits
- Client desires to release earnings shortly after year-end, which increases pressure to rely more heavily on interim work and decreases time to complete the year-end examination
- The increasing complexity of the business environment and information technology, which require greater training, technical expertise, and experience and may present difficulties for smaller firms with limited resources

- Public concern over the independent public accountant's responsibility to detect fraud and the resulting increased exposure to litigation, which can encourage improved audit quality, but also can result in decisions based on potential liability rather than on appropriate accounting or auditing principles.

The research study also identifies the following forces, internal to public accounting firms, that potentially can affect audit quality:

- Staff competence, which is influenced by, among other things, a firm's hiring practices and the quality of experience and training received by its staff
- Individual motivation, which is influenced by compensation levels, other organizational incentives, and overtime levels
- Time budget pressure, which can encourage independent public accountants to substitute lower quality audit evidence or to omit specific auditing procedures.

Nonaudit Services and the Independent Public Accountant's Independence

This briefing paper summarizes the historical debate concerning nonaudit services provided by a public company's independent public accountant. In doing so, the paper presents the arguments made during the late 1970s concerning the desirability of public disclosure of nonaudit services. It discusses SEC Accounting Series Release No. 250, which required disclosure of nonaudit services performed by a public company's auditor, and No. 263, which discussed the factors the SEC believed relevant to an audit committee's evaluation of the independent public accountant's independence. The paper also summarizes the factors that led the SEC to rescind both releases.

The paper concludes by summarizing the results of two recent surveys that deal with this issue: (1) "A Survey of Perceptions, Knowledge, and Attitudes Toward CPAs and the Accounting Profession," conducted on behalf of the AICPA by Louis Harris and Associates, Inc. (released October 1986) and (2) "Public Perceptions of Management Advisory Services Performed by CPA Firms for Audit Clients," conducted for the Public Oversight Board by Audits and Surveys, Inc. (released November 1986).

Public Accounting Profession's Self-Regulatory Programs

This briefing paper summarizes the current self-regulatory programs of the public accounting profession. The paper, which drew its information from current literature and AICPA manuals, discusses several key components of the profession's system of self-regulation. These include the AICPA Division for CPA Firms, consisting of the SEC Practice Section and the Private Companies Practice Section, the Public Oversight Board, the peer review process, concurring or second partner reviews, the Special Investigations Committee and quality control standards. In conjunction with the discussion of the peer review process, the briefing paper summarizes the peer review results during the last 3 years for the 14 largest public accounting firms.

Reports on Internal Control by Independent Public Accountants

This briefing paper summarizes current auditing standards as they relate to the independent public accountant's evaluation of internal control and his reports to management. These standards include Statements on Auditing Standards No. 1, Section 320, *The Auditor's Study and Evaluation of Internal Control*; No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*; and No. 30, *Reporting on Internal Accounting Control*. Among other things, these standards require the independent public accountant to inform the company's management and audit committee or board of directors of material weaknesses in the company's system of internal accounting control noted during the audit.

The paper presents five alternatives to the current professional guidance and discusses the costs and benefits of each alternative. The paper concludes by summarizing the significant changes in auditing standards contemplated in the proposed Statement on Auditing Standards entitled *The Auditor's Responsibility for*

Assessing Control Risk, and *The Communication of Control-Structure Related Matters Noted in an Audit*. These proposals are intended to clarify and broaden the types of controls an independent public accountant considers during the course of his audit, extend the minimum level of internal control review, and clarify the types of situations regarding the company's internal controls that should be communicated to management and the audit committee. If adopted, these proposals would replace SAS No. 1, Section 320, and SAS No. 20.

Second Partner Review

This briefing paper summarizes the emergence of second partner reviews, enumerates the current SECPS requirements concerning these reviews, and describes the policies that a group of national public accounting firms have for implementing second partner review. The paper notes that the firms' second partner review policies vary from general guidelines to more detailed instructions.

Structure of the Auditing Standards Board

This briefing paper contrasts the organizational structure of the Auditing Standards Board (ASB), the body responsible for establishing generally accepted auditing standards, and the Financial Accounting Standards Board (FASB), the body responsible for establishing generally accepted accounting principles. The briefing paper also summarizes the Cohen Commission's recommendations (1978) concerning the auditing standard-setting process and presents a number of potential changes to the ASB. The paper concludes by discussing the anticipated benefits and costs of two possible modifications of the ASB: (1) moving to a smaller, full-time body, and (2) including a larger number of representatives on the ASB from outside the public accounting profession.

Regulatory and Legal Environment

Criminal Law Enforcement Survey

This research survey asked the 71 members of the White Collar Crime Committee of the American Bar Association's Criminal Justice Section whether the regulatory and law enforcement environment may have tolerated unwittingly or contributed to the incidence of fraudulent financial reporting. The major conclusions drawn from the 20 respondents were:

- Over 75 percent considered fraudulent financial reporting to be as important a problem as insider trading and commodities fraud.
- More than 50 percent believed that increased sanctions (jail terms and fines) against convicted offenders would be highly effective in deterring or preventing fraudulent financial reporting.
- More than two-thirds agreed to some degree that the current level of law enforcement resources directed to fraudulent financial reporting is deficient and should be increased.
- Eighty-nine percent considered the public company's shareholders to be the category of persons most adversely affected by fraudulent financial reporting.

Legislative Initiatives Relating to Fraudulent Financial Reporting

This briefing paper summarizes the potential impact on financial reporting of several bills introduced during the 99th Congress. These Congressional initiatives include a provision in the Tax Reform Act of 1986 that treats one-half of a corporation's adjusted net book income in excess of the alternative minimum taxable income as a tax preference. This provision drew the attention of the FASB because of concerns (1) that linking financial reporting and tax regulations could have an adverse impact on financial accounting standard-setting, and (2) that the provision may provide public companies with a new incentive for fraud-

ulent financial reporting—reducing their federal taxes. Other Congressional initiatives (none of which was enacted into law) proposed amendments to the bribery and accounting provisions of the Foreign Corrupt Practices Act of 1977.

Overview of Disclosure Requirements and Enforcement Under Federal and State Securities Laws

This briefing paper summarizes the portions of the federal and state securities laws that are relevant to the Commission's study of fraudulent financial reporting. The major topics included are the purpose and disclosure requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, administrative and civil injunctive enforcement provisions of the federal securities laws, criminal penalties for violations of the federal securities laws, private causes of action under the federal securities laws, state law actions, and primary and secondary liability for securities laws violations.

Public-Private Debate on Rule 2(e) Proceedings

This briefing paper summarizes the issues concerning proposed amendments to one of the SEC's rules of practice, Rule 2(e). That rule gives the SEC the power to deny an individual the right to practice before it temporarily or permanently. Subpart (7) of the rule provides that all hearings "shall be nonpublic unless the SEC on its own motion or the request of another party otherwise directs."

The paper notes that on September 29, 1986, the SEC published for comment alternative amendments to Rule 2(e)(7) that would provide for (1) public Rule 2(e) proceedings, (2) public proceedings only in certain circumstances, or (3) a requirement that the SEC determine on a case-by-case basis whether the hearing shall be public or nonpublic. The paper summarizes the arguments for altering Rule 2(e)(7) that the SEC included in the September 29, 1986, request for comments, and the arguments against public Rule 2(e) proceedings included in the public response to a similar proposal the SEC made in 1974.

General

Analysis of the Proposed Financial Fraud Detection and Disclosure Act of 1986

This briefing paper includes a section-by-section summary of the provisions of the original Financial Fraud Detection and Disclosure Act of 1986 (H.R. 4886), introduced on May 22, 1986, and the revised bill (H.R. 5439), introduced on August 15, 1986. The bill is an outgrowth of the House Energy and Commerce Committee, Oversight and Investigations Subcommittee, hearings on the public accounting profession, financial reporting by public companies, and the SEC's oversight and enforcement activities.

Analysis of Related Studies on Fraudulent Financial Reporting

This report summarizes the recommendations related to fraudulent financial reporting that were included in the following 13 studies:

- *Improving the Accountability of Publicly Owned Corporations and Their Auditors*, Senate Subcommittee on Reports, Accounting and Management, Lee Metcalf, Chairman, 1977.
- *Federal Regulation and Regulatory Reform*, House Subcommittee on Oversight and Investigations, John E. Moss, Chairman, 1976.
- *The Public Accounting Regulatory Act*, H.R. 13175, June 16, 1978, Introduced by Congressman John Moss.
- *The Commission on Auditors' Responsibilities: Report, Conclusions and Recommendations*, AICPA, Manuel F. Cohen, Chairman, 1978.

- *Restructuring Professional Standards to Achieve Professional Excellence in a Changing Environment*, AICPA, George D. Anderson, Chairman, April 16, 1986.
- *The Future Relevance, Reliability, and Credibility of Financial Information*, (Recommendations to the AICPA Board of Directors) by Arthur Andersen & Co., Arthur Young, Coopers & Lybrand, Deloitte Haskins + Sells, Ernst & Whinney, Peat, Marwick, Mitchell & Co., and Touche Ross & Co., April 1986.
- *Challenge and Opportunity for the Accounting Profession: Strengthening the Public's Confidence*, Price Waterhouse, December 1985.
- *A Quest for Excellence, Final Report to the President*, President's Blue Ribbon Commission on Defense Management, David Packard, Chairman, June 1986.
- *Preparing for Special Examinations of Federal Crown Corporations: A Status Report*, Canadian Comprehensive Auditing Foundation, September 1985.
- *The Extra Mile—A Commitment to Soundness and Service in Banking*, American Bankers Association, July 1986.
- *Report of the Working Party on Fraud Submitted to the General Purposes and Finance Committee of the Institute of Chartered Accountants in England and Wales*, July 1985.
- *The Report of the Special Committee to Examine the Role of the Auditor*, Canadian Institute of Chartered Accountants, 1978.
- *Substandard CPA Audits of Federal Financial Assistance Funds—The Accounting Profession is Failing the Taxpayers*, H.R. 99-970, The House Committee on Government Operations, Jack Brooks, Chairman, October 7, 1986.

Appendix D

PERSONS CONSULTED BY THE COMMISSION

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Appendix E

**COMPOSITE CASE STUDIES IN
FRAUDULENT FINANCIAL REPORTING,
HARVARD BUSINESS SCHOOL**

Disctech Inc.

On a grey December day in 1985 Mr. William Winslow, the newly appointed president of Disctech Inc., sat at his desk contemplating the future of the company. Disctech had been the rising star of the computer disk memory industry. After going public in 1979, sales had grown at a compound rate of 33% and earnings had grown at 47%. Earnings per share (EPS) had risen every quarter, and the stock price had increased from \$3.00 a share in 1979 to \$67.50 a share in October 1985. (See *Exhibits 1 and 2* for financial data.)

In just the last week the entire fortune of the company changed for the worse as the company was rocked by reports of fraudulent sales, inflated inventory values, and possible insider stock trading. The board of directors had stepped in and asked the chief executive officer (CEO), chief financial officer (CFO), and the executive vice president for sales and marketing to take leave without pay until their investigation of the matter was complete, and they abruptly resigned. The board also selected a new president/CEO, Mr. Winslow, and retained an outside law firm to conduct an investigation of possible improprieties.

Bill Winslow viewed his job for the next few months as reorganizing the company to get it through this difficult period. This would require identifying and relieving the stresses that had brought on this crisis and restoring employee, consumer and investor confidence in the company.

The Hard Disk Industry

Disctech manufactured and sold disk drives. Disks are circular platters covered with magnetic material on which data are recorded in concentric circles. Disks access data more slowly than true random access devices like semiconductors or magnetic cores but faster than magnetic tape. Since the mid-1960s, disks had dominated the rapid access portion of the data storage market.

Although disk technology was well-established, the market was fast-growing and dynamic. Data capacity was doubling every three years, and this trend was expected to continue. Market positions changed rapidly, and disk drive manufacturers had to keep up with technological advances in order to survive.

The market for disk drives can be divided into two distinct submarkets: one for disks installed as part of large computer systems and one for those installed as part of minicomputer systems. The market for large computer disk drives was dominated by IBM, although other large mainframe manufacturers such as Sperry and Control Data also made disk drives for their own use. Independent disk drive manufacturers served this market by supplying IBM plug-compatible systems directly to end users. Independent disk drive manufacturers concentrated on replacing IBM drives because the sales volume for non-IBM models was considered too small. The mainframe disk drive market was expected to grow at about 5% per year.

The market for minicomputer disk drives, in which Disctech participated, was highly competitive. Some leading minicomputer manufacturers made some of their own disk drives, but most minicomputer manu-

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facturers were part of the Original Equipment Manufacturer (OEM) market serviced by a large number of small independent disk drive manufacturers. This market was expected to grow 25-30% per year.

Disctech

Disctech was founded in 1977 by Mr. John Garvey, an executive who had left his job with a large manufacturer of minicomputers and computer disk memories. John was an electrical engineer by training, but was better known for his interest in and talent for organizing. John had felt constrained by the staid corporate environment and wanted to venture out on his own. He felt that with a good product, good marketing, and the right pitch to the capital markets a "killing could be made." Three other talented executives left the large company to join with John in his new endeavor: Ed Steinborn (controller for the large manufacturer) became Disctech's chief financial officer, Peter Farrell (director of manufacturing) became the vice president for Design and Operations, and Mary Foley (manager of Minicomputer Marketing) became the executive vice president for Sales and Marketing. (See *Exhibit 3* for an organization chart.)

The period 1977-78 was spent organizing the corporation and building prototypes of the advanced 14- and 8-inch disk drives that the company would market. Early in 1979 the corporation went public with 3.3 million shares offered at \$3.00 a share. At a large party for shareholders and analysts, John announced that the corporation already had significant amounts of guaranteed sales for its new drives and that he expected Disctech products to become an industry standard. John also stated that the company expected to increase revenues and earnings per share (EPS) by a minimum of 30% per year.

Since the inception of the company, the planning cycle had been a very simple, top-down process. During the summer of each year, John met with Mary and Ed and set sales growth for the next year. This sales figure would then be rolled to the bottom line using expected margins and estimates of fixed expenses to get a net income figure and a tentative EPS. Prior to the beginning of the fiscal year in October, these goals for net income and EPS would then be passed down through the Finance and Marketing organizations where they became "law." The Design and Operations division planned production from the expected revenue and gross margin figures, while the R&D budget was negotiated separately between John and Peter.

Strategies to reach the annual plan were conceived and implemented at regularly scheduled "revenue meetings." Attendees included John, Ed, Mary, and the senior people of the marketing and sales staff. These meetings primarily sought the means of identifying and generating potential revenues.

Revenues for Disctech were derived from the sale and service of the company's equipment. Revenues were recorded at the time of shipment of products or performance of services. Customer orders were initiated by Disctech's receipt of an Equipment Order Form (EOF); this was either completed by the customer, or prepared by Disctech personnel pursuant to a Master Sales Agreement signed by the customer. The EOF included a description of the equipment, the price of the equipment, and the earliest equipment delivery date that was acceptable to the customer.

Board of Directors and Audit Committee. Since the company's inception, Disctech's board of directors had consisted of seven members: two inside directors (the CEO and the CFO) and five outside directors. The board usually met four times a year to review the corporation's progress and plans for the future. The meetings were generally short and standardized, with John in control of the agenda. The outside directors were all impressed with the company's performance and the dedication displayed by the top officers.

The Audit Committee of the board consisted of three outside directors. The members of the Audit Committee served three-year terms on a rotating basis, although the chairman of the committee usually served for a longer period. The Audit Committee generally met twice a year, before and after the annual audit.

A number of changes came about in 1982 after Richard (Rich) O'Donnell, an outside director, was named as chairman of the Audit Committee. Rich firmly believed that an audit committee "could not be effective without being active." He increased the committee's schedule to at least four meetings a year and set up private meetings between the committee and the outside auditors. Rich tried to get the committee to look

at the company's exposures and to question discretionary items in the financial statements. He suggested that the inside and outside auditors make some unannounced inspections and audits, and he wanted to strengthen the internal audit function, such as through training and improved hiring practices.

Rich admitted in 1983 that he had some concerns about serving on a board of directors and, particularly, on an Audit Committee.

A member of an Audit Committee is always a potential victim of management and the outside auditors since you depend on them so much. To a great extent you have to trust them. However, I try to set a tone of watchfulness by asking a lot of questions at all of our meetings; but I need to get other board members to do it or I will just look like an old crank.

Perhaps my concerns are just excessive caution, however, because it appears that the top officers are very talented, and John Garvey is very dedicated to the company. He wants to make good disk drives and sell a lot of them.

Internal and External Audit. The Internal Audit division, consisting of the head auditor, Doug McAneny, and two staff members, reported to Ed Steinborn (CFO). The primary roles of Internal Audit were to ensure that corporate accounting policies were followed and that safeguards existed to ensure that the company's assets were protected. A secondary role was to be alert to opportunities for cost-cutting and efficiency.

At the request of Rich O'Donnell, Doug McAneny had attended some meetings of the Audit Committee. Rich tried to establish a rapport with Doug and assured him that any misgivings that he had about anything, or anyone, in the company would be brought to the attention of the Audit Committee.

Disctech's external audit firm was Touche, Young and Andersen (TYA), a Big Eight firm. Each year in July, the auditors met with top management and the Audit Committee to lay out the schedule of the annual audit and to review changes in the company since the previous year.

1979-82

The years 1979-82 were very exciting at Disctech; sales revenues grew at a compound rate of 39%. Every quarter the company announced record earnings, and the stock market reacted as John predicted, with the trading price continually reaching new highs. John made regular announcements about the company, stating how earnings were going to continue to grow at above industry rates. The total market in 1979 for minicomputer disk memories at OEM prices was \$2.1 billion, so there was plenty of room for Disctech to grow.

Disctech had continued to make modest R&D expenditures, but by the middle of 1982 its once "head of the pack" products were beginning to fall behind the latest technology. In response, John applied pressure to the Product Design division to come out with new products, even if they were only slight improvements on existing products.

1983

The sales pattern in 1983 proved to be a little erratic. John Garvey and Mary Foley (Executive Vice President-Sales and Marketing) agreed that quarterly sales (and earnings) had to continue to grow to keep the glowing image of Disctech alive. To maintain this growth record, they sometimes found it necessary to have the shipping department work round-the-clock during the last few days of each quarter in order to push as many orders as possible out the door so as to recognize the revenue for those transactions.

Mary also decided to take advantage of the way some OEMs ordered disk drives. Many OEMs would place a large order for 100-200 disks, get a discount, and then ask for delivery at a date 2 to 3 months in the future. This assured them of a supply of the disks and a delivery date that supported their computer construction and shipment schedules. Many times an order placed in one quarter would not be scheduled for delivery until the next quarter. To recognize these sales in the present period, Mary directed that as many orders as possible

receive early shipment to the OEM, with the understanding that the OEMs would not be liable for payment until the previously agreed-upon delivery dates.

The auditors from TYA questioned this early shipment program but Ed Steinborn was able to convince them that the sales met the requirements of "sales" as defined under generally accepted accounting principles: Title to the disks did transfer to the OEM upon shipment; under the contract the OEM was obliged to pay Disctech for the disks; and Disctech did contact the OEM prior to shipment to get their authorization. What was not clear at the time was that some of these authorizations were verbal: the salesperson responsible for an account would get the authorization and call it back to the home office.

This early shipment policy was fine with some OEMs, but many other OEMs did not have extra storage room and would not accept early delivery. The salespeople were told to "use their imaginations" and find storage at the local Disctech distributor or another convenient location. The company needed the sales and the salespeople were told to "get as many authorizations as possible."

The net result of these two policies was that by the end of 1983 revenues had grown from \$81.1 million to \$107.1 million, but \$5.9 million of the 1983 sales were for disks originally scheduled for delivery in 1984. (Of the \$5.9 million, \$3.7 million were shipped without a valid authorization.)

1984

The only major change at Disctech in 1984 was in marketing policy. John Garvey had long thought that the minicomputer memory industry would slowly evolve to become more like the mainframe business, with fewer sales to computer manufacturers and more sales directly to end users. This evolution was accelerated as the economy slowed, as many companies held onto the systems they already had installed. John believed that a truism of computers—"information to be stored, quickly grows to fill all available memory"—would be the salvation of Disctech. More salespeople were hired, and the sales force was directed to start approaching all current users of minicomputers compatible with Disctech disk memories to attempt to generate sales in this potentially large market.

After the results of the second quarter were announced (another record high), John called Mary, Ed, and Peter together for a private meeting. John indicated that he was very proud of their results and that he knew they would continue to outperform the industry. He pointed out, however, that each quarter's goals had been harder and harder to reach, and that delays in the completion of new disk designs and prototype construction and the growing obsolescence of their inventory might level or even decrease the company's short-term earnings.

John went on to say that with his children nearing college age he needed a lot of money set aside that was not tied up in risky investments. As a result he had begun quietly to sell some of his Disctech stock, which had appreciated so much since 1979. He told them he was still optimistic about the company's future but that it might be wise for them to look carefully at their own financial needs. If they were going to sell stock, he reminded them that they would have to inform the Securities and Exchange Commission of the sales, but he urged them to be discreet about the sales in all other ways.

The marketing shift toward memory end users was a big success and significantly contributed to another record year, and early shipments continued to increase as the marketing department pressured OEMs and salespeople for early authorization. Total sales for the year were \$134.9 million. Early-shipment revenues were \$12.4 million of which \$9.8 million was shipped without a valid authorization.

Inventory Control and Reserves for Obsolescence

Inventory at Disctech was broken down into three categories: raw materials, work in process (WIP) and finished goods inventory (FGI). In 1981, over 85% of total inventory was in FGI, and this percentage increased in later years. This unusual inventory mix was the result of a general shortage of raw materials in the industry, and Disctech and other manufacturers responded by sending raw materials directly to the

production line. In addition, Disctech wanted as little work-in-process inventory as possible because partially assembled disk drives were highly susceptible to damage; even the slightest dirt or dent rendered the disk or its drive unit inoperable.

Assembled units were tested and then stored until sale and shipment. The company's first-year production capacity was very limited, so units were shipped out as soon as they were assembled. Efforts to improve efficiency and cleanliness raised production yields, and by 1980 production began to produce drives for inventory.

In 1982 the Design Division began to make a large number of small improvements to the disk drives to ensure that the product remained competitive. This had a large effect on inventory levels. Disassembling the finished disk drive often caused complete disk failure, and as a result very little rework on FGI drives was done. Instead, new drives in production would be modified and then assembled. Thus each change or alteration created another layer of FGI slightly different from the last.

Disctech's policy for creating reserves for obsolescence of inventory was:

- Any equipment over two years old would be reserved at 5% per quarter for five years so that at the end of seven years there would be a 100% reserve.
- Any equipment declared unmarketable would have a 100% reserve taken against it.

These rules resulted in small reserves. Very little equipment that was technically obsolete was actually very old. Moreover, Disctech had no corporate standards or guidelines for determining when disk drives became unmarketable. This problem was intensified by the corporate attitude that Disctech equipment was not subject to obsolescence.

At the end of 1982 a production controller forwarded a memo via Peter Farrell to the CFO and the executive vice president for Sales and Marketing that summarized a study he had done on the growing inventory problem. It listed three recommendations:

1. A study to produce a new reserve policy, since it appeared that the product life cycle was far shorter than five years.
2. An intensive effort by the Marketing department to sell the older inventory as soon as possible.
3. An increase in the reserve for obsolescence from \$800,000 to \$1.4 million.

This memo was discussed by the senior corporate officers who all felt that the problem was not that serious; they were absolutely unwilling to increase the reserve by any amount. Marketing, however, attempted to stimulate sales of the older disk drives with various specials, discounts, and promotions. The CFO also stated that he would "closely watch the inventory problem."

In 1983 the amount of obsolete inventory grew faster than the reserves, and by the end of the fiscal year the deficit was estimated by the production controller to be almost \$2.4 million. The outside auditors did not see the total extent of the problem but they did question the reserve policy in their management letter.

Continual monitoring of Disctech's FGI reserve policy is required and procedures should be implemented to develop historical experience to measure the propriety of the formula adopted. The policy should also be extended to recognize obsolescence of products no longer in production sooner than required by the present formula.

Disctech's management acknowledged the auditors' report but also informed the Audit Committee that they already had done an internal study in 1982 and were working actively to fix all problems with inventory control.

During 1984, Disctech management was aware that the exposure for FGI obsolescence was increasing, but little was done other than continuing the marketing promotions and taking reserves as calculated by the reserve formula. Disctech's management maintained that reserving for or writing off inventory made it less

likely that it would be sold. They stressed that they had an obligation to the stockholders to find uses for the inventory rather than write it off.

By the time of the 1984 year-end audit, the auditors had become more agitated by the inventory situation (in addition to the aggressive revenue recognition practices) and sought written assurance from Disctech's management that a formal program existed to "significantly impact the obsolescence exposure." The CFO, Ed Steinborn, wrote to the auditors:

Our response to the problems in the inventory area will be to outline the programs we have underway to reduce inventory levels. We will agree to study policy alternatives in the area of providing reserves for excess equipment; however, affordability considerations really preclude our ability to make any meaningful change in this area this year.

Management informed the board and the Audit Committee that a problem with inventory control still existed and that efforts to rectify the situation were ongoing. They were also told that "reserves for obsolescence may have to be increased next year as the product life cycle for disk memories shortens." They were not given an exhibit to the 1984 auditors' management letter that contained the following sentence:

This policy results in full valuation of excess inventory, overstates inventory, and may lead to serious future financial adjustments.

The board was not told that the exposure on FGI had grown to an estimated \$3.9 million.

The Audit Committee asked questions about inventory valuation, but John and Ed had quick answers and were confident that the inventory situation would soon be under control. Nevertheless, the Audit Committee in a private session with the outside auditors admitted that some things, including inventory obsolescence, had begun to worry them. They also told the engagement partner that they intended to meet more often in 1985 and they wanted a senior representative from the outside auditors and Doug McAneny, the head of internal auditing, at their meetings.

1985

The year 1985 was difficult for Disctech, and tremendous pressure was placed on the sales force to achieve the planned sales goal. A combination of a soft market for the 14-inch disk drives and unexpected delays in production of the advanced 8- and the new 5¼-inch drives made sales difficult.

Some salespeople came up with some ingenious ideas to stimulate sales that were often designed to take advantage of the company's aggressive revenue policies. For example, one such scheme could occur when a customer filled out an EOF with a delivery date far in the future and submitted it to Disctech for processing. Within a week or two the responsible salesperson would contact the Marketing department and inform them that he had convinced the customer to accept an early delivery in the current quarter—with the understanding that payment would not be due until the date on the EOF. From the salesperson's view this made everyone happy: Disctech booked a sale, the salesperson got a commission, and the customer received a disk memory at a reasonable price with delayed payments and no finance charges.

At the same time sales were becoming more difficult, order cancellations were becoming a problem. As Disctech's competitors came out with new products, many OEMs switched disk memory suppliers; direct end-user sales were also affected because people wanted more memory and shorter access time for their dollars.

Near the end of the first quarter of 1985, a Marketing department meeting was held to discuss the order cancellation problem. Mary chose this opportunity to announce a new policy: any order cancelled within six weeks of expected delivery would still be shipped and the revenue recorded. Her staff told her that most customers would just refuse to accept delivery. She responded that on each of these deliveries the responsible salesperson would go along and ensure that "the sale stuck." All of these problems caused a lot of

consternation in the sales force but they all knew better than to argue with Mary when her mind was made up.

A Midyear Meeting. At midyear John Garvey called a meeting of the top officers to review some pressing problems. The first problem was financing. As receivables had grown, cash was getting short. Consequently \$10 million in bonds would be issued for public sale early in the fourth quarter; \$4 million of the cash raised would be used to retire the bonds currently outstanding, and the rest of the proceeds would go to operations.

Second, inventory problems were getting worse. An internally generated estimate of the current obsolescence exposure was \$6.8 million, and this was expected to grow to over \$8 million by the end of the year. The outside auditors were very worried about the obsolescence exposure, but John explained he had placated them by informing them that the company was currently doing another internal study of obsolescence policies and that he expected a significant writedown probably as early as the first quarter of 1986.

Third, the new disk memory designs still had development problems but John expected them to be available before the end of the calendar year. Finally, there was a growing problem with returned equipment. This would probably cause a significant reversal in revenues in future periods.

Putting these all together, John admitted that the record string of growth and profits would probably be broken. John wanted the company to take all its "lumps" in the first quarter of 1986, and he wanted to take the inventory writedown at the same time as the new product announcement. He also stated that strong quarterly and annual results in 1985 would help the bond issue and would likely mitigate the impact of a loss in the first quarter of 1986. Everyone came away from the meeting clearly understanding that they had to make the 1985 budget—no matter what they had to do.

Despite heroic efforts by the sales force, fourth quarter predictions indicated that without further action Disctech would come up short of the 1985 budget. A plan was worked out in the Marketing department to make a large shipment to a warehouse rented by Disctech under another name; this shipment (for \$4.2 million) was booked as revenue in 1985. Plans were to use the equipment to help fill early 1986 orders.

In the end, the 1985 goal of \$162 million in sales was achieved; total annual sales were \$164.6 million. Early shipment revenues totaled \$15.8 million, of which \$10.6 million was equipment shipped without authorization. This \$15.8 million did not include the \$4.2 million shipped to the new warehouse.

1986

The board of directors met in late October to review the results of 1985. John first went over the high points of the year and the records achieved. He next turned to the inventory problem and gave a quick summary of the events of the last few years. John then told them that to bring inventory back in line, a one-time writedown of \$8.2 million would be required.

Unfortunately for John, this did not take the outside directors by surprise. Prompted by knowledge of a large number of customer complaints, increasing levels of returned equipment, and the possible inventory obsolescence problem, they had asked the external and internal auditors to conduct some additional investigations in the last two quarters. The outside directors proceeded to ask John some difficult questions about the company's policies and practices and also questioned him on his personal finances and his recent stock dealings.

Receiving nothing but evasive answers, they told John they were retaining an outside law firm to conduct an investigation to be reported directly to the Audit Committee. The board also informed John that it would be best if he, Ed, and Mary were to go on leave until the investigation was complete.

With feelings of anger and humiliation, all three resigned immediately rather than accept the forced leave of absence. Disctech hired an interim president, Bill Winslow, and the SEC was informed that an internal investigation was being started that could impact their reported financial statements for the last three years.

EXHIBIT 1
DISCTECH, INC.

Income Statements for Fiscal Years Ending September 30
(000s omitted)

	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Revenue	\$5,997	\$30,003	\$42,004	\$59,646	\$81,119	\$107,076	\$134,916	\$164,598
Cost of Sales	<u>6,531</u>	<u>21,288</u>	<u>29,403</u>	<u>41,752</u>	<u>55,161</u>	<u>72,812</u>	<u>91,743</u>	<u>111,927</u>
Gross Margin	(534)	8,715	12,601	17,894	25,958	34,264	43,173	52,671
R&D Expense	1,354	2,528	3,760	3,772	4,056	4,283	4,722	4,938
SG&A Expense	<u>1,990</u>	<u>4,138</u>	<u>5,220</u>	<u>6,561</u>	<u>10,545</u>	<u>13,920</u>	<u>17,539</u>	<u>21,398</u>
Operating Profit	(3,878)	2,049	3,621	7,561	11,357	16,061	20,912	26,335
Interest Income	<u>131</u>	<u>(517)</u>	<u>84</u>	<u>119</u>	<u>162</u>	<u>214</u>	<u>(104)</u>	<u>(541)</u>
Profit before Tax	(3,747)	1,532	3,705	7,680	11,519	16,275	20,808	25,794
Income Tax	<u>0</u>	<u>767</u>	<u>1,704</u>	<u>3,533</u>	<u>5,299</u>	<u>7,487</u>	<u>9,572</u>	<u>11,866</u>
Profit after Tax	\$(3,747)	\$ 765	\$ 2,000	\$ 4,147	\$ 6,220	\$ 8,788	\$ 11,236	\$ 13,928
Tax Loss								
Forward	<u>0</u>	<u>685</u>	<u>1,400</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Net Income	\$(3,747)	\$ 1,450	\$ 3,401	\$ 4,147	\$ 6,220	\$ 8,788	\$ 11,236	\$ 13,928
Earnings per								
Share	\$ (1.06)	\$ 0.21	\$ 0.50	\$ 0.60	\$ 0.90	\$ 1.27	\$ 1.61	\$ 1.99

Source: Annual reports.

EXHIBIT 2

DISCTECH, INC.

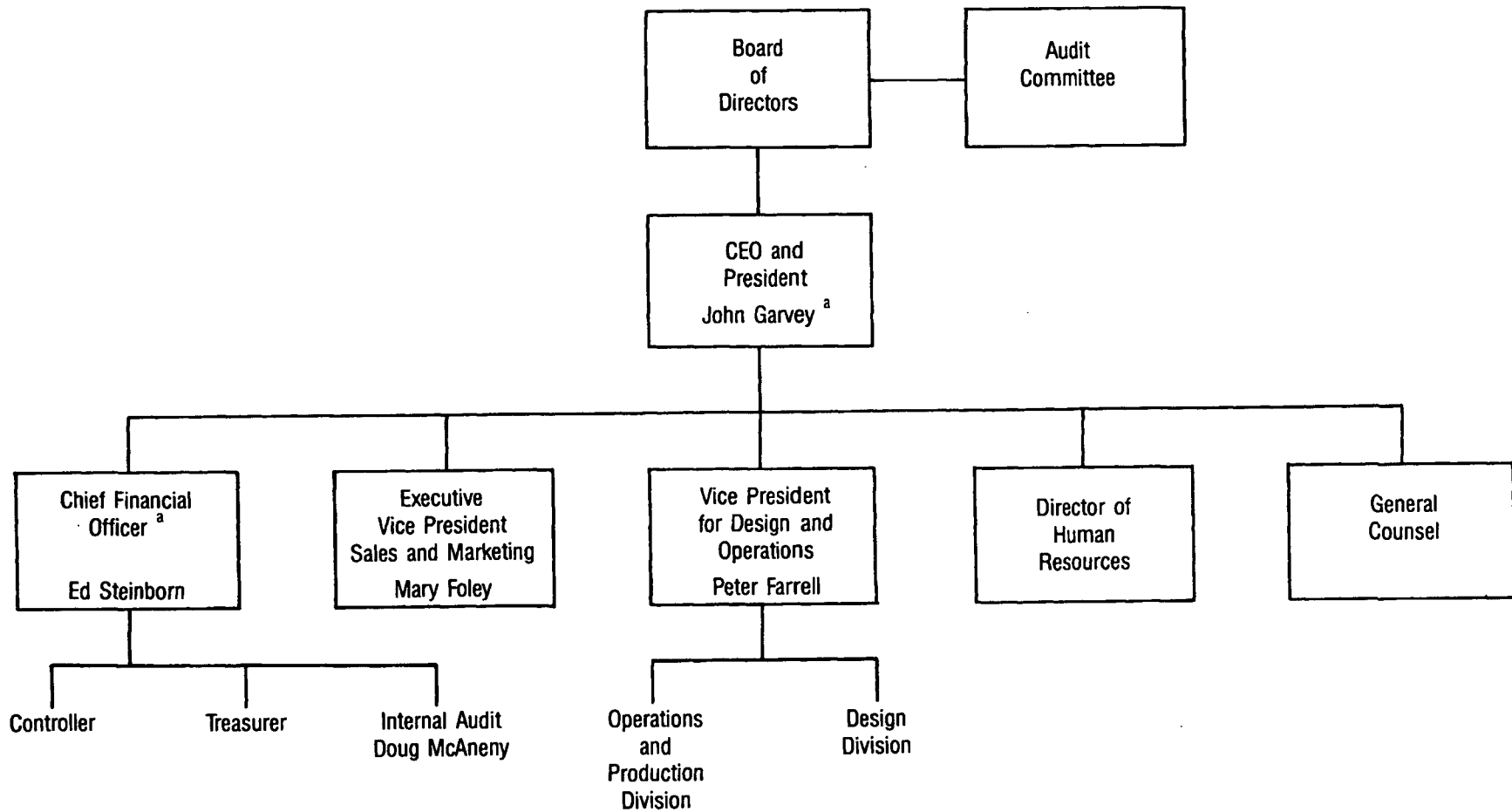
Consolidated Balance Sheets at September 30
(000s omitted)

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
<i>Assets</i>							
Cash and Marketable							
Securities	\$10,020	\$ 3,654	\$ 3,778	\$ 3,273	\$ 2,947	\$ 2,808	\$ 3,920
Accounts Receivable (net)	8,752	9,801	11,921	15,508	22,091	30,843	39,300
Inventories (net)	12,221	8,601	11,241	15,122	22,046	27,557	36,682
Prepaid Expenses	<u>142</u>	<u>375</u>	<u>525</u>	<u>746</u>	<u>730</u>	<u>750</u>	<u>809</u>
Total Current Assets	31,135	22,431	27,465	34,649	47,814	63,958	80,711
Property, Plant							
and Equipment (net)	2,110	6,901	9,661	13,719	18,657	24,628	31,031
Other	<u>929</u>	<u>120</u>	<u>169</u>	<u>239</u>	<u>284</u>	<u>321</u>	<u>364</u>
Total Assets	<u>\$34,174</u>	<u>\$29,452</u>	<u>\$37,295</u>	<u>\$48,607</u>	<u>\$66,755</u>	<u>\$86,907</u>	<u>\$112,106</u>
<i>Liabilities</i>							
Notes Payable	\$ 4,050	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Accounts Payable	5,664	3,600	5,041	9,158	12,734	16,849	23,190
Accrued Liabilities	<u>1,179</u>	<u>1,500</u>	<u>2,100</u>	<u>2,982</u>	<u>4,056</u>	<u>5,354</u>	<u>6,746</u>
Total Current Liabilities	\$10,893	\$ 5,100	\$ 7,141	\$12,140	\$16,790	\$18,203	\$ 29,936
Bank Debt	0	0	0	0	0	2,000	0
Capital Leases	1,363	4,485	6,820	8,917	12,127	16,008	18,170
Bonds	3,570	0	0	0	4,000	4,000	10,000
<i>Equity</i>							
Common Stock	3,651	3,677	3,703	3,729	3,755	3,782	3,807
Other Capital	20,978	21,020	21,062	21,104	21,146	21,188	21,231
Retained Earnings	<u>(6,281)</u>	<u>(4,831)</u>	<u>(1,431)</u>	<u>2,717</u>	<u>8,937</u>	<u>17,726</u>	<u>28,962</u>
Total Liabilities and Equities	<u>\$34,174</u>	<u>\$29,452</u>	<u>\$37,295</u>	<u>\$48,607</u>	<u>\$66,755</u>	<u>\$86,907</u>	<u>\$112,106</u>

Source: Annual reports.

DISCTECH, INC.
Organizational Chart

EXHIBIT 3



^a Member of the board of directors.

Graves Industries Inc. (A)

At the annual stockholders' meeting in April 1981, Henry Graves, chairman, CEO, and president of Graves Industries, announced the creation of a new division of Graves Industries Inc.:

Ever since the founding of Graves Industries we have worked to be on the leading edge of technology, always seeking to create machines for the factory of the future. Today, we are taking a large step into that future with the founding of the Flexible Manufacturing Systems division. The world of computer-integrated manufacturing has become so complex that we have created a new division dedicated to that industry. Big steps like this don't come cheaply. In the next four years we will spend over \$100 million in research and development alone, for this division. You say this is a large risk, and I agree with you, but the potential payoff is tremendous....

This new division fundamentally alters the way we look at the corporation and what we view as our primary business. I have authorized a number of new programs designed to cut costs throughout the corporation and improve our profitability. We will continue to be the standard of excellence in our other businesses, but clearly our focus is on the future.....

This case provides background information on Graves Industries Inc. for use with the (B) case focused on Graves' Marine Hardware division and/or the (C) case focused on the Consumer Hardware division.

Company History

Graves Industries was founded in the early 1920s as a manufacturer of industrial hardware and tooling. The company went public in 1926 and was listed on the New York Stock Exchange. The company was small and experienced only modest growth until 1941. Then, capitalizing on the rapid growth of industry during the war, Graves Industries grew tremendously. Revenues climbed from \$8.2 million in 1941 to \$41.5 million in 1945.

From 1946 until 1981 the corporation changed little except to branch out into other areas of hardware and tooling. In 1946, Graves started a small consumer products division to produce and sell tools and hardware to hardware distribution chains. The Consumer Products division was very successful, and by 1981 sales had risen to \$122 million. In 1958, a separate automotive division was founded by splitting out the automotive sections of the Consumer and Industrial divisions. In 1963, the corporation moved into marine hardware by acquiring the Lohnes Marine Hardware Company of Portsmouth, N.H.

In the 1970s, Henry Graves, now the chairman and CEO, recognized that flexible manufacturing was the wave of the future and that to be part of it Graves Industries would have to make some large investments. The company started by building numerically controlled (NC) tools in the Industrial division. This field was so complex, however, and the potential market was so large (\$26 billion in 1982) that in 1981 a new division was formed. (*Exhibit 1* presents a financial summary of recent fiscal years.)

Organization

Graves Industries used a divisionalized organization structure. The corporate headquarters, located in Groton, Connecticut, consisted of the principal corporate officers and their relatively small staffs. The operating divisions were relatively autonomous; operating companies (see *Exhibit 2*) and division managers were directly responsible for the division's products and services. They also operated their own research and development, manufacturing, and marketing facilities. Division staff reported directly to division managers and had relatively weak, "dotted line" relationships with corporate staff.

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Headquarters controlled divisional performance by reviewing plans and budgets and by monitoring financial reports. If performance was in line with corporate financial goals, few inquiries were made into divisional operations, but if negative variances resulted, headquarters gave divisions a great deal of attention, and pressure was applied to improve results. Formal reviews were held quarterly to discuss the actual results and the forecast for the year.

Henry Graves felt that it was very important for the corporation, and thus the divisions, to maintain a steady pattern of growth because “that is what the stock market values.” Thus, consistency and predictability were the watchwords; surprises were to be avoided. One division president noted that, “There are only two things important in this company: profit, and turning it in in a predictable fashion.”

Profit Planning

Profit planning was done in two distinct cycles: strategic planning and budgeting. Strategic planning involved creative thinking about corporate strengths, weaknesses, opportunities, and threats in the next three-year period. The division managers were required to submit a narrative analysis of their businesses and plans, supported by summary numerical schedules. Presentations of the strategic plans were made to top management in August and September.

After the strategic plans were approved, the divisions began working on their budgets. The budgets were expressed in terms of monthly income statements and balance sheets for the coming year. They were reviewed by top management and the board of directors in November and December. The budgets were considered a commitment of earnings and return on net assets (RONA) from division managers to the corporation and from the corporation to the board of directors.

While the intent of the profit planning process was “bottom-up,” it was typical for the division managers to have to adjust their targets after the review meetings. Henry Graves liked his managers to have aggressive budgets, and it was often said that “Henry always wants to take something from each division when he leaves the table.”

Management Incentive Plan

Graves offered its management personnel a base salary that was slightly below that of its competitors, and it relied on a Management Incentive Plan (MIP) to help motivate and retain its key personnel. The MIP offered annual cash awards based on the actual vs. budgeted levels of RONA achieved by the entity to which the individual was assigned (division or above).

About 60 employees were enrolled in the MIP, including most managers down to one level below division manager. The payouts in the plan were potentially lucrative. For example, the payouts for a division manager ranged up to 100% of salary, as shown in Figure 1.

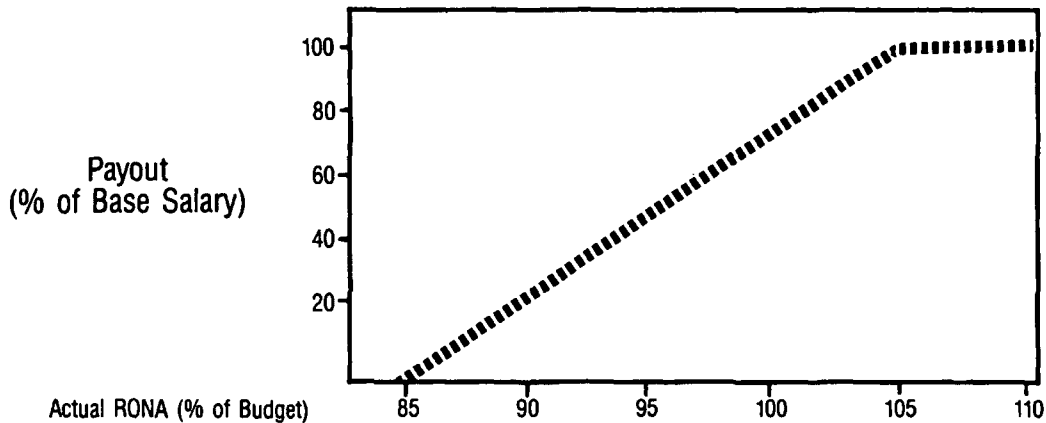
The incentive plan clearly attracted the attention of the managers. In a survey done several years after the plan was implemented, the managers all reported that they understood how the plan worked and that it affected their decision making.

Board of Directors

The board of directors consisted of five members, two inside directors (Henry and the president of the Industrial Division, Steve Sinko), and three outside directors. The outside directors were all either active or retired executives who were long-time acquaintances of Henry Graves. The board usually met four times a year to review the corporation’s progress and plans for the future.

FIGURE 1

MANAGEMENT INCENTIVE PLAN PAYOUT FOR DIVISIONAL PRESIDENT



The Audit Committee consisted of the three outside directors. This committee was created in 1973 in response to the endorsement of the Securities and Exchange Commission and the New York Stock Exchange for all publicly held companies to establish audit committees.

Internal Audit

The Internal Audit staff consisted of the head auditor and three staff members. The Internal Audit group ensured that corporate accounting policies were followed and verified that safeguards existed to protect the company's assets. Their workload was heavy and even though they were scheduled to visit each division each year, sometimes they were able to perform audits only on alternate years.

Outside Auditors

Since 1971 Graves had used a Big Eight accounting firm, Ernst, Mitchell and Sells (EMS). Harvey Krantz had been the EMS partner on the Graves account for the last three years, and during that period Harvey and Henry Graves had developed an excellent working relationship. Socially, they were involved in many of the same activities, were members of the same country club, and occasionally played golf together.

In the last two years, however, the relationship had been strained as Graves applied pressure to reduce the audit fees. The growth of the FMS division, as described in the opening comment of this case, created a need to free up capital through cost cutting and other measures.

EXHIBIT 1

GRAVES INDUSTRIES INC. (A)

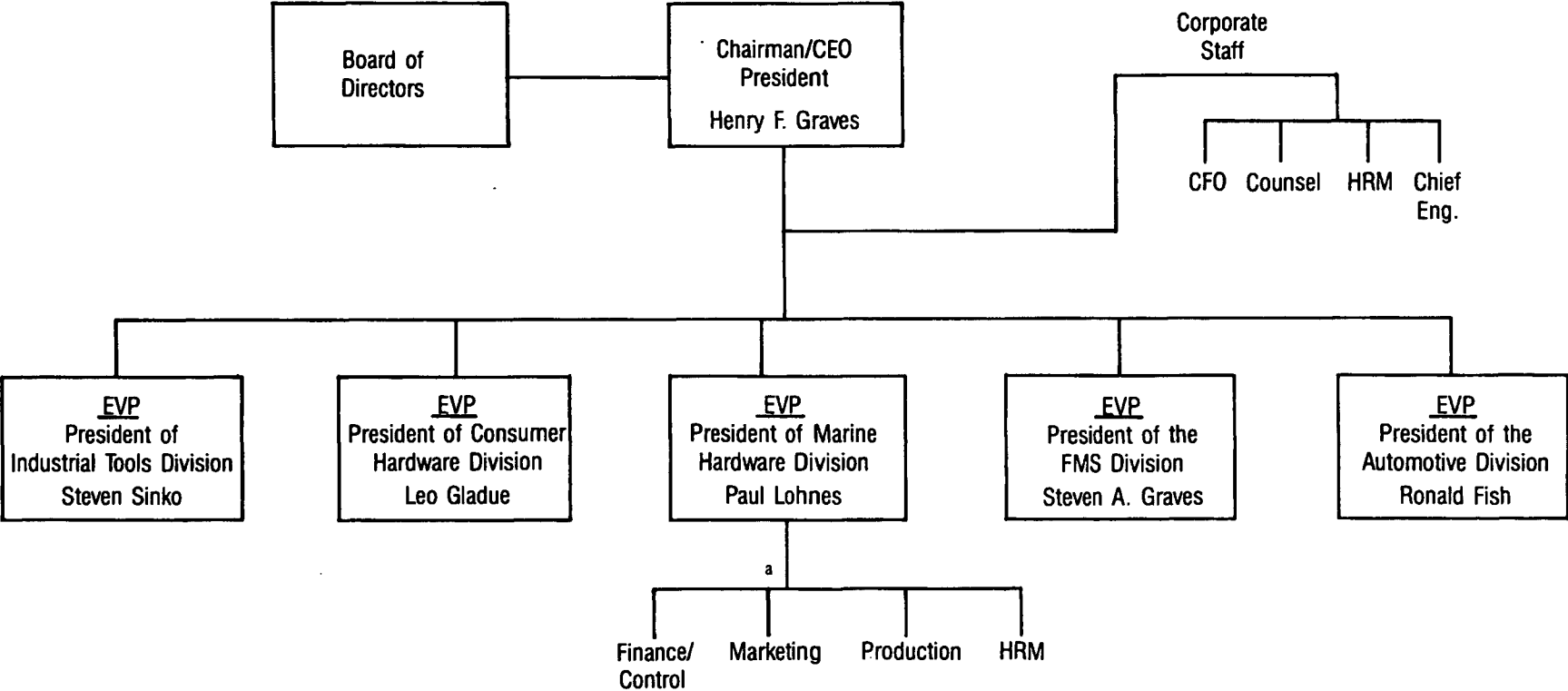
*Consolidated Income Statements
for Years Ending December 31
(\$ millions)*

	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>
Revenue	\$476.3	\$524.9	\$580.0	\$640.9	\$708.2
Cost of Sales	<u>319.1</u>	<u>351.7</u>	<u>388.6</u>	<u>429.4</u>	<u>460.3</u>
Gross Margin	\$157.2	\$173.2	\$191.4	\$211.5	\$247.9
R&D Expense	20.2	31.0	36.0	44.0	58.3
SG&A Expense	<u>56.6</u>	<u>62.0</u>	<u>68.2</u>	<u>74.8</u>	<u>82.2</u>
Operating Profit	\$ 80.4	\$ 80.2	\$ 87.2	\$ 92.7	\$107.4
Corporate Expense	11.9	13.1	14.5	16.0	17.7
Interest Expense	<u>7.0</u>	<u>7.0</u>	<u>9.0</u>	<u>9.0</u>	<u>9.0</u>
Profit before Tax	\$ 61.5	\$ 60.1	\$ 63.7	\$ 67.7	\$ 80.7
Income Tax	<u>28.3</u>	<u>27.6</u>	<u>29.3</u>	<u>31.1</u>	<u>37.1</u>
Net Income	<u>\$ 33.2</u>	<u>\$ 32.5</u>	<u>\$ 34.4</u>	<u>\$ 36.6</u>	<u>\$ 43.6</u>

Source: Corporate records.

GRAVES INDUSTRIES INC. (A)
Corporate Organizational Chart

EXHIBIT 2



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^aEach division had a staff similar to the Marine Division.
 Source: Corporate records.

Graves Industries Inc. (B)
Lohnes Marine Hardware Division

In January 1986, Don O'Grady, controller and financial officer of the Lohnes Marine Hardware Division of Graves Industries Inc., reviewed the financial results for 1985. It was another record year for the Lohnes division: sales were up 12% and operating profits had increased 13% (see *Exhibit 1*). Don knew that the division president, Paul Lohnes, would be very happy to see that the final figures were a couple of million dollars above budget. The company was also well positioned for a big jump on 1986's budgeted goals.

In contrast to 1984, the fourth quarter of 1985 had been relatively relaxed. Sales were strong throughout the year, and by the beginning of the last quarter the division had already achieved almost 90% of budgeted profits and sales. In 1984, the division had only 68% of budgeted goals going into October, and it had taken a large effort by all employees to make sure the division finished on budget.

The distress of last year reinforced in Don's mind the advice he had received on his first job out of school. The controller of that company had told him (when discussing the accounting policies of his new employer) that "only a fool does not have reserves salted away for rainy days." The reserves the Lohnes division built up had been very important in 1984. But now Don wondered if the division reserves went beyond the bounds of reasonableness.

The Division

Lohnes Marine Hardware was founded in 1954 by Paul Lohnes. Paul was an avid sailboat builder in the Portsmouth, N.H., area who became frustrated by the poor support existing marine hardware companies were giving sailboat builders and owners. Paul reasoned that a full-service marine hardware and tooling business that provided special services for sailboaters could be very successful. He also felt that as disposable income increased in the United States, boating would become increasingly popular, and the market would grow rapidly.

The new Lohnes Company did very well; by 1963 the company was well-established in New England, and Paul was looking at expanding into other regions. An important part of this success was the tools and marine rigging that Paul had originally designed and built for his own use that were now marketed by his company. The boating market was still young and growing, and Paul figured that if he could expand quickly and get a toehold across the country, he would be in good position to take his share of the market. Paul had the knowledge, but lacked the financial resources to support a large expansion.

During the summer of 1963 Paul was approached by Henry Graves, executive vice president of Graves Industries Inc., a large producer and distributor of industrial and commercial hardware and tooling. The Graves wanted to expand into marine hardware, but they did not have any experience in this specialized area and were looking to make an acquisition.

At first Paul rejected the Graves' offers, but in the fall of 1963 he reconsidered, and a deal was quickly hammered out. For an undisclosed sum (rumored to be quite sizeable), 100% interest in Lohnes Marine Hardware was transferred to Graves Industries Inc. This transfer included the name of the company, Lohnes Marine Hardware Company, and all the proprietary products manufactured by the company. As part of the agreement Paul was to remain as president of the new marine division.

One of the major reasons Paul agreed to the acquisition was the Graves' decentralized management philosophy; the company would leave him in control of the Lohnes division with almost no corporate interference as long as results were at or above the corporation's long-term growth targets of 8% in sales

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and profits, and budgets were consistently achieved. Lohnes' organization, personnel policies, and accounting systems would remain as they were before the acquisition. (See organization chart in *Exhibit 2*.) The only additional procedures required were a formal capital appropriation request and a monthly reporting of financial results to headquarters for consolidation. Corporate staff monitored division results (primarily sales, profits, cash and asset control), and occasionally the division president or controller was asked for explanations of variances from budget.

The infusion of capital was just what the Lohnes Marine division needed, and sales grew from \$4.1 million in 1963 to \$88.4 million in 1982—a compound growth rate of 17.5%. The division almost always met its budget targets. The toughest years were during the energy crisis of 1974-75, which rocked the power boat industry. While the marine division did not make budget those years, it still remained very profitable due to its strength in the sailboat segment of the market.

During his tenure with Graves Industries, Paul realized that good performance, although well rewarded, was soon forgotten during the next fiscal year. Furthermore, because of the way the budget cycle and bonus program worked, an excellent year this year tended to make next year's goals even higher. This was not really much of a problem for the Marine division, however, as expanded production and a booming boat market caused it to be consistently among Graves' best-performing divisions.

In the early 1980s the situation in Graves changed because of the formation of the Flexible Manufacturing Systems (FMS) division within Graves Industries. The FMS division had a R&D budget of \$14 million in 1982, and this grew to \$46 million in 1985, and the corporation was trying to fund this division internally by raising growth goals for the operating divisions and by instituting cost-cutting programs. The new, more aggressive goals made management of the Lohnes division very difficult because the boating industry was hit hard by the second oil crisis in 1979 and a business downturn in 1984.

1983

In late January 1983, Paul met with his new controller/financial officer, Don O'Grady, to go over the division's financial condition and to consider plans for the future. Don pointed out that 1982 had been a relatively good year; sales had reached \$88.4 million, slightly in excess of the division's goal of \$85 million. In addition the division had been able to maintain relatively large reserves where "a few nuts were stored away for a bad winter."

Paul said that was all well and good, but that he was worried about future prospects, and he wanted to have more control over his reported sales and profits. He suggested a number of ways the increased control could be brought about. He told Don that when the division was having a good period he wanted to meet the assigned goals and then be very conservative in the accounting so as to have a good start on making the goals for the next period. For example, if the division was near its quarterly target, it would be good to declare a shipping moratorium for the last week or two of the quarter to shift some sales to the next quarter. He also suggested increasing the reserves taken against inventory, accounts receivable, and potential liabilities.

Paul said Don should meet with Patti Allen of Sales and Jack Nelan of Production and Purchasing to do some brainstorming for more ideas. He also told Don that the discussions should be discreet. Even though none of this was illegal, he did not want to cause waves at headquarters. Don indicated that he understood.

The year 1983 proved to be surprisingly good, and by mid-March the division had exceeded its quarterly sales goal. Patti Allen imposed a shipping moratorium for the last ten days of March, and \$3.8 million in finished goods were held until the first days of April. Even though she agreed with trying to smooth earnings, Patti did complain to Don and Paul that complete halts in shipping caused problems with workload scheduling, product damage, and delayed deliveries to customers. Paul agreed there were costs associated with this shipment policy, but he felt they could be minimized.

Patti said that she would like to be able to do some shipping to their large customers. She suggested that she could ship some large orders in the current quarter but ensure that they were not entered in the shipping log. She would date the invoices and the bills of lading for the beginning of the next quarter and hold them on her desk until the second week of the new quarter. She would then submit the invoices to the accounting

department for processing as a new-quarter sale, and make the entries to the shipping log. In case any auditors asked why the invoices were out of order, she planned to tell them that the shipments had been held up for a brief time at the last minute.

In 1983 sales continued strong, and Patti's invoice-dating program allowed for smooth growth in quarterly earnings. On December 31, Patti held invoices for \$7.4 million in goods to be "shipped" in the first week of January.

Other company efforts to prepare for the unknown future included a buildup of obsolescence, liability, and bad debt reserves (a total of \$900,000) and a new marketing-expense program. This latter program, worked out between the Sales & Marketing department and the Marine division's advertising firm, allowed for the prepayment of part of the next year's marketing expenses. Rather than being booked as a prepaid expense, however, these expenses would appear on a bill from the ad agency which listed them as services for the current year; and the division would then book them as an expense of the current period. The Sales and Marketing department kept a separate ledger to keep track of these expenditures to ensure that the paid-for services were received. A total of \$600,000 of 1984 advertising expenditures was paid for in 1983.

1984

The long-anticipated downturn came in 1984; sales were very sluggish for the first two quarters. Paul and Don were somewhat worried but took no action other than maintaining their pressure on Sales and Marketing. When the third quarter continued the slow trend, Don started to liquidate some of the reserves, and by the end of 1984, reserves were reduced by \$1.8 million. The auditors questioned these changes in reserves, but Don and Paul gave them an explanation based on an analysis of changes in inventory composition and estimates of forthcoming bad debt losses and expenses. The auditors were skeptical, but they eventually concurred with the changes.

Another big step taken by the division was the establishment of the Early Order Program for distributors and larger boat builders. Those who ordered early (e.g., the end of 1984 instead of early 1985) received large discounts. This program also provided liberal credit terms; no payments were due for 90 days, and no late-payment penalties were assessed until at least 120 days after receipt of the shipment. Some of the more aggressive salespeople told their clients to "order the stuff now and don't worry about any payment dates; just pay us when you sell it, and you get to pocket the extra margin." Although this was never formally sanctioned, a flurry of fourth quarter sales brought the year-end results just above the budgeted goal of \$108 million.

1985

The first quarter of 1985 was slow due to all of the Early Orders that were placed in 1984. But by the middle of the second quarter, sales had picked up and were soon roaring along. In fact, third quarter results were so good that \$4.7 million had to be "transferred" to the fourth quarter, and the Early Order Program of 1984 was suspended.

By the end of 1985 the company had not only passed all required goals, but also had a \$10.4 million start on 1986 revenues, had restored \$2.2 million in reserves, and had paid for \$0.8 million of 1986's advertising. Once again the changing of the reserves was questioned, but the auditors accepted Don's explanation of "wanting to be conservative."

1986

Don knew the Lohnes division was well positioned for the new year but he worried where all this management of earnings would lead. He had hoped it would not continue, but the financial drains of the FMS division were growing, and he expected the corporation to start pressing all of the other divisions even more. He also knew that Paul and Patti were already discussing new ways to smooth income, and Don wondered what he should do and whom he could speak to about this sensitive matter.

EXHIBIT 1

GRAVES INDUSTRIES INC. (B)

*Lohnes Marine Hardware Division
Divisional Income and Budget Statements
for Fiscal Years Ending 31 December
(\$ millions)*

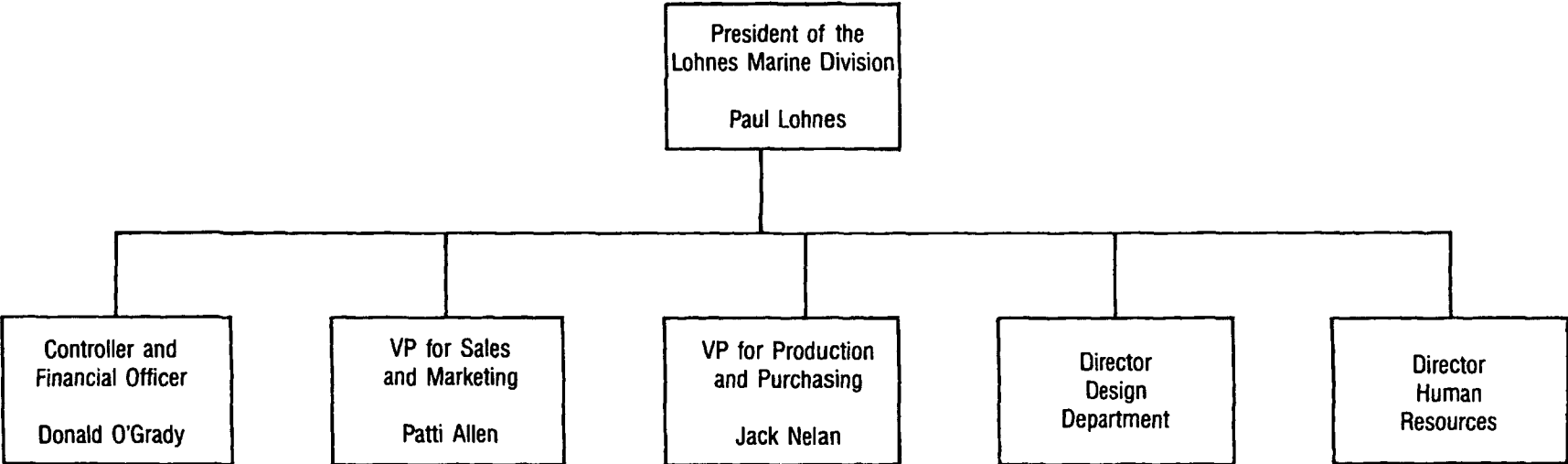
	1982		1983		1984		1985	
	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>	<u>Actual</u>
Revenue	\$85.0	\$88.4	\$96.0	\$99.1	\$108.0	\$109.2	\$119.0	\$122.2
Cost of Sales	<u>55.7</u>	<u>57.5</u>	<u>62.4</u>	<u>64.4</u>	<u>71.8</u>	<u>72.9</u>	<u>77.4</u>	<u>79.4</u>
Gross Margin	\$29.3	\$30.9	\$33.6	\$34.7	\$ 36.2	\$ 36.3	\$ 41.6	\$ 42.8
R&D Expense	0.6	0.6	0.8	0.8	0.8	0.8	0.8	0.8
SG&A Expense	<u>10.8</u>	<u>10.9</u>	<u>11.2</u>	<u>12.1</u>	<u>11.8</u>	<u>11.3</u>	<u>14.0</u>	<u>14.8</u>
Operating Profit	<u>\$17.9</u>	<u>\$19.4</u>	<u>\$21.6</u>	<u>\$21.8</u>	<u>\$ 23.6</u>	<u>\$ 24.2</u>	<u>\$ 26.8</u>	<u>\$ 27.2</u>

Source: Corporate records.

GRAVES INDUSTRIES INC. (B)

EXHIBIT 2

Lohnes Marine Hardware Division Organizational Chart



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Source: Corporate records.

Graves Industries Inc. (C)
Consumer Hardware Division

It was one week before Christmas in 1984 and Leo Gladue, the president of the Graves Industries' Consumer Hardware division, had just returned to his offices after a long and difficult budget meeting with Henry Graves, the chairman and CEO of Graves Industries Inc. It had been a tough year for the Consumer division, and they had just barely made budget. Leo had argued that with a slow economy the division could only expect growth of 3-4% in 1985, but Henry insisted that growth of at least 8% was possible. Leo resisted, but he gave in when Henry chided him for his lack of aspiration and questioned whether he had the vision necessary to manage the business. (See *Exhibit 1* for financial results and budgets for 1982-85.)

As he sat in his office, Leo knew that possibly a lot more than just his bonus was riding on making the division's assigned goals for 1985. The growth of the new Flexible Manufacturing Systems (FMS) division was affecting the whole corporation; the other divisions were being squeezed hard for profits so as to fund this FMS growth. Leo wondered if they were being squeezed too much.

Division History

The Consumer division was founded in 1946 to allow the company to branch out and use its large, wartime production capacity effectively. The division started out producing simple home tools that were sold through distributors. Realizing the Graves name could be a distinct advantage, the division's managers moved into producing a wide variety of high-quality tools and hardware. The division developed a brand-name image and sold only through distributors to selected hardware chains.

The Consumer Hardware division experienced slow, steady growth until the mid-1950s, when Henry Graves took over as divisional president. Henry had just returned from serving with the Navy during the Korean War, and he had some new ideas. He promoted the idea of "professional tools for the home mechanic" and pushed the safety and reliability of Graves products. He also expanded the product line and the distribution system in search of faster growth. He continued to find ways to grow, and for the next 12 years the division enjoyed revenue growth at a compound annual rate of 11%.

In 1968, Henry was promoted to CEO; his father retained the chairmanship until 1972. Leo Gladue, who had worked for the Graves for 22 years in the Industrial and the Consumer Hardware divisions, was appointed as the next president of the Consumer division. Leo was well regarded for his technical knowledge and his ability to get along with the distributors, but his knowledge of finance and accounting was considered relatively weak.

In the late 1970s and early 1982, the division's growth began to slow. Sales targets were getting harder to reach, and the startup of the FMS division only compounded the problem as the Consumer Hardware division was expected to continue to achieve Graves' long-term growth target of 8% per year.

Revenue Recognition

The Consumer Hardware division sold its goods to distributors who took title as soon as the orders were shipped. No goods were put on consignment, so sales revenue was recognized as soon as the goods were loaded on a truck. As was the industry standard, Graves Consumer division did offer large discounts for distributors who placed large orders early and used a wide variety of seasonal promotions as needed to stimulate sales.

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Every now and then the Consumer Hardware division had been known to load some of the trucks in their fleet at the end of a fiscal period to generate "sales in place." The loaded trucks would move a short distance away from the loading dock and park until it was time to make their deliveries.

1984

The year 1984 was difficult for the Consumer Hardware division; the economy was slow and interest rates were high—the worst combination for a hardware and tool business. As midyear approached and predictions for the annual totals did not look good, Leo applied additional pressure to the Sales and Marketing department to "get more orders." Sales and Marketing responded with a plan that they implemented but kept secret for a long time. Tim Bonsaint and John Ahern were the only senior managers to know about the plan in 1984. (See *Exhibit 2* for a recent organizational chart.)

The Consumer division used approximately 30 distributors, but eight of them generated 75% of Graves' business. Tim and John's plan was to ship additional, unordered products to the large distributors; these unordered shipments would be rotated among the large distributors and sent out along with their regular orders near the end of the month. These extra shipments would then be recorded as revenues. Four methods were used to cause the unordered product to be shipped including: (1) reentering a previously entered order; (2) doubling, tripling, or otherwise increasing the amount of product actually ordered; (3) creating fictitious orders on behalf of the distributors; and (4) shipping an unordered product when the product ordered was not in stock.

Once the unordered shipments were delivered, steps were taken to keep the goods from being returned or at least to delay their return. Overshipments were blamed on administrative and computer errors, and salespeople were directed to "make the sales stick" by (1) offering special prices for credit terms, (2) exchanging the goods for other Consumer division goods, (3) storing the goods (at Graves' expense) until needed, (4) arranging trades between distributors, and (5) ignoring the distributors' attempts to return the goods until the distributor had time to "digest" the shipment.

This plan worked rather well; even though the amount of "returned goods" increased, the net effect was to increase revenues by \$2.8 million and operating profit by \$600,000.

A Planning Meeting

Leo Gladue, unaware of Tim and John's scheme, scheduled a meeting for the second week in January 1985. He wanted his management team to review 1984 and start planning on where to come up with the additional sales required under the new budget.

The meeting was held on January 10, 1985. The first item on the agenda was a review of the 1984 final results. The financial officer, John Ahern, reported that the level of sales had just come in over budget. Operating profits were close to budget, and after a few journal entries were made to reduce June reserves held against inventories and receivables, the operating profit and RONA targets would be met.

The next item was the most important one: identifying new sources of revenues and other areas of cost savings that would be necessary for meeting the new budget. The discussion went on for hours, but there were no clear solutions. When the meeting adjourned, Leo Gladue instructed all department heads to commence internal studies to identify potential revenue sources and cost savings.

Sales and Marketing

In the following week, the Sales and Marketing department decided to expand the overshipment program started at the end of 1984, and they decided not to tell Leo about the specifics of the program. Tim Bonsaint, the head of Sales and Marketing, just promised Leo that through "selective discounts and promotions we will increase the average order size of our largest distributors." The actual size of the overshipments was to be carefully controlled by Tim, using forecasts of actual quarterly and annual sales.

Production and Purchasing

The Production and Purchasing department could do little to help with new revenues, but its manager, Kimberly Colson, knew she could have a large impact on controlling the expenses of the company's contracts with its suppliers. Some of Graves' suppliers sold both machines and parts to the division, and it was possible to alter contracts to adjust the amount of the expenditure to be capitalized. For example, Graves had a contract with the Riley Machine Company for \$500,000; \$200,000 of this amount was for two new ratchet machines, and the rest of the money was for 50,000 ratchet assemblies. By having Riley change the invoices to indicate that \$300,000 was for the two machines, the price of the individual ratchet assemblies would drop by 33%. The extra \$100,000 could be capitalized (and expensed over the life of the machines), and the immediate effect was an increase in profit.

Kim knew many variations on this scheme, such as adding a special "tooling charge" to the reduced base price of the ratchet. This tooling charge could be capitalized by the Consumer division, the price of the machines would not have to be changed, and Graves would still get the ratchets at the reduced price. And by mixing methods, no clear pattern would emerge. Such a system could easily be run by Kim and a few of her purchasing people, so she only told Leo that by putting pressure on suppliers, she had negotiated some price reductions on components.

1985 Results

The year 1985 was slow, and the Consumer Hardware division struggled; but with the assistance of the two special programs, it was able to meet budget. By the end of the year the Sales and Marketing department had "overshipped" (after returns) a total of \$8.9 million in goods that increased operating profits by \$1.8 million, and Production and Purchasing had negotiated contracts that reduced current expenses by \$2.7 million (\$2.2 million after depreciation). Not all of this went completely unnoticed, however, and by the end of the year Leo had started to ask questions about the higher-than-normal level of returns, complaints from distributors and capital expenditures.

The Auditors

In the first week of December, Roger Sexauer, the manager assigned to the Graves Industries audit, was sitting in his office at Ernst, Mitchell & Sells when he received a phone call from Don Hubbard, the senior assigned to the audit of the Consumer Hardware and Automotive divisions of Graves Industries. The conversation went approximately as follows:

Roger: Hello Don, what can I do for you?

Don: I am calling in regard to the Consumer Hardware division audit. I have come across some unusual transactions and I can't seem to get any reasonable answers from the company staff.

Roger: What's the problem?

Don: One of my staff accountants was performing a review of capital expenditures for this past year and found some things that didn't seem right.

Roger: Like what?

Don: Large price hikes in what appears to be standard equipment for this division and an unusually large total of "tooling charges" and "tooling premiums."

Roger: Have you investigated the reason? Perhaps the equipment has been specially modified and, as a result, costs more. Also, this division has always had "tooling charges." For any special product they want produced they help the supplier pay for the modifications to his equipment. Since this is a capital improvement they can capitalize the portion that they pay for.

- Don: I know that, but I have checked a lot of this equipment myself and it all looks to be the same as the ones bought previously. When I ask people in Purchasing, they don't have a good answer. They say the differences are caused by inflation or some kind of internal modification. Now, as to the tooling charges, in 1984 they totaled \$147,000. This year, through November, they total over \$400,000.
- Roger: That is a sharp increase. Perhaps they have made modifications to the parts in question and the supplier has billed them to cover his fixed investment.
- Don: I don't think so because the parts do not look like they have changed. However, this leads me to what I think is the heart of the matter. Do you remember when we asked Kim Colson about the decrease in price on some of the parts they were purchasing?
- Roger: Yes I do, and if I remember correctly, she said that since Graves had become such a large buyer for the output of some of their suppliers she was able to negotiate large discounts. Also, she said something to the effect that the suppliers had made so many of the items that their cost of production per item had gone down significantly.
- Don: That's right. But when you stand back and look at the whole situation, the suppliers that gave them the large discounts on parts are the same ones that either raised their prices on capital equipment and/or are charging them for tooling charges.
- Roger: Now I see the picture. This is either an incredible coincidence or there is a systematic plan to capitalize current expenses and overstate profits.
- Don: Right! Now comes the hard question—what do I do now? Should I talk to the division's president now or wait for you to get here?
- Roger: No, no! Keep on going with the audit, but be extra careful. If there is one problem like this there may be others. This division is under a lot of pressure to increase operating profits. What is the total impact of this on their bottom line?
- Don: We are still working on this but it looks like about \$1.7 million to \$1.9 million for 1985, and it could be higher.
- Roger: Well that should only be about 4-5% of the division's operating profit and corporate net income. Right?
- Don: As of right now that's correct, but if we find anything else it could go higher, especially if this has been going on for a couple of years.
- Roger: That's true. Well, you push on there. I will talk to Harvey¹ and let him know what you have found. Then I'll meet you and look over what you have found. In the meantime don't say anything to anyone at the company till I get back to you.

Roger sat at his desk and thought about what Harvey would do if his suspicions were correct. The amount of money involved so far was large for the division, but perhaps immaterial from the standpoint of the entire corporation.

¹Harvey Krantz, the partner assigned to the Graves audit.

December 1985

In the middle of December, Tim and John, finding it increasingly difficult to keep their scheme going and virtually impossible to meet their 1985 targets, decided they had better be honest with Leo. They were sure that with his support they could lay out a convincing story for the events of 1985 and get the auditors off their backs.

As they told the whole story, Leo sat dumbfounded. Shortly thereafter, Kim explained what she had been doing. Leo felt he had no choice but to inform corporate headquarters and the external auditors immediately.

EXHIBIT 1

GRAVES INDUSTRIES INC. (C)
Divisional Income and Budget Statements
 31 December 1985
 (\$ millions)

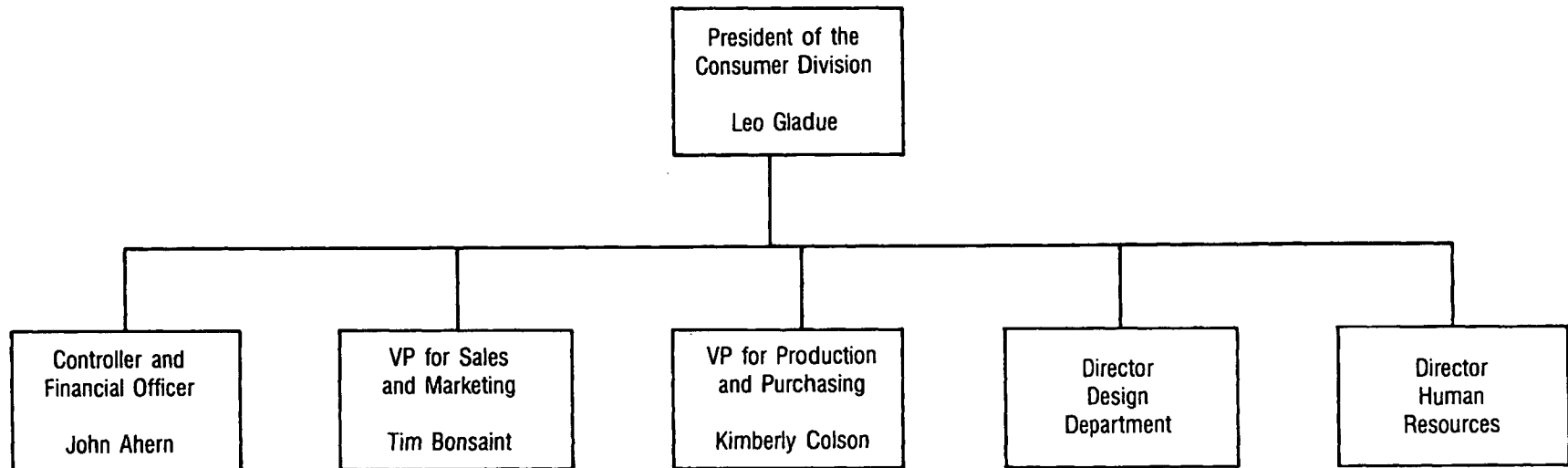
	<i>1982</i>		<i>1983</i>		<i>1984</i>		<i>1985</i>
	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>	<u>Actual</u>	<u>Budget</u>
Revenue	\$125.0	\$127.5	\$139.0	\$140.3	\$153.5	\$154.3	\$168.0
Cost of Sales	<u>80.0</u>	<u>81.6</u>	<u>89.0</u>	<u>89.2</u>	<u>98.2</u>	<u>98.3</u>	<u>107.5</u>
Gross Margin	\$ 45.0	\$ 45.9	\$ 50.0	\$ 51.1	\$ 55.3	\$ 56.0	\$ 60.5
R&D Expense	1.1	1.1	1.3	1.3	1.4	1.4	1.5
SG&A Expense	<u>15.2</u>	<u>15.1</u>	<u>16.4</u>	<u>16.2</u>	<u>17.9</u>	<u>18.5</u>	<u>20.6</u>
Operating Profit	<u>\$ 28.7</u>	<u>\$ 29.6</u>	<u>\$ 32.3</u>	<u>\$ 33.6</u>	<u>\$ 36.0</u>	<u>\$ 36.1</u>	<u>\$ 38.4</u>

Source: Corporate records.

GRAVES INDUSTRIES INC. (C)
Divisional Organizational Chart

EXHIBIT 2

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Source: Corporate records.

Appendix F

**GOOD PRACTICE GUIDELINES
FOR ASSESSING THE RISK
OF FRAUDULENT FINANCIAL REPORTING**

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Good Practice Guidelines for Assessing the Risk of Fraudulent Financial Reporting

I. Introduction

Many different incentives and opportunities can contribute to fraudulent financial reporting. Effectively preventing and detecting fraudulent financial reporting requires understanding these incentives and opportunities, and assessing the risk of fraudulent financial reporting that these factors can create in a company.

These guidelines describe such incentives and opportunities. Because these incentives and opportunities are present to some degree in every public company, the guidelines are not necessarily predictive or diagnostic. That is, they are not intended to be used as a means for reliably predicting specific companies where fraudulent financial reporting will occur. Rather, they are intended to help sensitize the participants in the financial reporting process to the broad range of factors that can have implications for the risk of fraudulent financial reporting. The inescapable fact is that doing business inherently introduces forces that can lead to fraudulent financial reporting, and the starting point for checking and controlling these risks is awareness.

All the participants in the financial reporting process—management, the audit committee, internal auditors, and independent public accountants—should assess the risks of fraudulent financial reporting present in the company's financial reporting environment. Rather than entailing a separate effort or project, this process entails bringing to regular management activities a heightened awareness of and sensitivity to the potential for fraudulent financial reporting. Accordingly, it is not intended that this process involve costly documentation, such as that which many companies have undertaken in response to the Foreign Corrupt Practices Act of 1977.

For corporate management, the factors described in these guidelines are frequently the same as those dealt with in connection with a wide variety of business operating and administrative decisions. For example, many incentives and opportunities result from perfectly valid management techniques, such as management by objective and decentralized operations. So assessing the risk of fraudulent financial reporting does not necessitate a separate effort but only a heightened awareness and sensitivity to the implications of these factors for fraudulent financial reporting. This sensitivity enables the company to design and implement internal controls to minimize the risks it identifies. Audit committees also should be sensitive to the potential risks these factors may create and to the need for management awareness.

Similarly, these guidelines should not suggest a separate effort by internal auditors. Internal auditors would consider the factors discussed herein when planning their financial audits. The guidelines provide internal auditors with an appreciation for the potential financial statement effect of the results of their operational audits.

The Commission recommends in Chapter Three that independent public accountants be required to assess the risk of fraudulent financial reporting when planning and conducting each audit. These guidelines may provide insight into the causes of fraudulent financial reporting; therefore sensitivity to the factors in these guidelines may assist an independent public accountant in completing audit planning and risk assessment.

Sensitivity to the factors in these guidelines not only helps to detect and prevent fraudulent financial reporting but it is good business practice for corporate management, the audit committee, and auditors. Public companies can benefit from such sensitivity through reduced probability of inadvertent financial statement errors and through enhanced internal controls that improve profitability and efficiency. Similarly, auditors will benefit through improvements in both audit efficiency and effectiveness that inevitably result from a better-focused examination.

The factors discussed in these guidelines were drawn from various sources, including the Commission's study of SEC enforcement actions, a review of the auditing policies and procedures of 10 of the 14 largest public accounting firms in the United States, and a review of published academic and professional literature that relates to fraudulent financial reporting.

These guidelines do not constitute a "cookbook" approach meant to be applied mechanically, but present a frame of reference for understanding and assessing the types of factors that may contribute to the risk of fraudulent financial reporting. These guidelines are not all-inclusive; they capture the broader points and subjects applicable to most public companies and illustrate the types of factors that can be important in assessing the risk of financial reporting fraud. Judgment and creativity applied to this starting point will generate additional ideas about matters relevant to particular circumstances.

II. The Effect of the Environment on the Risk of Fraudulent Financial Reporting

A. Why the Environment Is Assessed

The company's internal and external environments influence the inherent risk of fraudulent financial reporting. The Commission's studies of the financial reporting system revealed that the environmental, institutional, and individual forces and pressures that can lead to fraudulent financial reporting are present to some degree in every public company. These forces and pressures provide incentives and opportunities for individuals and companies to engage in fraudulent financial reporting.

Assessing the risk of fraudulent financial reporting involves (1) analyzing the company's internal and external environment to identify the unique incentives and opportunities present in the company and (2) assessing how these incentives and opportunities affect the risk of fraudulent financial reporting. Chapter One of the report discusses the general types of incentives and opportunities noted in the review of alleged instances of fraudulent financial reporting and how the presence of these factors contributes to fraudulent financial reporting.

These guidelines present environmental considerations as neutrally as possible, because not all environmental considerations increase the risk of fraudulent financial reporting; some decrease the risk. Assessing how a risk factor affects an individual company requires judgment, experience, and knowledge of the particular circumstances. For example, one consideration discussed here is the impact of new accounting pronouncements affecting the industry. Such an event can decrease the risk of fraudulent financial reporting by providing clearer accounting guidance in an evolving area, eliminating a potential opportunity for fraudulent financial reporting. On the other hand, a new accounting pronouncement could have a material adverse impact on a company's financial position, resulting in an incentive to fraudulently manipulate other portions of the financial statements. While the objective was a neutral discussion, fraudulent financial reporting generally takes the form of overstated income and assets. Accordingly, many examples discuss these conditions.

B. The Interaction of Incentives and Opportunities

While one or more incentives and opportunities are present in most instances of fraudulent financial reporting, the presence of one or more incentives or opportunities does not automatically mean fraudulent financial reporting has occurred or is likely to occur. Most companies and managers at one time or another experience intense incentives and are exposed to inviting opportunities without succumbing to fraudulent financial reporting. So identifying any certain number of risk factors is not an accurate predictor of fraudulent financial reporting.

The interaction of several different incentives and opportunities produces the combustible mixture that elevates the risk of fraudulent financial reporting. For example, the combination of declining profits due to

product obsolescence, a weak control environment, a risk-taking management, and the use of aggressive accounting principles presents a much greater risk of fraudulent financial reporting than the sum of the risks presented individually by these factors.

Finally, each company has its own unique and evolving culture and chemistry that determine the relative risk of each factor. Thus the factors that produce this combustible mixture change from company to company and from year to year. Effectively assessing the risk of fraudulent financial reporting requires seasoned judgment, experience, and creativity to properly identify, understand, and assess each company's environmental risks.

III. Factors to Be Considered

A. The Internal Environment

The internal environment consists of the conditions, circumstances, and influences affecting the company's operations subject to management's influence. Internal environmental conditions include the company's (1) internal controls, (2) financial characteristics, (3) operations, (4) individual management characteristics, and (5) accounting policies and procedures.

1. Internal Controls

Chapter Two discusses the importance the Commission places on maintaining internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection. This chapter also notes that it refers to internal controls broader than the traditional definition of internal *accounting* control—it includes the control environment. Both internal accounting controls and the control environment are discussed here.

a. Internal Accounting Controls

A company's internal accounting controls consist of its accounting system and specific controls.

The accounting system comprises the methods and records established to identify, assemble, classify, analyze, record, and report an entity's transactions, and to maintain accountability for the related assets. An effective accounting system has both adequate physical documents and records, and adequate procedures to: (1) identify and record all valid transactions, (2) describe the transactions in sufficient detail to permit them to be properly classified, (3) measure the value of the transactions accurately, (4) ensure the transactions are recorded in the proper accounting period, and (5) present and disclose the transactions properly in the financial statements.

Specific controls are the individual policies and procedures pertaining to processing transactions that management establishes to provide assurance its objectives will be achieved. Effective specific controls help to ensure: (1) functions are adequately segregated, (2) all transactions are executed in accordance with management's general or specific authorization, (3) adequate physical control is maintained over assets and accounting records, and (4) regular, independent checks on performance, and comparison and reconciliation of assets to recorded accountability, are made.

Specific control procedures include clerical checks, document comparisons and cancellations, transaction approvals such as standard price lists or customer credit limits, computer comparison of run to run totals, reconciliations, reviews of data used to prepare management reports, independent asset counts, segregation of duties such as requiring that the bank reconciliation be performed by individuals with no cash receipts or disbursements responsibilities, and control over access to and use of computer programs and data files by procedures such as passwords and secured facilities.

The accounting system and specific controls a company establishes are influenced by its size, complexity, ownership characteristics, and business nature. A company designs its accounting system and specific controls to provide reliable financial statements. So internal accounting controls address many different types of situations. Some portions of the internal accounting controls, such as segregation of duties and clerical checks, are designed to prevent or detect inadvertent errors or corporate frauds such as embezzlements. Other portions of the internal accounting controls, such as review of management reports, are more closely associated with preventing and detecting fraudulent financial reporting.

Descriptions of methods of implementing effective accounting systems and specific controls abound within the accounting and auditing literature. Accordingly, this Appendix does not include extensive discussions of the merits of individual procedures. Because many portions of a company's internal accounting controls are important in preventing and detecting fraudulent financial reporting, however, they should be considered when assessing the risk of such fraud.

b. Control Environment

As Chapter Two makes clear, internal accounting controls are important, but a company also must look to its control environment to prevent and detect fraudulent financial reporting.

The company's control environment is the corporate atmosphere in which the accounting controls exist and the financial statements are prepared. A strong control environment reflects management's consciousness of and commitment to an effective system of internal control. While a strong control environment does not guarantee the absence of fraudulent financial reporting, it reduces the chance that management will override internal accounting controls. On the other hand, a weak control environment undermines the effectiveness of a company's internal accounting controls and may reflect a predisposition toward misrepresentations in the financial statements.

A company's control environment consists of its organizational philosophy and operating style, organizational structure, methods of communicating and enforcing the assignment of authority and responsibility, organizational control methods, and personnel management methods. (This description of the control environment is based in large part on the discussion in the Auditing Standards Board's proposed Statement on Auditing Standards on Control Risk.)

A company's organizational philosophy and operating style encompass a broad range of characteristics, such as (1) management's and the board of directors' attitudes and actions toward financial reporting, ethics, and business risks, (2) management's emphasis on meeting budget, profit, or other financial or operating goals, (3) management's preference for centralized or decentralized administration and operations, and (4) the extent to which one or a few individuals dominate management. A company's philosophy and operating style are often the most important parts of the control environment.

An effective organizational structure gives the company an overall framework for planning, directing, and controlling its operations. It considers such matters as (1) the form, nature, and reporting relationships of an entity's organizational units and management positions, and (2) the assignment of authority and responsibility to these units and positions and the constraints established over their functioning. A key part of an effective organizational structure is a vigilant, informed, and effective audit committee.

Effective methods of communicating and enforcing the assignment of authority and responsibility clarify the understanding of, and improve compliance with, the organization's policies and objectives. These methods consider such matters as: (1) the delegation of authority and responsibility for matters such as organizational goals and objectives, operating functions, and regulatory requirements, (2) the policies regarding acceptable business practices and conflicts of interest, and (3) employee job descriptions delineating specific duties, responsibilities, and constraints. A key method of communicating employee responsibility is through a written code of corporate conduct.

Organizational control methods affect the company's ability to control and supervise its employees and operations effectively. Effective organizational control methods consider such matters as: (1) establishing

adequate planning, accounting, and reporting systems, (2) requiring reports that communicate to appropriate individuals exceptions from planned performance, (3) establishing procedures to take appropriate corrective action when exceptions are identified, and (4) monitoring accounting and control systems so they can be modified when necessary. An effective internal audit function is often a particularly important organizational control method.

Personnel management methods influence the company's ability to employ sufficient competent personnel. Effective personnel management methods consider such matters as policies for hiring, training, evaluating, promoting, and compensating employees.

Because of the subjective nature of a company's control environment, assessing its individual components can be difficult. The overall strength of the control environment, however, can be assessed by an individual with sufficient wisdom, experience, and judgment to consider such matters as:

- The degree of emphasis placed on achieving earnings forecasts, meeting budgeted targets, and maintaining or manipulating the market value of the company's stock. Management may be unduly interested in the market price of the company's stock to assist the company with future financing, to prevent secured loans from being called, or to make stock options and other stock compensation more valuable.
- Turnover in key personnel, with special consideration given to unusual retirements or replacements of in-house counsel, internal auditors, or key individuals in the accounting department.
- Management's compensation plans. Plans featuring significant bonuses tied to reported earnings or other quantified targets warrant special attention, as do situations where a significant part of management's compensation results from stock options.
- The company's relationships with outside parties. This analysis considers, for example, how often the company changes independent public accountants, legal counsel, and bankers.
- The company's organizational structure. An unnecessarily complex organizational structure can be used to conceal fraudulent activities.
- Management's attitude toward financial reporting, particularly toward the selection and application of accounting policies.
- The company's delegation of authority and responsibility. This analysis considers whether operating unit management has adequate authority to manage the unit's operations, or whether one or a few individuals dominate the company's financial and operating decisions. Special consideration is given to whether management is so dominant that it impairs the ability of the board of directors and audit committee to exercise their oversight responsibility.
- The capabilities of the company's accounting department. This analysis considers the training and the experience of the key accounting personnel, and the adequacy of overall staffing levels for handling the department's day-to-day activities.
- The effectiveness of the company's internal audit department. This analysis considers such matters as whether the internal auditors have independent access to the audit committee and the CEO, whether the auditors have been adequately trained, and whether they have had sufficient experience. In large entities with decentralized operations, this analysis also can consider the focus and findings of recent internal audit examinations, and the operation's response to the audit findings.
- Management's concern for possible or existing weaknesses in the internal control system, and its responsiveness to known weaknesses in the system.
- The adequacy of the company's internal reporting system. This analysis considers such factors as the quality and the historical accuracy of the company's budgets, whether budgeted and actual amounts are regularly compared, and whether the responsible parties promptly pursue the resolution of any identified differences.
- The company's personnel policies and practices. This analysis considers, for example, whether background checks are made before hiring new employees, whether the company's promotion criteria are fair

and adequate, and what the company's policies are for disciplining employees who violate company policies.

- The company's written code of corporate conduct, if one exists. This analysis also considers top management's attitudes toward the written (or unwritten) code of corporate conduct—the key factor determining compliance with the code.
- Management's attitudes toward compliance with laws and regulations affecting the company. This analysis might consider, for example, whether management strives to comply with the full spirit and the intent of regulations or attempts to meet only the minimum standards required.
- Whether the company maintains an established mechanism to report to upper management apparent violations of company policy. Methods frequently used to accomplish this objective include hotlines and ombudsmen. This analysis also considers how the company protects employees from reprisal.

2. Financial Characteristics

When assessing the risk of fraudulent financial reporting, it is important to consider the company's current and future financial characteristics. Such a review encompasses the company's profitability, liquidity, and capital adequacy. Fraudulent financial reporting has traditionally been associated with companies experiencing financial difficulties. While the Commission's studies revealed that most instances of fraudulent financial reporting are detected when the company is experiencing financial difficulties, there is some evidence that the fraudulent activity sometimes starts during good economic conditions. The fraudulent acts may be discovered more often during financial difficulties because of the increased scrutiny a company receives at these times. So while the following discussion focuses on financial difficulties, profitable companies should consider these characteristics when assessing their exposure to fraudulent financial reporting. Examples of specific factors for consideration include:

- The company's liquidity. This analysis considers such matters as the adequacy of the company's working capital and the trend in cash flow. Significant differences between net earnings and cash flow may indicate the use of improper revenue or expense recognition policies. Furthermore, inadequate cash flow may result in curtailment of supplies, less-generous credit terms, or bankruptcy proceedings forced on an otherwise profitable company—all incentives for fraudulent financial reporting.
- The relative profitability of the company. This analysis considers such matters as:
 - The trend in sales and profits. A decrease in the quality of sales—which may indicate the potential for lower sales and profits in future periods—may be evidenced by a liberalization of the company's credit policies, the introduction of unusual discount and payment programs, or other changes in business practices. This analysis also may involve reviewing the company's sales backlog. A significant decrease in the sales backlog may predict financial difficulties in future years.
 - Whether the company's sales and profits forecasts can be achieved.
 - How the company's sales and profits compare to others in the industry.
 - The adequacy of the company's reserves, e.g., provision for bad debts or loan losses.
- The need and the ability of the company to obtain additional borrowing. Analysis of the need for additional borrowing includes consideration of such factors as the need for funds for research and development, an inability to pay current bills, and the need to expand productive capacities. Analysis of the ability to obtain additional borrowing considers such matters as the company's credit ratings, current debt-to-equity ratio, the amount of unrestricted collateral, the marketability of existing collateral, and existing debt restrictions.
- The company's compliance with restrictive debt covenants. A projection of a narrow margin of compliance with a particular covenant may be of as much concern as situations where the restrictive covenant already has been violated.
- The quality of the company's accounts receivable. Significant increases in the aging of the receivables, or slowdowns in average daily receipts, may portend significant economic difficulties for the company.

3. Operations

To assess the risk of fraudulent financial reporting effectively, it is important to consider the company's current and future operating characteristics. Many different operating characteristics influence the risk of fraudulent financial reporting. Examples of specific factors for consideration include:

- Any recent or planned changes in the company's operations, such as:
 - Introduction of new production techniques, which might increase available inventories, encouraging management to increase sales fraudulently by shipping without customer authorization. This factor also can increase sales costs, providing an incentive to manipulate other portions of the financial statements so earnings are not adversely affected.
 - New types of marketing arrangements, especially those involving sales incentive programs, which might provide sales personnel with an incentive to increase sales fraudulently.
 - Installation of new computer hardware or software, which might give employees or management opportunities to automate fraudulent activities.
 - Realignment of the company's operating divisions (e.g., alignment by product instead of by geography), which might help conceal a fraudulent manipulation of financial records. This change also could reduce the risk of fraudulent financial reporting by ensuring rotation of employees.
 - Introduction of a new compensation system for company employees, which might encourage manipulation of financial performance to ensure receipt of performance bonuses.
- Any planned, pending, or probable mergers or acquisitions. Such events may encourage fraudulent financial reporting to increase the company's stock price.
- The company's relationship with its customers. The level of customer complaints and/or returns may indicate a problem in the quality of revenue and signal the existence of an incentive for fraudulent financial reporting. Among other things, this review looks at the reason for any significant changes in the pattern of customer complaints and/or returns.
- The company's relationship with related parties. The existence of related-party transactions that are material, individually or in the aggregate, gives management an opportunity to manipulate the financial statements fraudulently. Of special concern are significant transactions that do not appear to have been negotiated at arms-length.
- Whether the company maintains significant business relationships with a limited number of customers or suppliers. Such relationships allow these customers or suppliers to impose additional external oversight in the normal course of protecting their own self-interests, thus potentially reducing the risk of fraudulent financial reporting. Furthermore, a company may try to maintain and project a positive corporate ethical climate to further close relationships with a key supplier or customer. On the other hand, the loss of a key supplier or customer can create an incentive for fraudulent financial reporting.

4. Individual Management Characteristics

The personal characteristics of the company's management play an important role in the company's internal environment. If an individual in a sensitive area of the company has weak ethics, the potential for fraudulent financial reporting is significantly increased. Accordingly, to assess the risk of fraudulent financial reporting effectively it is important to consider whether there are managers with characteristics such as:

- A record of criminal convictions, SEC civil proceedings, or participation in other inappropriate activities (e.g., previous violations of company policies).
- Significant personal financial difficulties arising from such factors as high personal debts, inadequate income, extensive stock market speculation, gambling, or heavy use of drugs or alcohol.
- A significant level of instability in personal life.
- A feeling of being treated unfairly or inadequately by the organization.

- An extreme need to succeed or be accepted within the organization arising from such complex factors as community or social expectation, peer group pressure from within the company, or simple factors such as personal greed.

5. Accounting Policies and Procedures

A company's accounting policies and procedures are the specific methods used to apply Generally Accepted Accounting Principles (GAAP). These methods are influenced by the company's size, the nature of its operations, and the industry in which it conducts its business. Many opportunities to commit or conceal fraudulent activities involve the company's accounting policies and procedures. So the quality of the company's accounting policies and procedures has a significant impact on the risk that fraudulent financial reporting may occur.

Examples of specific matters concerning a company's accounting policies and procedures include:

- The existence of transactions involving contentious, difficult, or evolving accounting issues.
- The existence of significant inventory balances, or other assets, with special valuation problems.
- The occurrence of any very large transactions or unusual adjustments at or near year-end or quarter-end.
- Whether the company's procedures for identifying and recording related-party transactions are adequate in the circumstances.
- The overall quality of the company's accounting records. This analysis considers such matters as whether the records are well designed and well organized, the accounting procedures are performed in a conscientious fashion, an up-to-date accounting policies and procedures manual is maintained, routine transactions are processed in a systematic manner, and reasonable procedures are used when computing significant estimates and judgments.
- The quality of the company's accounting principles. This analysis might consider whether the company employs exceptionally aggressive, controversial, unusual, or liberal interpretations of GAAP—especially with regard to revenue recognition—and whether disputes between the company and its independent public accountants concerning the company's application of GAAP are frequent.
- The quality of the company's internal financial reporting system. This analysis might consider such matters as whether management uses these reports in controlling the operations of the company, and whether financial statements are submitted at regular intervals to the board of directors.
- The existence of financial statement elements that depend heavily on the exercise of subjective judgment or unusually difficult or complex calculations.

B. The External Environment

The external environment is made up of the conditions, circumstances, and influences that affect operations beyond management's direct control. External environmental conditions include matters affecting (1) the company's industry, (2) the business environment, and (3) regulatory and legal considerations.

1. Industry Conditions

Analysis of the industry establishes an overall perspective from which to assess the company's operations. Events affecting the industry usually affect the individual companies within the industry. Knowing how the company compares to the industry as a whole can point out unusual situations. For example, when the overall industry's sales have decreased by 20 percent, an increase in company sales of 10 percent points to a situation that warrants further investigation.

The analysis concentrates on the matters currently influencing the company's industry. However, matters that have influenced the industry in the past, and those likely to influence it in the future, are also considered. Industry conditions include such matters as:

- Whether specific trends are prevalent in the industry. This analysis considers such matters as the overall demand for the industry's products (e.g., whether the industry's products are becoming out of fashion or technologically obsolete and how demand is influenced by price changes), whether any favorable or adverse economic events are affecting the industry, and whether the industry is expanding or declining.
- The impact of any new accounting pronouncements affecting the industry.
- Whether the industry is subject to cyclical or seasonal fluctuations. If so, the analysis considers what stage of the cycle the industry is currently experiencing. The strategies commonly used to minimize the vulnerability to the fluctuations also are assessed.
- The industry's capital needs. Both initial start-up costs and continuing capital needs are assessed. As an example of the latter, in many high-technology or capital-intensive industries, it is necessary regularly to spend large amounts of money on research and development or on facilities and equipment to remain competitive.
- Whether the industry is currently in a state of transition. When the industry is in a state of rapid evolution, management may find it is no longer able to control the company's operations in the same fashion as before. Control systems may not evolve to keep pace with rapid changes in, for example, products, services, lines of business, and methods of operating. Furthermore, the company's profits may shrink dramatically. Such situations can place inordinate pressure on the company, its management, and its financial statements at a time when the company's control systems are vulnerable.

2. Business Environment

In addition to industry matters it is important to consider the company's business environment—external matters that relate to the economy as a whole. Among these are:

- The current credit environment. This analysis considers the general availability of funds for additional borrowing and the prevailing interest rates.
- The current equity market. This analysis considers the general level and direction of market activity as well as any unusual activity or price fluctuations in the company's shares. This analysis also considers how the price of the company's stock relates to the company's current condition and prospects for future performance, particularly in relation to others in the company's industry.
- Contests for ownership of the company. This analysis considers whether the company is undergoing an internal contest for control or is the target of a hostile takeover. It also considers management's perception of whether the company is vulnerable to a hostile takeover. Such a perception can lead to pressure to increase the company's stock price, and raises the incentive for fraudulent financial reporting.
- The sensitivity of the company's operations and profits to such economic and political factors as inflation, interest rates, unemployment, foreign exchange rates, and restrictions on the repatriation of profits and cash from foreign operations or subsidiaries.
- The continued viability of the company's products in the marketplace. Consideration generally is given to such matters as the potential for technological obsolescence resulting from innovations in competing products, and the price of the company's products in relation to those of competitors.

3. Legal and Regulatory Considerations

Increasing government involvement in business operations worldwide has resulted in significant regulatory legislation, particularly in employee protection, environmental protection, and consumer protection. Furthermore, governments continue to regulate many aspects of their capital and credit markets.

These increases in regulation have had a significant impact on many companies' operations and can be a significant factor in determining the risk of fraudulent financial reporting. Examples of matters for consideration include:

- The status of the company's business licenses or agreements. This analysis gives particular attention to situations where it appears the company's licenses or agreements may be suspended or revoked. This potential is heightened when the company's record of compliance with regulatory requirements is poor.
- The potential impact of new tax laws or interpretations.
- The company's relationships with regulatory bodies. This analysis considers the general history of the company's relationship, the results of any recent investigations by government agencies, and the impact of rulings on matters currently under investigation. Rulings or findings that adversely affect the company's operations may increase the incentives for fraudulent financial reporting. On the other hand, continual review by regulators may reduce the company's opportunities to commit fraudulent financial reporting.
- The extent of government control over operations, prices charged, the quality of the company's products, and so forth. This analysis is concerned with how these regulations have affected past development of the industry and how they will affect future development. These considerations are particularly important when a dramatic change has occurred or is likely to occur in the extent of government regulation.

IV. Conclusion

By illustrating the types of environmental conditions that can produce incentives and opportunities for fraudulent financial reporting, these guidelines should heighten the sensitivity of the participants in the financial reporting process to the wide range of factors that can influence the risk of fraudulent financial reporting.

Incentives and opportunities cannot be viewed in isolation or simply be added together. It is the complex, dynamic interaction of these conditions that may produce the combustible mixture leading to fraudulent financial reporting. Identifying risk factors does not necessarily mean that fraudulent financial reporting will occur, but simply indicates that the potential for such fraud, of which management and others should be aware, may be greater.

These guidelines do not represent a "cookbook" approach, meant to be applied mechanically. Effectively assessing the risk of fraudulent financial reporting requires judgment, experience, and creativity to properly identify and weigh the various incentives and opportunities in a company's unique environment.

Appendix G
**STANDARDS FOR THE PROFESSIONAL
PRACTICE OF INTERNAL AUDITING,
THE INSTITUTE OF INTERNAL AUDITORS**

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249 Maitland Avenue,
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INTERNAL AUDITORS SHOULD BE INDEPENDENT OF THE ACTIVITIES THEY AUDIT.

- .01 Internal auditors are independent when they can carry out their work freely and objectively. Independence permits internal auditors to render the impartial and unbiased judgments essential to the proper conduct of audits. It is achieved through organizational status and objectivity.

110 Organizational Status

The organizational status of the internal auditing department should be sufficient to permit the accomplishment of its audit responsibilities.

- .01 Internal auditors should have the support of management and of the board of directors so that they can gain the cooperation of auditees and perform their work free from interference.
- .1 The director of the internal auditing department should be responsible to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of audit reports, and appropriate action on audit recommendations.
- .2 The director should have direct communication with the board. Regular communication with the board helps assure independence and provides a means for the board and the director to keep each other informed on matters of mutual interest.
- .3 Independence is enhanced when the board concurs in the appointment or removal of the director of the internal auditing department.
- .4 The purpose, authority, and responsibility of the internal auditing department should be defined in a formal written document (charter). The director should seek approval of the charter by management as well as acceptance by the board. The charter should (a) establish the department's position within the organization; (b) authorize access to records, personnel, and physical properties relevant to the performance of audits; and (c) define the scope of internal auditing activities.
- .5 The director of internal auditing should submit annually to management for approval and to the board for its information a summary of the department's audit work schedule, staffing plan, and financial budget. The director should also submit all significant interim changes for approval and information. Audit work schedules, staffing plans, and financial budgets should inform management and the board of the scope of internal auditing work and of any limitations placed on that scope.
- .6 The director of internal auditing should submit activity reports to management and to the board annually or more frequently as necessary. Activity reports should highlight significant audit findings and recommendations and should inform management and the board of any significant deviations from approved audit work schedules, staffing plans, and financial budgets, and the reasons for them.

120 Objectivity

Internal auditors should be objective in performing audits.

- .01 Objectivity is an independent mental attitude which internal auditors should maintain in performing audits. Internal auditors are not to subordinate their judgment on audit matters to that of others.
- .02 Objectivity requires internal auditors to perform audits in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Internal auditors are not to be placed in situations in which they feel unable to make objective professional judgments.

Note: The five general standards are expressed in *italicized* statements in upper case. Following each of these general standards are specific standards expressed in *italicized* statements in lower case. Accompanying each specific standard are guidelines describing suitable means of meeting that standard.

- .1 Staff assignments should be made so that potential and actual conflicts of interest and bias are avoided. The director should periodically obtain from the audit staff information concerning potential conflicts of interest and bias.
 - .2 Internal auditors should report to the director any situations in which a conflict of interest or bias is present or may reasonably be inferred. The director should then reassign such auditors.
 - .3 Staff assignments of internal auditors should be rotated periodically whenever it is practicable to do so.
 - .4 Internal auditors should not assume operating responsibilities. But if on occasion management directs internal auditors to perform nonaudit work, it should be understood that they are not functioning as internal auditors. Moreover, objectivity is presumed to be impaired when internal auditors audit any activity for which they had authority or responsibility. This impairment should be considered when reporting audit results.
 - .5 Persons transferred to or temporarily engaged by the internal auditing department should not be assigned to audit those activities they previously performed until a reasonable period of time has elapsed. Such assignments are presumed to impair objectivity and should be considered when supervising the audit work and reporting audit results.
 - .6 The results of internal auditing work should be reviewed before the related audit report is released to provide reasonable assurance that the work was performed objectively.
- .03 The internal auditor's objectivity is not adversely affected when the auditor recommends standards of control for systems or review procedures before they are implemented. Designing, installing, and operating systems are not audit functions. Also, the drafting of procedures for systems is not an audit function. Performing such activities is presumed to impair audit objectivity.

INTERNAL AUDITS SHOULD BE PERFORMED WITH PROFICIENCY AND DUE PROFESSIONAL CARE.

- .01 Professional proficiency is the responsibility of the internal auditing department and each internal auditor. The department should assign to each unit those persons who collectively possess the necessary knowledge, skills, and disciplines to conduct the audit properly.

The Internal Auditing Department

210 Staffing

The internal auditing department should provide assurance that the technical proficiency and educational background of internal auditors are appropriate for the audits to be performed.

- .01 The director of internal auditing should establish suitable criteria of education and experience for filling internal auditing positions, giving due consideration to scope of work and level of responsibility.
- .02 Reasonable assurance should be obtained as to each prospective auditor's qualifications and proficiency.

220 Knowledge, Skills, and Disciplines

The internal auditing department should possess or should obtain the knowledge, skills, and disciplines needed to carry out its audit responsibilities.

- .01 The internal auditing staff should collectively possess the knowledge and skills essential to the practice of the profession within the organization. These attributes include proficiency in applying internal auditing standards, procedures, and techniques.
- .02 The internal auditing department should have employees or use consultants who are qualified in such disciplines as accounting, economics, finance, statistics, electronic data processing, engineering, taxation, and law as needed to meet audit responsibilities. Each member of the department, however, need not be qualified in all of these disciplines.

230 Supervision

The internal auditing department should provide assurance that internal audits are properly supervised.

- .01 The director of internal auditing is responsible for providing appropriate audit supervision. Supervision is a continuing process, beginning with planning and ending with the conclusion of the audit assignment.
- .02 Supervision includes:
- .1 Providing suitable instructions to subordinates at the outset of the audit and approving the audit program.
 - .2 Seeing that the approved audit program is carried out unless deviations are both justified and authorized.
 - .3 Determining that audit working papers adequately support the audit findings, conclusions, and reports.
 - .4 Making sure that audit reports are accurate, objective, clear, concise, constructive, and timely.
 - .5 Determining that audit objectives are being met.
- .03 Appropriate evidence of supervision should be documented and retained.
- .04 The extent of supervision required will depend on the proficiency of the internal auditors and the difficulty of the audit assignment.
- .05 All internal auditing assignments, whether performed by or for the internal auditing department, remain the responsibility of its director.

The Internal Auditor

240 Compliance with Standards of Conduct

Internal auditors should comply with professional standards of conduct.

- .01 The *Code of Ethics* of The Institute of Internal Auditors sets forth standards of conduct and provides a basis for enforcement among its members. The *Code* calls for high standards of honesty, objectivity, diligence, and loyalty to which internal auditors should conform.

250 Knowledge, Skills, and Disciplines

Internal auditors should possess the knowledge, skills, and disciplines essential to the performance of internal audits.

- .01 Each internal auditor should possess certain knowledge and skills as follows:
 - .1 Proficiency in applying internal auditing standards, procedures, and techniques is required in performing internal audits. Proficiency means the ability to apply knowledge to situations likely to be encountered and to deal with them without extensive recourse to technical research and assistance.
 - .2 Proficiency in accounting principles and techniques is required of auditors who work extensively with financial records and reports.
 - .3 An understanding of management principles is required to recognize and evaluate the materiality and significance of deviations from good business practice. An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to be able to carry out the research necessary to arrive at reasonable solutions.
 - .4 An appreciation is required of the fundamentals of such subjects as accounting, economics, commercial law, taxation, finance, quantitative methods, and computerized information systems. An appreciation means the ability to recognize the existence of problems or potential problems and to determine the further research to be undertaken or the assistance to be obtained.

260 Human Relations and Communications

Internal auditors should be skilled in dealing with people and in communicating effectively.

- .01 Internal auditors should understand human relations and maintain satisfactory relationships with auditees.
- .02 Internal auditors should be skilled in oral and written communications so that they can clearly and effectively convey such matters as audit objectives, evaluations, conclusions, and recommendations.

270 Continuing Education

Internal auditors should maintain their technical competence through continuing education.

- .01 Internal auditors are responsible for continuing their education in order to maintain their proficiency. They should keep informed about improvements and current developments in internal auditing standards, procedures, and techniques. Continuing education may be obtained through membership and participation in professional societies; attendance at conferences, seminars, college courses, and in-house training programs; and participation in research projects.

280 Due Professional Care

Internal auditors should exercise due professional care in performing internal audits.

- .01 Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent internal auditor in the same or similar circumstances. Professional care should, therefore, be appropriate to the complexities of the audit being performed. In exercising due professional care, internal auditors should be alert to the possibility of intentional wrongdoing, errors and omissions, inefficiency, waste, ineffectiveness, and conflicts of interest. They should also be alert to those conditions and activities where irregularities are most likely to occur. In addition, they should identify inadequate controls and recommend improvements to promote compliance with acceptable procedures and practices.

- .02 Due care implies reasonable care and competence, not infallibility or extraordinary performance. Due care requires the auditor to conduct examinations and verifications to a reasonable extent, but does not require detailed audits of all transactions. Accordingly, the internal auditor cannot give absolute assurance that noncompliance or irregularities do not exist. Nevertheless, the possibility of material irregularities or noncompliance should be considered whenever the internal auditor undertakes an internal auditing assignment.
- .03 When an internal auditor suspects wrongdoing, the appropriate authorities within the organization should be informed. The internal auditor may recommend whatever investigation is considered necessary in the circumstances. Thereafter, the auditor should follow up to see that the internal auditing department's responsibilities have been met.
- .04 Exercising due professional care means using reasonable audit skill and judgment in performing the audit. To this end, the internal auditor should consider:
 - .1 The extent of audit work needed to achieve audit objectives.
 - .2 The relative materiality or significance of matters to which audit procedures are applied.
 - .3 The adequacy and effectiveness of internal controls.
 - .4 The cost of auditing in relation to potential benefits.
- .05 Due professional care includes evaluating established operating standards and determining whether those standards are acceptable and are being met. When such standards are vague, authoritative interpretations should be sought. If internal auditors are required to interpret or select operating standards, they should seek agreement with auditees as to the standards needed to measure operating performance.

SCOPE OF WORK

THE SCOPE OF THE INTERNAL AUDIT SHOULD ENCOMPASS THE EXAMINATION AND EVALUATION OF THE ADEQUACY AND EFFECTIVENESS OF THE ORGANIZATION'S SYSTEM OF INTERNAL CONTROL AND THE QUALITY OF PERFORMANCE IN CARRYING OUT ASSIGNED RESPONSIBILITIES.

- .01 The scope of internal auditing work, as specified in this standard, encompasses what audit work should be performed. It is recognized, however, that management and the board of directors provide general direction as to the scope of work and the activities to be audited.
- .02 The purpose of the review for adequacy of the system of internal control is to ascertain whether the system established provides reasonable assurance that the organization's objectives and goals will be met efficiently and economically.
- .03 The purpose of the review for effectiveness of the system of internal control is to ascertain whether the system is functioning as intended.
- .04 The purpose of the review for quality of performance is to ascertain whether the organization's objectives and goals have been achieved.
- .05 The primary objectives of internal control are to ensure:
 - .1 The reliability and integrity of information.
 - .2 Compliance with policies, plans, procedures, laws, and regulations.
 - .3 The safeguarding of assets.
 - .4 The economical and efficient use of resources.
 - .5 The accomplishment of established objectives and goals for operations or programs.

310 Reliability and Integrity of Information

Internal auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information.

- .01 Information systems provide data for decision making, control, and compliance with external requirements. Therefore, internal auditors should examine information systems and, as appropriate, ascertain whether:
 - .1 Financial and operating records and reports contain accurate, reliable, timely, complete, and useful information.
 - .2 Controls over recordkeeping and reporting are adequate and effective.

320 Compliance with Policies, Plans, Procedures, Laws, and Regulations

Internal auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on operations and reports, and should determine whether the organization is in compliance.

- .01 Management is responsible for establishing the systems designed to ensure compliance with such requirements as policies, plans, procedures, and applicable laws and regulations. Internal auditors are responsible for determining whether the systems are adequate and effective and whether the activities audited are complying with the appropriate requirements.

330 Safeguarding of Assets

Internal auditors should review the means of safeguarding assets and, as appropriate, verify the existence of such assets.

- .01 Internal auditors should review the means used to safeguard assets from various types of losses such as those resulting from theft, fire, improper or illegal activities, and exposure to the elements.
- .02 Internal auditors, when verifying the existence of assets, should use appropriate audit procedures.

340 Economical and Efficient Use of Resources

Internal auditors should appraise the economy and efficiency with which resources are employed.

- .01 Management is responsible for setting operating standards to measure an activity's economical and efficient use of resources. Internal auditors are responsible for determining whether:
 - .1 Operating standards have been established for measuring economy and efficiency.
 - .2 Established operating standards are understood and are being met.
 - .3 Deviations from operating standards are identified, analyzed, and communicated to those responsible for corrective action.
 - .4 Corrective action has been taken.
- .02 Audits related to the economical and efficient use of resources should identify such conditions as:
 - .1 Underutilized facilities.
 - .2 Nonproductive work.
 - .3 Procedures which are not cost justified.
 - .4 Overstaffing or understaffing.

350 Accomplishment of Established Objectives and Goals for Operations or Programs

Internal auditors should review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

- .01 Management is responsible for establishing operating or program objectives and goals, developing and implementing control procedures, and accomplishing desired operating or program results. Internal auditors should ascertain whether such objectives and goals conform with those of the organization and whether they are being met.
- .02 Internal auditors can provide assistance to managers who are developing objectives, goals, and systems by determining whether the underlying assumptions are appropriate; whether accurate, current, and relevant information is being used; and whether suitable controls have been incorporated into the operations or programs.

AUDIT WORK SHOULD INCLUDE PLANNING THE AUDIT, EXAMINING AND EVALUATING INFORMATION, COMMUNICATING RESULTS, AND FOLLOWING UP.

.01 The internal auditor is responsible for planning and conducting the audit assignment, subject to supervisory review and approval.

410 Planning the Audit

Internal auditors should plan each audit.

.01 Planning should be documented and should include:

- .1 Establishing audit objectives and scope of work.
- .2 Obtaining background information about the activities to be audited.
- .3 Determining the resources necessary to perform the audit.
- .4 Communicating with all who need to know about the audit.
- .5 Performing, as appropriate, an on-site survey to become familiar with the activities and controls to be audited, to identify areas for audit emphasis, and to invite auditee comments and suggestions.
- .6 Writing the audit program.
- .7 Determining how, when, and to whom audit results will be communicated.
- .8 Obtaining approval of the audit work plan.

420 Examining and Evaluating Information

Internal auditors should collect, analyze, interpret, and document information to support audit results.

.01 The process of examining and evaluating information is as follows:

- .1 Information should be collected on all matters related to the audit objectives and scope of work.
- .2 Information should be sufficient, competent, relevant, and useful to provide a sound basis for audit findings and recommendations.
 - Sufficient* information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor.
 - Competent* information is reliable and the best attainable through the use of appropriate audit techniques.
 - Relevant* information supports audit findings and recommendations and is consistent with the objectives for the audit.
 - Useful* information helps the organization meet its goals.
- .3 Audit procedures, including the testing and sampling techniques employed, should be selected in advance, where practicable, and expanded or altered if circumstances warrant.
- .4 The process of collecting, analyzing, interpreting, and documenting information should be supervised to provide reasonable assurance that the auditor's objectivity is maintained and that audit goals are met.
- .5 Working papers that document the audit should be prepared by the auditor and reviewed by management of the internal auditing department. These papers should record the information obtained and the analyses made and should support the bases for the findings and recommendations to be reported.

430 Communicating Results

Internal auditors should report the results of their audit work.

- .01 A signed, written report should be issued after the audit examination is completed. Interim reports may be written or oral and may be transmitted formally or informally.
- .02 The internal auditor should discuss conclusions and recommendations at appropriate levels of management before issuing final written reports.
- .03 Reports should be objective, clear, concise, constructive, and timely.

- .04 Reports should present the purpose, scope, and results of the audit; and, where appropriate, reports should contain an expression of the auditor's opinion.
- .05 Reports may include recommendations for potential improvements and acknowledge satisfactory performance and corrective action.
- .06 The auditee's views about audit conclusions or recommendations may be included in the audit report.
- .07 The director of internal auditing or designee should review and approve the final audit report before issuance and should decide to whom the report will be distributed.

440 Following Up

Internal auditors should follow up to ascertain that appropriate action is taken on reported audit findings.

- .01 Internal auditing should determine that corrective action was taken and is achieving the desired results, or that management or the board has assumed the risk of not taking corrective action on reported findings.

THE DIRECTOR OF INTERNAL AUDITING SHOULD PROPERLY MANAGE THE INTERNAL AUDITING DEPARTMENT.

- .01 The director of internal auditing is responsible for properly managing the department so that:
 - .1 Audit work fulfills the general purposes and responsibilities approved by management and accepted by the board.
 - .2 Resources of the internal auditing department are efficiently and effectively employed.
 - .3 Audit work conforms to the *Standards for the Professional Practice of Internal Auditing*.

510 Purpose, Authority, and Responsibility

The director of internal auditing should have a statement of purpose, authority, and responsibility for the internal auditing department.

- .01 The director of internal auditing is responsible for seeking the approval of management and the acceptance by the board of a formal written document (charter) for the internal auditing department.

520 Planning

The director of internal auditing should establish plans to carry out the responsibilities of the internal auditing department.

- .01 These plans should be consistent with the internal auditing department's charter and with the goals of the organization.
- .02 The planning process involves establishing:
 - .1 Goals.
 - .2 Audit work schedules.
 - .3 Staffing plans and financial budgets.
 - .4 Activity reports.
- .03 The *goals* of the internal auditing department should be capable of being accomplished within specified operating plans and budgets and, to the extent possible, should be measurable. They should be accompanied by measurement criteria and targeted dates of accomplishment.
- .04 *Audit work schedules* should include (a) what activities are to be audited; (b) when they will be audited; and (c) the estimated time required, taking into account the scope of the audit work planned and the nature and extent of audit work performed by others. Matters to be considered in establishing audit work schedule priorities should include (a) the date and results of the last audit; (b) financial exposure; (c) potential loss and risk; (d) requests by management; (e) major changes in operations, programs, systems, and controls; (f) opportunities to achieve operating benefits; and (g) changes to and capabilities of the audit staff. The work schedules should be sufficiently flexible to cover unanticipated demands on the internal auditing department.
- .05 *Staffing plans and financial budgets*, including the number of auditors and the knowledge, skills, and disciplines required to perform their work, should be determined from audit work schedules, administrative activities, education and training requirements, and audit research and development efforts.
- .06 *Activity reports* should be submitted periodically to management and to the board. These reports should compare (a) performance with the department's goals and audit work schedules and (b) expenditures with financial budgets. They should explain the reason for major variances and indicate any action taken or needed.

530 Policies and Procedures

The director of internal auditing should provide written policies and procedures to guide the audit staff.

- .01 The form and content of written policies and procedures should be appropriate to the size and structure of the internal auditing department and the complexity of its work. Formal administrative and technical audit manuals may not be needed by all internal auditing departments. A small internal auditing department may be managed informally. Its audit staff may be directed and controlled through daily, close supervision and written memoranda. In a large internal auditing department, more formal and comprehensive policies and procedures are essential to guide the audit staff in the consistent compliance with the department's standards of performance.

540 Personnel Management and Development

The director of internal auditing should establish a program for selecting and developing the human resources of the internal auditing department.

- .01 The program should provide for:
 - .1 Developing written job descriptions for each level of the audit staff.
 - .2 Selecting qualified and competent individuals.
 - .3 Training and providing continuing educational opportunities for each internal auditor.
 - .4 Appraising each internal auditor's performance at least annually.
 - .5 Providing counsel to internal auditors on their performance and professional development.

550 External Auditors

The director of internal auditing should coordinate internal and external audit efforts.

- .01 The internal and external audit work should be coordinated to ensure adequate audit coverage and to minimize duplicate efforts.
- .02 Coordination of audit efforts involves:
 - .1 Periodic meetings to discuss matters of mutual interest.
 - .2 Access to each other's audit programs and working papers.
 - .3 Exchange of audit reports and management letters.
 - .4 Common understanding of audit techniques, methods, and terminology.

560 Quality Assurance

The director of internal auditing should establish and maintain a quality assurance program to evaluate the operations of the internal auditing department.

- .01 The purpose of this program is to provide reasonable assurance that audit work conforms with these *Standards*, the internal auditing department's charter, and other applicable standards. A quality assurance program should include the following elements:
 - .1 Supervision.
 - .2 Internal reviews.
 - .3 External reviews.
- .02 *Supervision* of the work of the internal auditors should be carried out continually to assure conformance with internal auditing standards, departmental policies, and audit programs.
- .03 *Internal reviews* should be performed periodically by members of the internal auditing staff to appraise the quality of the audit work performed. These reviews should be performed in the same manner as any other internal audit.
- .04 *External reviews* of the internal auditing department should be performed to appraise the quality of the department's operations. These reviews should be performed by qualified persons who are independent of the organization and who do not have either a real or an apparent conflict of interest. Such reviews should be conducted at least once every three years. On completion of the review, a formal, written report should be issued. The report should express an opinion as to the department's compliance with the *Standards for the Professional Practice of Internal Auditing* and, as appropriate, should include recommendations for improvement.

Appendix H

**NEW YORK STOCK EXCHANGE LISTED
COMPANY MANUAL, SECTION 3,
CORPORATE RESPONSIBILITY—
AUDIT COMMITTEE**

303.00 Audit Committee

Exchange Policy

Each domestic company with common stock listed on the Exchange, as a condition of listing and continued listing of its securities on the Exchange, shall establish no later than June 30, 1978 and maintain thereafter an Audit Committee comprised solely of directors independent of management and free from any relationship that, in the opinion of its Board of Directors, would interfere with the exercise of independent judgment as a committee member. Directors who are affiliates of the company or officers or employees of the company or its subsidiaries would not be qualified for Audit Committee membership.

A director who was formerly an officer of the company or any of its subsidiaries may qualify for membership even though he may be receiving pension or deferred compensation payments from the company if, in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee. However, a majority of the Audit Committee shall be directors who were not formerly officers of the company or any of its subsidiaries.

* * * * *

Supplementary Material

In order to deal with complex relationships that may arise, the following guidelines are provided to assist the Board of Directors to observe the spirit of the policy in selecting members of the Audit Committee.

A director who has been or is a partner, officer or director of an organization that has customary commercial, industrial, banking or underwriting relationships with the company which are carried on in the ordinary course of business on an arms-length basis may qualify for membership unless, in the opinion of the Board of Directors, such director is not independent of management or the relationship would interfere with the exercise of independent judgment as a committee member.

A director who, in addition to fulfilling the customary director's role, also provides additional services directly for the Board of Directors and is separately compensated therefor, would nonetheless qualify for membership on the Audit Committee. However, a director who, in addition to his director's role, also acts on a regular basis as an individual or representative of an organization serving as a professional advisor, legal counsel or consultant to management, would not qualify if, in the opinion of the Board of Directors, such relationship is material to the company, the organization represented or the director.

A director who represents or is a close relative of a person who would not qualify as a member of the Audit Committee in the light of the policy would likewise not qualify for the committee. However, if the director is a close relative of an employee who is not an executive officer or if there are valid countervailing reasons, the Board of Directors' decision as to eligibility shall govern.

While rule 405 under the Securities Act of 1933 may be helpful to the Board of Directors in determining whether a particular director is an affiliate or a close relative for purposes of this policy, it is not intended to be so technically applied as to go beyond the spirit of this policy.

Appendix I

GOOD PRACTICE GUIDELINES FOR THE AUDIT COMMITTEE

Introduction

Primary responsibility for the company's financial reporting lies with top management, overseen by the board of directors. To help boards of directors carry out this oversight responsibility, the Commission recommends that all public companies establish audit committees consisting of independent directors. Establishment of such committees, of course, does not relieve the other directors of their responsibility with respect to the financial reporting process. The Commission therefore reinforces its general recommendation with more specific recommendations for audit committee duties and responsibilities.

First, specific recommendations directed to audit committees highlight the need for the audit committee (1) to be informed and vigilant, (2) to have its duties and responsibilities set forth in a written charter, and (3) to be given resources and authority adequate to discharge its responsibilities. Among other things, the audit committee should review management's evaluation of factors related to the independence of the company's public accountant, help preserve that independence and review management's plans for engaging the company's independent public accountant to perform management advisory services during the coming year, considering the types of services that may be rendered and the amount budgeted for such services.

In addition, the Commission highlights other important audit committee functions throughout Chapter Two. The audit committee should review the company's process of assessing the risk of fraudulent financial reporting and the program that management establishes to monitor compliance with the code of corporate conduct. The audit committee should have open lines of communication with the chief accounting officer and the chief internal auditor. In fact, the chief internal auditor's direct and unrestricted access to the audit committee is vital to his objectivity. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue. Audit committees should oversee the quarterly reporting process. Finally, the chairman of the audit committee should write a letter describing the committee's activities and responsibilities for inclusion in the annual report to stockholders.

The Commission developed this set of recommended audit committee duties and responsibilities from a review and consideration of the practices many well-managed companies follow today, of the extensive guidance the public accounting and legal professions have published on the subject, and of practices suggested by the results of the Commission's research projects, and by presentations made to the Commission.

The Commission believes that more detailed delineation and description of responsibilities is best left to the discretion of management and the board of directors to tailor to the needs and circumstances of each company. In the course of its research and deliberations, however, the Commission has identified additional, more specific practices and procedures that can help audit committees perform their oversight role effectively. The Commission is not prescribing these additional measures, and therefore has not included them as recommendations, but offers this guidance in the form of the following Good Practice Guidelines, which companies can consider within the exercise of their judgment. To companies that already have audit committees, the guidelines will serve as a standard for review and assessment. Other companies — those just establishing audit committees or those seeking to improve their committees' effectiveness — may find them to be helpful in suggesting practical ways for audit committees to discharge their responsibilities.

General Guidelines

- *Size and Term of Appointment.* An audit committee normally should consist of not fewer than three independent directors. The maximum size may vary, but the committee should be small enough so that each member is an active participant. The term of appointment is at the discretion of the board of

directors, but it is desirable to have terms arranged to maintain continuity while bringing fresh perspectives to the work of the committee.

- *Meetings.* The committee should meet on a regular basis and special meetings should be called as circumstances require. The committee should meet privately with the internal auditor and the independent public accountant.
- *Reporting to the Board of Directors.* The committee should report its activities to the full board on a regular basis, such as after each meeting, so that the board is kept informed of its activities on a current basis.
- *Expand Knowledge of Company Operations.* A systematic and continuing learning process for audit committee members will increase their effectiveness. One way is to review various financial aspects of the company on a planned basis.
- *Company Counsel.* The committee should meet regularly with the company's general counsel, and outside counsel when appropriate, to discuss legal matters that may have a significant impact on the company's financial statements. In a number of companies the general counsel and/or outside counsel attend meetings.
- *Audit Plans.* The committee should review with the chief internal auditor and the independent public accountant their annual audit plans, including the degree of coordination of the respective plans. The committee should inquire as to the extent to which the planned audit scope can be relied upon to detect fraud or weaknesses in internal controls.
- *Electronic Data Processing.* The committee should discuss with the internal auditor and the independent public accountant what steps are planned for a review of the company's electronic data processing procedures and controls, and inquire as to the specific security programs to protect against computer fraud or misuse from both within and outside the company.
- *Other Auditors.* The committee should inquire as to the extent to which independent public accountants other than the principal auditor are to be used and understand the rationale for using them. The committee should request that their work be coordinated and that an appropriate review of their work be performed by the principal auditor.
- *Officer Expenses and Perquisites.* The committee should review in-house policies and procedures for regular review of officers' expenses and perquisites, including any use of corporate assets, inquire as to the results of the review, and, if appropriate, review a summarization of the expenses and perquisites of the period under review.
- *Areas Requiring Special Attention.* The committee should instruct the independent public accountant and the internal auditor that the committee expects to be advised if there are any areas that require its special attention.

Selection of an Independent Public Accountant

A primary responsibility of the audit committee should be the selection of an independent public accountant for the company. The actual selection generally is proposed by management, with the audit committee confirming management's selection, and is ratified by the stockholders. Suggested below are a number of considerations that may enter into the decision. There will be variations, of course, including those that depend upon whether the committee is considering management's proposal to retain the present independent public accountants or management's proposal to appoint a new public accounting firm.

Issues related to this audit:

- Opinions on the performance of the public accounting firm by appropriate management and the chief internal auditor
- The proposed audit fee and the independent public accountant's engagement letter; explanations for fee changes

- The expected level of participation by the partner and other management personnel in the audit examination, the mix of skills and experience of the staff, and staff rotation policy
- If a new public accounting firm is being considered, the steps planned to ensure a smooth and effective transition.

Issues related to the firm generally:

- The report of the public accounting firm's latest peer review conducted pursuant to a professional quality control program
- Any significant litigation problems or disciplinary actions by the SEC or others
- The public accounting firm's credentials, capabilities, and reputation and a list of clients in the same industry and geographical area.

Post-Audit Review

- The committee should obtain from management explanations for all significant variances in the financial statements between years. (This review may be performed at a meeting of the entire board.) The committee should consider whether the data are consistent with the Management's Discussion and Analysis (MD&A) section of the annual report.
- The committee should request an explanation from financial management and the independent public accountant of changes in accounting standards or rules promulgated by the Financial Accounting Standards Board, Securities and Exchange Commission or other regulatory bodies, that have an effect on the financial statements.
- The committee should inquire about the existence and substance of any significant accounting accruals, reserves, or estimates made by management that had a material impact on the financial statements.
- The committee should inquire of management and the independent public accountant if there were any significant financial reporting issues discussed during the accounting period and if so how they were resolved.
- The committee should meet privately with the independent public accountant, to request his opinion on various matters including the quality of financial and accounting personnel and the internal audit staff.
- The committee should ask the independent public accountant what his greatest concerns were and if he believes anything else should be discussed with the committee that has not been raised or covered elsewhere.
- The committee should review the letter of management representations given to the independent public accountant and inquire whether he encountered any difficulties in obtaining the letter or any specific representations therein.
- The committee should discuss with management and the independent public accountant the substance of any significant issues raised by in-house and outside counsel concerning litigation, contingencies, claims or assessments. The committee should understand how such matters are reflected in the company's financial statements.
- The committee should determine the open years on federal income tax returns and whether there are any significant items that have been or might be disputed by the IRS, and inquire as to the status of the related tax reserves.
- The committee should review with management the MD&A section of the annual report and ask the extent to which the independent public accountant reviewed the MD&A section. The committee should inquire of the independent public accountant if the other sections of the annual report to stockholders are consistent with the information reflected in the financial statements.
- The committee and the board of directors should consider whether the independent public accountant should meet with the full board to discuss any matters relative to the financial statements and to answer any questions that other directors may have.

Appendix J

GOOD PRACTICE GUIDELINES FOR MANAGEMENT'S REPORT

How management carries out its financial reporting responsibilities is of interest to the investing public. Widespread implementation of management reports, tailored to fit individual company circumstances, will improve communication with financial statement users about the nature of financial information and the processes and responsibilities that surround its preparation and presentation.

The Commission has recommended that all annual reports to stockholders be required by SEC rule to include a management report, signed by the company's chief executive officer and the chief financial officer and/or the chief accounting officer. The controller may serve as the chief accounting officer, or the chief financial officer also may perform the functions of a chief accounting officer. This report should acknowledge management's responsibilities for the financial statements and internal controls, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls.

Content of the Management Report

An informative management report should discuss the following matters, as applicable:

- Management's responsibilities for the financial statements. This part of the management report should specifically acknowledge management's responsibilities for:
 - Preparing the financial statements so that they are fairly presented in accordance with generally accepted accounting principles appropriate in the circumstances and not misstated due to material fraud or error
 - Preparing the other information in the annual report to stockholders and ensuring that such information is correct and consistent with the financial statements
 - Determining the estimates and judgments used in preparing the financial statements.
- Management's responsibility for establishing and maintaining a system of internal control designed to provide reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets, and the prevention and detection of fraudulent financial reporting. Management's discussion of internal control also should include:
 - Management's opinion as to the effectiveness of the company's internal controls as of the end of the company's fiscal year, or at some other point in time during the fiscal year
 - A description of management's basis for its opinion on the company's internal controls
 - Management's statement that it has appropriately responded to the internal auditor's and independent public accountant's recommendations concerning the company's internal control system.

Other Disclosures in the Management Report

The exact contents of management's report cannot be prescribed; to attempt to do so would encourage boilerplate reports of little value. In addition to the matters specifically noted above, other topics that management may wish to discuss include:

- The financial records and documents, and minutes of important meetings, that were made available to the independent public accountants and the validity and accuracy of the representations that were made to the independent public accountants
- A change in independent public accountants during the year

- The reporting relationships within the company of individuals with significant roles in the financial reporting process
- The work of the company's internal auditors
- The inherent limitations of internal control
- The existence of a code of conduct which is monitored and enforced; this discussion also could include an assessment of the company's compliance with the code
- Uncertainties whose resolution could have a material impact on the financial statements.

Example of Management Report

The following is an illustration of a management report. Actual management reports should be tailored to the facts and circumstances of each company.

MANAGEMENT REPORT ON RESPONSIBILITY FOR FINANCIAL REPORTING

The management of ABC Corporation and its subsidiaries has the responsibility for preparing the accompanying financial statements and for their integrity and objectivity. The statements were prepared in accordance with generally accepted accounting principles applied on a consistent basis and are not misstated due to material fraud or error. The financial statements include amounts that are based on management's best estimates and judgments. Management also prepared the other information in the annual report and is responsible for its accuracy and consistency with the financial statements.

The corporation's financial statements have been audited by XYZ Co., independent certified public accountants, elected by the shareholders. Management has made available to XYZ Co. all the corporation's financial records and related data, as well as the minutes of stockholders' and directors' meetings. Furthermore, management believes that all representations made to XYZ Co. during its audit were valid and appropriate.

Management of the corporation has established and maintains a system of internal control that provides reasonable assurance as to the integrity and reliability of the financial statements, the protection of assets from unauthorized use or disposition, and the prevention and detection of fraudulent financial reporting. The system of internal control provides for appropriate division of responsibility and is documented by written policies and procedures that are communicated to employees with significant roles in the financial reporting process and updated as necessary. Management continually monitors the system of internal control for compliance. The corporation maintains a strong internal auditing program that independently assesses the effectiveness of the internal controls and recommends possible improvements thereto. In addition, as part of its audit of the corporation's financial statements, XYZ Co. completed a study and evaluation of selected internal accounting controls to establish a basis for reliance thereon in determining the nature, timing, and extent of audit tests to be applied. Management has considered the internal auditor's and XYZ Co.'s recommendations concerning the corporation's system of internal control and has taken actions that we believe are cost-effective in the circumstances to respond appropriately to these recommendations. Management believes that, as of [date], the corporation's system of internal control is adequate to accomplish the objectives discussed herein.

Management also recognizes its responsibility for fostering a strong ethical climate so that the corporation's affairs are conducted according to the highest standards of personal and corporate conduct. This responsibility is characterized and reflected in the corporation's code of corporate conduct, which is publicized throughout the corporation. The code of conduct addresses, among other things, the necessity of ensuring open communication within the corporation; potential

conflicts of interests; compliance with all domestic and foreign laws, including those relating to financial disclosure; and the confidentiality of proprietary information. The corporation maintains a systematic program to assess compliance with these policies.

Joe Doe
Chief Executive Officer
Jane Smith
Chief Financial Officer
(and/or)
Jane Brown
Controller

Appendix K

GOOD PRACTICE GUIDELINES FOR AUDIT COMMITTEE CHAIRMAN'S LETTER

Audit committees play an important role in overseeing the financial reporting process and the establishment and maintenance of strong internal controls. The Commission recommends that the Securities and Exchange Commission require all annual reports to stockholders to include a letter from the chairman of the audit committee describing the committee's responsibilities and activities.

Among other subjects, the audit committee chairman's letter could discuss:

- The composition of the audit committee
- The identity of each audit committee member, unless disclosed elsewhere
- The audit committee's purpose, objectives, and responsibilities
- The activities of the audit committee during the past year including matters such as the number of meetings held and the significant topics discussed with management, internal auditors, and independent public accountants.

The following is an example of a letter by the chairman of an audit committee. This illustrative letter does not contain the precise wording that the audit committee chairman should use or in any way limit the selection of topics the chairman may wish to discuss.

AUDIT COMMITTEE CHAIRMAN'S LETTER

The audit committee of the board of directors is composed of _____ independent directors. The members of the audit committee are: John Doe, Chairman, _____, and _____ . The committee held _____ meetings during fiscal year _____ .

The audit committee oversees the company's financial reporting process on behalf of the board of directors. In fulfilling its responsibility, the committee recommended to the board of directors, subject to shareholder approval, the selection of the company's independent public accountant. The audit committee discussed with the internal auditor and the independent public accountant the overall scope and specific plans for their respective audits. The committee also discussed the company's consolidated financial statements and the adequacy of the company's internal controls. The committee met regularly with the company's internal auditor and independent public accountant, without management present, to discuss the results of their examinations, their evaluations of the company's internal controls, and the overall quality of the company's financial reporting. The meetings also were designed to facilitate any private communication with the committee desired by the internal auditor or independent public accountant.

John Doe, Chairman
Audit Committee