

96th Congress }
2d Session }

COMMITTEE PRINT

SECURITIES AND EXCHANGE COMMISSION
REPORT TO CONGRESS ON THE
ACCOUNTING PROFESSION AND THE
COMMISSION'S OVERSIGHT ROLE

PREPARED FOR THE
SUBCOMMITTEE ON GOVERNMENTAL EFFICIENCY
AND THE DISTRICT OF COLUMBIA

OF THE
COMMITTEE ON GOVERNMENTAL AFFAIRS
UNITED STATES SENATE

BY THE
SECURITIES AND EXCHANGE COMMISSION



AUGUST 1980

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1980

67-051 O

KF
1446
A87
1980
C.1

JUDICIARY

6

COMMITTEE ON GOVERNMENTAL AFFAIRS

ABRAHAM RIBICOFF, Connecticut, *Chairman*

HENRY M. JACKSON, Washington
THOMAS F. EAGLETON, Missouri
LAWTON CHILES, Florida
SAM NUNN, Georgia
JOHN GLENN, Ohio
JIM SASSER, Tennessee
DAVID PRYOR, Arkansas
CARL LEVIN, Michigan

CHARLES H. PERCY, Illinois
JACOB K. JAVITS, New York
WILLIAM V. ROTH, Jr., Delaware
TED STEVENS, Alaska
CHARLES MCC. MATHIAS, Jr., Maryland
JOHN C. DANFORTH, Missouri
WILLIAM S. COHEN, Maine
DAVID DURENBERGER, Minnesota

RICHARD A. WEGMAN, *Chief Counsel and Staff Director*

PAUL HOFF, *Counsel*

HANNAH S. SISTARE, *Chief Minority Counsel and Staff Director*

ELIZABETH A. PREAST, *Chief Clerk*

SUBCOMMITTEE ON GOVERNMENTAL EFFICIENCY AND THE DISTRICT OF COLUMBIA

THOMAS F. EAGLETON, Missouri, *Chairman*

CARL LEVIN, Michigan

CHARLES MCC. MATHIAS, Jr., Maryland
TED STEVENS, Alaska

IRA S. SHAPIRO, *Chief Counsel and Staff Director*

MARGARET P. CRENSHAW, *Counsel*

GLENN C. SMITH, *Counsel*

EILEEN C. MAYER, *Counsel for the Minority*

(II)

ABRAHAM RIBICOFF, CONN., CHAIRMAN
HENRY M. JACKSON, WASH.
THOMAS F. EAGLETON, MO.
LAWTON CHILES, FLA.
SAM NUNN, GA.
JOHN GLENN, OHIO
JIM SASSER, TENN.
DAVID PRYOR, ARK.
CARL LEVIN, MICH.

RICHARD A. WEGMAN
CHIEF COUNSEL AND STAFF DIRECTOR

CHARLES H. PERCY, ILL.
JACOB K. JAVITS, N.Y.
WILLIAM V. ROTH, JR., DEL.
TED STEVENS, ALASKA
CHARLES MCC. MATHIAS, JR., MD.
JOHN C. DANFORTH, MO.
WILLIAM S. COHEN, MAINE
DAVID DURENBERGER, MINN.

SUBCOMMITTEE

THOMAS F. EAGLETON, MO., CHAIRMAN
CARL LEVIN, MICH. CHARLES MCC. MATHIAS, JR., MD.
TED STEVENS, ALASKA

IRA S. SHAPIRO, CHIEF COUNSEL AND STAFF DIRECTOR
333 DIRKSEN BUILDING

United States Senate

COMMITTEE ON
GOVERNMENTAL AFFAIRS
SUBCOMMITTEE ON GOVERNMENTAL EFFICIENCY
AND THE DISTRICT OF COLUMBIA
WASHINGTON, D.C. 20510

September 2, 1980

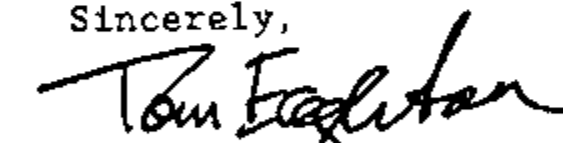
The Honorable Abraham Ribicoff
Chairman
Committee on Governmental Affairs
3308 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

I am herewith transmitting to you the recently-prepared report of the Securities and Exchange Commission which is entitled "Report to Congress on The Accounting Profession and the Commission's Oversight Role."

In response to an SEC request, I am asking that this report be published as a committee print so that it will be available for use by Members of Congress and the public.

Sincerely,



Thomas F. Eagleton
Chairman

TFE:isa

(III)



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D. C. 20540

The Honorable Walter F. Mondale
President of the Senate

The Honorable Thomas P. O'Neill, Jr.
Speaker
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Speaker:

I am pleased to submit to the Congress the third "Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role." This Report represents a continuation of a commitment I made in testimony before the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs on June 13, 1977 for the Commission to report periodically to the Congress on the accounting profession's response to the various challenges which the Congress and others have placed before it, as well as on the Commission's own oversight role and initiatives in this area.

The Commission's commitment resulted from the increasing public and Congressional attention focused on the role of the accounting profession in promoting public confidence in the integrity and credibility of financial reporting by publicly-owned companies. Careful scrutiny of the accounting profession had conveyed a sense of expectation and urgency regarding actions which the profession and the Commission might take to increase public confidence in the profession's ability and resolve to develop and maintain a viable system of self-regulation and self-discipline; in the independence of accountants; and in the process by which accounting and auditing standards are promulgated.

Responses to the challenges which resulted from the increased attention paid to the accounting profession have been the principal focus of the Commission's 1978 and 1979 Reports to the Congress. This year's Report similarly describes the initiatives of the private sector to establish meaningful self-regulation and self-discipline; to foster and maintain the independence of accountants; and to improve the accounting and auditing standard-setting processes of the

private sector. Additionally, the Report discusses the Commission's own oversight role and activities and provides insight as to its present posture regarding each of these areas. Finally, for your convenience, I have highlighted below some of the major activities and developments of the preceding year.

As you know, among the principal initiatives undertaken by the accounting profession in recent years in furtherance of its efforts towards effective self-regulation and self-discipline is the system of peer reviews conducted under the auspices of the American Institute of Certified Public Accountants' SEC Practice Section. Given the central importance of this initiative to the success of the profession's self-regulatory efforts, it is imperative for the Commission to secure meaningful access to the peer review working papers generated by the process in order that we might assure ourselves -- and, in turn, the Congress -- of both the overall adequacy of the quality control system designed and developed by the profession and the commitment of the Public Oversight Board and the Section to its effective implementation and operation. As indicated in my letter to our oversight subcommittees of July 15, 1980, submission of the Commission's 1980 Report has been delayed somewhat so that it might reflect the final agreement reached between the Section and the Commission on the access question. I am pleased at this time to inform you that, as discussed further in the Report itself, the Section and the Commission have now reached an arrangement which we believe assures the Commission sufficient access to peer review working papers to meet fully its oversight responsibilities, while at the same time accommodating the legitimate client confidentiality and proprietary concerns expressed by the Section's membership.

Although experience alone will tell us whether the peer review program itself and the agreed upon Commission access to the working papers generated in the process are adequate to meet their objectives, the Commission has recently been encouraged about the prospect of future success for the venture by the effective leadership displayed by the Public Oversight Board in facilitating the Commission and the Section's efforts to reach an appropriate accommodation on the access issue, as well as by events which evidence a meaningful commitment on behalf of the Section and the Public Oversight Board to take appropriate measures to protect users of audited financial statements in response to both alleged or possible audit failures, as well as quality control or other deficiencies uncovered by peer reviews. While other questions concerning the effectiveness of the Section's review and disciplinary mechanisms still remain -- as well as other

potential problems, such as the extent of membership in the Section -- the Commission continues to believe that the profession's efforts to date to create and maintain a meaningful system of self-regulation and self-discipline deserve the continued support of the Congress and the Commission.

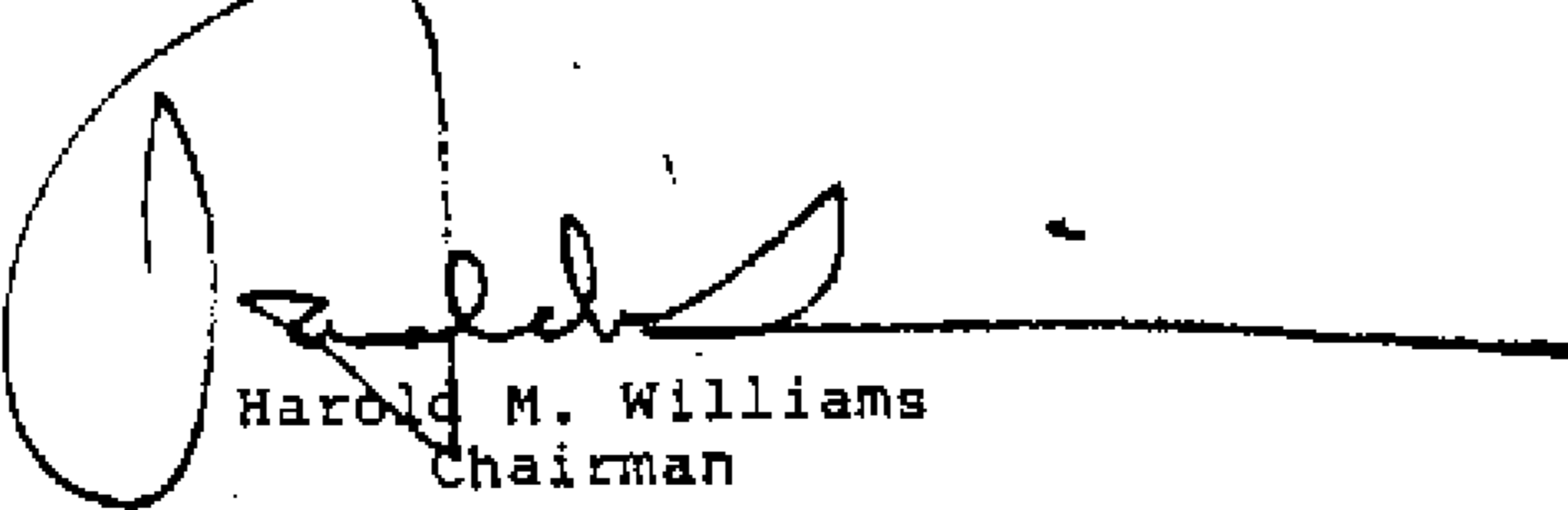
Similarly, I would like to take this opportunity to reaffirm the Commission's continued strong support for, and general satisfaction with, the work of the Financial Accounting Standards Board. During this past year, the FASB has undertaken a number of controversial projects and has made some significant progress in its Conceptual Framework Project, as well as in such specific areas as accounting for the effects of changing prices and pension accounting and disclosure. At the same time, however, the Commission will continue to actively oversee the private accounting standard-setting process, as well as to closely monitor the private sector's implementation of specific FASB pronouncements, with a view towards determining whether Commission action might at any point be necessary or appropriate to further significantly the development of needed accounting and disclosure standards. In that regard, in addition to watching closely the effects of such specific initiatives as the ones in the inflation accounting and pension areas, the Commission expects to evaluate carefully various private sector initiatives relating to the Commission's announced intention to devise a system of Reserve Recognition Accounting for oil and gas producing activities.

In sum, in this year's Report, the Commission once again acknowledges that the accounting profession is continuing to make progress in meeting the difficult challenges confronting it, and notes that there remain some significant areas of uncertainty. Whether the profession can accomplish the ultimate goals of effective and meaningful self-regulation is still dependent upon future developments, and, therefore, this 1980 Report to the Congress must, as have previous reports, be read as an interim assessment and endorsement of the profession's current activities and commitment for the future.

Given the interim stage of these evolving developments, the Commission will continue to monitor closely the activities of the accounting profession and to offer guidance, comments, and leadership as necessary or appropriate. In addition,

the Commission will continue to apprise the Congress of important developments within the accounting profession, as well as to continue to offer its assessment of the degree to which the accounting profession is meeting the challenges which it faces.

Sincerely,



Harold M. Williams
Chairman

MICROFILM

CONTENTS

	Page
Letters of transmittal.....	iii
Introduction.....	1
Independence.....	6
Audit Committees.....	6
Scope of Services.....	10
Regulation and Oversight.....	18
The Role of the Public Oversight Board.....	21
The Peer Review Program.....	24
A. Oversight of the Peer Review Process.....	27
B. Results of Current Years' Reviews.....	31
C. Review of Audit Work Performed Outside the United States.....	36
Actions Resulting from the Special Investigations and Peer Review Processes.....	38
The Voluntary Aspect of the Program.....	47
The Accounting Standard-Setting Process.....	50
FASB Conceptual Framework Project.....	53
Financial Reporting and Changing Prices.....	61
Accounting for Oil and Gas Producing Companies.....	66
The Auditing Standard-Setting Process.....	72
Auditor Association with Required Supplemental Financial Information.....	73
Reporting on Internal Accounting Control.....	78
A. The Foreign Corrupt Practices Act.....	81
B. Voluntary Initiatives for Reports by Management.....	83
C. Involvement of Independent Accountants.....	86
Judicial Enforcement of Auditor Responsibilities.....	91
Conclusion.....	98

INTRODUCTION

For the past two years, the Commission has submitted to Congress reports on the accounting profession and the Commission's oversight role. The Commission's reports commented on the accounting profession's response to the various challenges which Congress and others had placed before it and on the Commission's own initiatives in this area.

As the Commission's previous reports indicate, both the private and public sectors responded to these challenges by undertaking substantial initiatives designed to assure the independence of auditors, to establish meaningful self-regulation and self-discipline and to improve the accounting and auditing standard-setting processes. The Commission and its staff have been -- and will continue to be -- active in overseeing the profession's initiatives. The overall objective of our oversight activities is to assure that the accounting profession continues to make substantial progress toward its primary goal of promoting public confidence in the integrity and credibility of financial reporting by public companies.

The Commission concluded its July 1979 Report by stating that progress had been sufficient to merit continued opportunity for the profession to pursue its efforts at self-regulation. The Commission also stated that the initiative for establishing and improving accounting and auditing standards should remain in the private sector, subject to Commission

JUDICIAL
6

oversight. The Commission noted, however, that the process of demonstrating that accountants themselves rather than government should (i) retain primary authority to regulate the profession, (ii) ensure and instill confidence in professionalism and objectivity, (iii) maintain control over the quality of the work of the profession's members and discipline those who fail to adhere to its standards, and (iv) formulate appropriate accounting and auditing standards, is one which will demand the profession's and the Commission's continued commitment. The Commission indicated that the need for increased leadership regarding these essential issues is greater than ever, and that whether that leadership would be effectively provided by the private sector and, if so, by whom, was not yet certain. The Commission also stated that it stands ready to consider any reasonable alternatives to achieve the essential objectives.

The most visible change made by the accounting profession in response to Congressional and public criticisms directed toward it during the mid-1970's was the creation, a little over two and one-half years ago, of the American Institute of Certified Public Accountants' Division for CPA Firms, and within that Division, the SEC Practice Section ("Section"). The creation of the Section was a major step by the profession toward implementing effective self-regulation.

Although the Section is in place, its programs and mechanisms are not yet fully implemented or tested. Thus, the

success of the Section as an effective self-regulatory body -- the translation of a concept into an operationally effective mechanism -- still is dependent upon further developments. The Commission has monitored closely the Section's establishment and its implementation of programs and procedures. Our attention has been focused on the profession's progress towards achieving the objectives outlined in the Commission's first Report to Congress which the Commission believes a self-regulatory structure must meet in order to be effective.

In its July 1979 Report, the Commission recognized that the continuing process of implementing the self-regulatory structure would not be easy, and that the profession would encounter many conceptual and practical obstacles. The Commission indicated that the successful resolution of these obstacles would demand strong leadership. The Commission stated that the Public Oversight Board ("POB") is in a position to fill that leadership role which is essential to the success of the profession's efforts.

In this year's report, the Commission again comments on the progress of the profession toward meeting its goals, and the status of the uncertainties which remain. The profession has made progress during the past year. Nevertheless, some of the uncertainties commented upon in the July 1979 Report remain. In particular, the effectiveness of the peer review program is not yet fully confirmed and the Section's sanctioning process and procedures remain untested. In

addition, further experience is necessary to demonstrate that the profession and the POB are fully assuming the leadership initiatives with respect to the self-regulatory efforts -- thereby internalizing the capacity for self-assessment, criticism and correction -- that they must for meaningful self-regulation to exist.

The profession's self-regulatory program is still evolving, and, considering the trial and error character of the implementation process, the experience provided by the completion and evaluation of additional peer reviews as well as consideration of the actions resulting from the special investigations and peer review processes is necessary for a meaningful evaluation. The experience gained as a result of monitoring developments during the first full cycle of peer reviews -- to be accomplished by the end of 1981 -- should provide sufficient information to enable the Commission to better assess the efficacy of the self-regulatory program. The Commission further believes that allowing the profession additional time to accomplish its objectives is appropriate, since the Commission is not convinced that comprehensive direct governmental regulation of accounting or accountants would afford the public either increased protection or a more meaningful basis for confidence in the work of public accountants.

In addition to monitoring the profession's self-regulatory efforts, the Commission and its staff have been active

during the past three years in overseeing the profession's initiatives concerning the independence of auditors and the accounting and auditing standard-setting processes.

The remainder of this report presents the Commission's views concerning the major initiatives during the past year.

JUDICIARY

6

INDEPENDENCE

The concept of independence and its importance to the accounting profession and to the credibility of the financial reporting process in general have been discussed at length in the Commission's previous reports. The need for the profession, as well as management, to encourage conduct which will enhance the overall integrity and credibility of corporate financial reporting has been discussed with special emphasis placed on the need for accountants to avoid conduct which would in any way impair auditor independence, in fact or appearance, or jeopardize public confidence in the profession. More specifically, prior reports have identified two individual areas which the Commission believes warrant the attention of the profession in the interest of maintaining auditor independence -- establishment of independent audit committees and consideration of scope of services which accountants should be permitted to perform for their audit clients. This year's report provides further discussion and insight as to the Commission's present posture regarding each of these areas.

Audit Committees

The existence of effectively functioning audit committees in publicly-held companies is one of the keys to reinforcing and assuring the independence of outside auditors. Such committees also enhance the ability of the board of directors to monitor the issuer's accounting, financial reporting and internal control systems.

While the audit committee is not a new concept, it is only in the past decade that it has come to be viewed as an important factor in auditor independence and corporate accountability. As early as 1940, the Commission and the New York Stock Exchange ("NYSE") advocated the establishment of audit committees composed of non-officer directors. Nevertheless, as late as 1970, the audit committee concept had spread very slowly, not because there were any strong objections to the establishment of such committees, but rather because the concept had received relatively little publicity. However, in the late 1960's, interest in audit committees began to develop. In 1967, the Executive Committee of the American Institute of Certified Public Accountants ("AICPA") issued a statement recommending the establishment of committees composed of outside directors to nominate independent auditors and to oversee audit activities. Beginning in the early 1970's, in a number of Commission enforcement actions, companies consented to the establishment of audit committees. Further, the revelation of questionable and illegal corporate payments in the mid-1970's, which culminated in passage of the Foreign Corrupt Practices Act of 1977, also focused attention on audit committees. Finally, the Commission, in 1974 and 1978, amended its proxy rules to require disclosure as to the existence of audit committees. Where audit committees have been established, the proxy rules require disclosure of the composition of the committee in terms of membership, the number of meetings held

during the latest fiscal year and a brief description of the functions of the committee.

The private sector also has taken the initiative to encourage the formation of audit committees. First, the NYSE, following a Commission suggestion, adopted a requirement that all listed companies have an audit committee which meets certain specified criteria. Second, while rejecting a mandatory audit committee requirement as an ethical or auditing standard because of a lack of authority, the AICPA, in 1978, emphasized its support of the establishment of audit committees. Third, the Business Roundtable in its statement on "The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation" and the Committee of Corporate Law, Section of Corporation Banking and Business Law of the American Bar Association in its Corporate Director's Guidebook endorsed the concept of audit committees and recommended that companies establish audit committees composed of non-management directors. Finally, the American Stock Exchange ("AMEX") recently adopted a recommendation encouraging all AMEX listed companies to establish audit committees composed of independent directors.

The Commission believes that the efforts of the private sector, as well as the Commission's own disclosure rules, have spurred issuers into the establishment of audit committees. Statistics that the Commission has generated from results of the recent amendments to the proxy rules described above indicate that approximately 85 percent of public companies

have established audit committees. Based on this demonstrated progress, the Commission has concluded that any formal action on its part, at this time, is not necessary. It will continue, however, to monitor the extent to which the trend of establishment of audit committees persists, and, if it appears to lapse, the necessity for further Commission action will be considered.

A more pressing problem today, however, is assuring that audit committees, once established, actually provide effective oversight with respect to financial reporting and related matters. Information gathered from last year's proxy statements indicates that some audit committees may not be reviewing the scope or the results of audits with the external auditors -- two functions essential to an effectively functioning audit committee. The staff of the Commission, in conjunction with its study of the broad area of corporate governance, is currently studying the makeup and functions of audit committees and will be submitting a report to the Commission shortly containing a discussion of characteristics thought by commentators to be important to effectively functioning audit committees as well as a description of current practice based on disclosures filed with the Commission. This staff report should provide the Commission with important information upon which to assess the performance of audit committees.

Scope of Services

The appropriate scope of services to be provided by independent public accountants has been a subject which has attracted substantial attention in recent years by the Congress, the Commission, the accounting profession and the Public Oversight Board of the SEC Practice Section of the Division for CPA Firms of the AICPA. Study and debate has centered around services performed which are of a non-audit nature (tax services, accounting and review services and management advisory services) with principal attention being focused on management advisory services ("MAS") and the potential impact that performance of such services may have on auditor independence.

During 1978, in response to an increase in concern over the scope of services issue and the lack of data available to reasonably evaluate the relationships existing in practice between registrants and their independent accountants, the Commission undertook to require the disclosure of such data by issuing Accounting Series Release No. 250, "Disclosure of Relationships with Independent Public Accountants." This release established for the first time rules requiring disclosure in registrants' proxy statements of the nature of nonaudit services performed by independent auditors and the percentage relationships of fees incurred for such services to total fees incurred for services performed in connection with the audit. The principal purposes of the new

disclosures are to provide users of financial information with data upon which they can better understand and evaluate relationships between companies and their auditors and to provide the Commission an empirical data base to assess existing practice. The Commission believes that ASR No. 250 will help to provide a better understanding of the auditor-client relationship and eliminate some of the mystique which has historically surrounded the scope of services issue. Further, disclosures provided as a result of ASR No. 250 will, over the long term, provide the Commission with the data needed to monitor the nature and extent of services performed by independent accountants and help to identify any favorable or unfavorable trends in practice.

Subsequent to the issuance of ASR No. 250, the profession, through the activities of the Public Oversight Board, studied the question of scope of services by CPA firms and a report was issued in March 1979. It was after reviewing this report that the Commission, dissatisfied with the lack of more specific guidance and of the opinion that the report failed to adequately sensitize the profession and its clients to the concerns over the performance of MAS, decided to issue ASR No. 264, "Scope of Services by Independent Accountants," presenting its views regarding factors it believes management, the audit committee and the accountant should consider in determining the appropriate scope of services to be performed by independent accountants. The factors to be considered and

LIBRARY

views expressed concerning them, contained in the release, were discussed in our 1979 Report.

The Commission believes that ASR Nos. 250 and 264 together provide an appropriate framework within which the parties who are responsible for the auditor-client relationship may determine the scope of services appropriate in the circumstances. As stated in last year's report, the Commission in developing ASR No. 264, consciously determined not to proscribe particular types of MAS engagements. Accountants must serve as the front line guardians of their professional independence, as their own ethics literature recognizes. Similarly, corporate boards should have primary responsibility for the credibility of issuer financial reporting. ASR No. 264 seeks to guide the auditor and the issuer's board in discharging these responsibilities.

In ASR No. 264, the Commission invited public comment on the views expressed therein. In response to this invitation, the AICPA submitted a letter of comment which voiced strong opposition to the release, stating that "unwarranted curtailment of nonaudit services is likely to be substantially realized simply by its issuance." The Commission's intent in issuing ASR No. 264 was, of course, not to promote the indiscriminate termination of MAS engagements or any other nonaudit services. Rather, its purpose was to encourage a careful assessment by management, audit committees, boards of directors and accountants of the potential impact on auditor independence resulting from non-audit services engagements.

The Commission did not seek to deprecate the benefits which may accrue from certain MAS activities. Clearly, the benefits in many cases can be significant. In view of the accounting provisions of the Foreign Corrupt Practices Act of 1977, for instance, services performed by independent auditors in assisting their clients in the review of internal accounting control systems should be very beneficial to registrants and, in addition, will often serve to enhance the quality of the audit. The Commission believes that in most engagements involving the review of internal accounting controls, the benefits of such services will outweigh any potential for impairment of independence which may accrue. However, the answer may not be as clear with respect to other engagements. The Commission believes that such decisions can only be made by responsible parties on a case-by-case basis with consideration given to the factors outlined in ASR No. 264.

Commentators to ASR No. 264 also raised questions with respect to the so-called "global test", which focuses on aggregate revenues generated from MAS and the relationship of those revenues to total firm revenues. Certain accounting firms -- particularly smaller firms -- appear to be concerned that the Commission may have stigmatized firms that derive a significant portion of their revenue from, for example, tax work and accounting and review services. This was not the Commission's intention. While ASR No. 264 uses the terms

"nonaudit services" and "MAS" somewhat interchangeably, the Commission recognizes that the terms are different and that MAS is only one component of total nonaudit services and encompasses a narrower range of services. In the context of firm-wide services, the Commission's principal concerns relate to the magnitude of MAS activities and their potential impact on the quality of audit work performed.

In this regard, many in the accounting profession believe that independence should be evaluated in terms of individual engagements only, and that the evaluation of the independence of a relationship should not be colored by the magnitude of the accounting firm's firm-wide involvement with MAS activities. While the Commission agrees that independence is primarily dependent on the nature of the accountant's relationship with individual audit clients, it disagrees with the notion that the profession may disregard the magnitude of MAS activities on a firm-wide basis. Undue emphasis on MAS could ultimately have an unfavorable effect on the quality of audit work performed. Similarly, the apparent tendency of some accounting firms -- particularly larger firms -- to compete on the basis of total revenues and the array of MAS activities offered is troubling. The Commission is concerned that the ultimate result of such a philosophy could be a subtle shift in emphasis -- perhaps real, perhaps apparent -- away from the auditor's primary function. It is this eventuality, and possible consequent effect on audit quality,

or on user confidence in the reliability of the auditor's report and the credibility of financial reporting, that the Commission sought to warn against in ASR No. 264.

During 1979 the Commission undertook to establish a system for monitoring the new disclosures required to be included in proxy statements by ASR No. 250. For 1979, a sample of approximately 1,200 proxy statements, including both exchange-listed and over-the-counter registrants, were chosen statistically for review. Emphasis was placed on obtaining a better understanding of the nature of nonaudit services being performed and the magnitude of such services in terms of percentage relationships to aggregate audit fees.

Results of this first year review showed that a large majority (approximately 91%) of companies engaged their auditors for some type of nonaudit services with the highest incidence being in tax related areas. The survey further indicated that the incidence of performance of certain specific services (i.e., actuarial services, plant layout, market surveys) was minimal. */ As for the magnitude of nonaudit services performed, the survey indicated that 68% of the companies incurred fees for nonaudit services representing 0-25%

*/ In ASR No. 264 the Commission had noted that the performance of such services may, in many cases, be difficult to justify on the basis of the factors set forth therein and the Report of the Senate Subcommittee on Reports, Accounting and Management of the Committee on Governmental Affairs (1977) had indicated that these services are incompatible with the public responsibilities of independent auditors.

of total audit fees; 21.9% of the companies were in the 26-50% range; 7.4% of the companies were in the 51-100% range; and 2.7% of the companies were over 100%.

While these new disclosures for 1979 contribute to an understanding of existing practice, the Commission does not believe that meaningful conclusions can be drawn from disclosures for a single year. The relationships need to be reviewed and evaluated over a longer period of time. Accordingly, the Commission plans to use, over the next several years, the disclosures provided in proxy statements to obtain a better understanding of the nature and extent of auditor-client relationships and to identify any trends which develop as a result of the guidance offered by ASR No. 264 or as a result of actions taken by the profession.

Concern has been expressed by some regarding the possible use by the Commission of ASR No. 250 disclosures to question independence, after the fact, in individual registrant situations based solely on the percentage relationships disclosed. The Commission does not intend to use the disclosures for this purpose. Although we will monitor the disclosures as to the nature and extent of particular services rendered, the purpose of this monitoring activity is to assist us in developing an empirical basis from which to determine the need for further action in this area. Any further action would be prospective.

Although the Commission believes that ASR Nos. 250 and 264 provide a meaningful framework for the determination of

the appropriate scope of services to be performed by independent accountants, it has not ended its examination of the scope of services issue. Rather, it views the issuance of ASR Nos. 250 and 264 as part of a continuing examination of the relationships between registrants and their independent accountants. After further monitoring of practice, the Commission will be in a better position to determine if any further action is necessary in this area.

REGULATION AND OVERSIGHT

The most visible change made by the accounting profession in response to Congressional and public criticisms directed toward it during the mid-1970's */ was the creation, a little over two and one-half years ago, of the American Institute of Certified Public Accountants' Division for CPA Firms, and within that Division, the SEC Practice Section ("Section"). The creation of the Section was a major step by the profession toward implementing effective self-regulation. Although the Section is in place, its programs and mechanisms are not yet fully implemented or tested. Thus, the success of the Section as an effective self-regulatory body -- the translation of a concept into an operationally effective mechanism -- still is dependent upon further developments.

The Commission has monitored closely the Section's establishment and its implementation of programs and procedures. Our attention has been focused on the profession's progress towards achieving the objectives which the Commission believes a self-regulatory structure must meet in order to be effective.

These objectives were outlined in the Commission's first two Reports to Congress on the Accounting Profession and the Commission's Oversight Role as follows:

- Regulation of the practice of public accountancy should be thoroughly involved with the public

*/ These criticisms were discussed in the Commission's July 1978 Report.

interest, and therefore, not left exclusively to those engaged in the profession.

- The self-regulatory structure must have available to it the capability and resources necessary to anticipate, address and resolve accounting and professional issues needed to assure quality performance.
- The self-regulatory structure must be firm, timely, even-handed and fair in both its administration and disciplinary procedures.

The Commission's oversight has entailed reviewing (and commenting, where appropriate) on all materials generated by the Section including those relating to the Section's organizational structure and functions, standards for performing and reporting on quality control compliance reviews, standards for quality control review panels, administrative procedures, and membership requirements. In addition, we have reviewed the peer review program and the sanctioning process and procedures developed by the Section.

In each of the Commission's first two reports, the Commission was able to conclude that the profession's progress had been sufficient to merit continued opportunity to pursue its efforts at self-regulation. The Commission recognized, however, that some significant uncertainties remained, and that these could hinder the Section's ability to meet its objectives. Major areas highlighted by the Commission in its earlier reports included: (i) the role of the Public Oversight Board ("POB") as an effective overseer of the Section's activities; (ii) the effectiveness of the profession's peer review program; (iii) the effectiveness of the Section's

sanctioning process and procedures; and (iv) the need for more broad-based membership in the Section.

In this year's report, the Commission again comments on the progress of the profession toward meeting its goals, and the status of the uncertainties which remain. The profession has made progress during the past year. Nevertheless, some of the uncertainties commented upon in the July 1979 Report remain. In particular, the effectiveness of the peer review program is not yet fully confirmed and the Section's mechanisms governing actions resulting from the special investigations and peer review processes remain untested. In addition, further experience is necessary to demonstrate that the profession and the POB are fully assuming the leadership initiatives with respect to self-regulatory efforts -- thereby internalizing the capacity for self-assessment, criticism and correction -- that they must for meaningful self-regulation to exist.

The Commission continues to believe that the POB must exercise a strong leadership role with respect to the self-regulatory effort in order for the structure and process as a whole to function effectively. The Commission is encouraged by certain of the POB's initiatives during the past year -- particularly the leadership displayed in connection with resolving the difficult question of Commission access to peer review working papers and the POB's efforts in connection with the Section's establishment of the Special Investigations

Committee. Nevertheless, the Commission and its staff continued to provide impetus to the Section's development of its self-regulatory program. In the Commission's view, the stimulation for necessary change should come principally from the POB.

The profession's self-regulatory program is still evolving, and considering the trial and error character of the implementation process, the experience provided by the completion and evaluation of additional peer reviews as well as consideration of the Section's actions resulting from the special investigations and peer review processes is necessary for a meaningful evaluation. The experience gained as a result of monitoring developments during the first full cycle of peer reviews -- to be accomplished by the end of 1981 */ -- should provide sufficient information to enable the Commission to better assess the efficacy of the self-regulatory program.

The remainder of this section discusses: (i) the role of the POB; (ii) the peer review program; (iii) actions resulting from the special investigations and peer review processes, and (iv) the voluntary aspect of the program.

The Role of the Public Oversight Board

The POB functions in an oversight and advisory capacity with respect to the self-regulatory activities of the Section.

*/ Each member firm of the Section is required to undergo a peer review at least once during a three year period.

On March 31, 1980, the POB issued its second annual report covering its activities for the twelve months then ended. In its report, the POB comments on (i) the peer review program; (ii) procedures with respect to audit failures; (iii) a study of the auditor's work environment conducted by the Section in response to a recommendation in the report of the Commission on Auditors' Responsibilities; (iv) scope of services by CPA firms; and (v) SEC Practice Section membership. These issues are generally discussed in other sections of this report.

The POB concluded its report as follows:

The Board believes that in the past year the Section has shown continued strong commitment to the success of its self-regulatory program. This is evidenced by (1) further progress in developing and administering its peer review program, (2) adoption of an initial program for surveillance and disciplinary action in cases of alleged or possible audit failure, (3) the review of the auditor's work environment, (4) efforts to enlarge membership of the Section, and (5) continued attention to the scope of services issue. The SEC continues to be supportive with its constructive criticism and comments. The Section will face many challenges in 1980-1981 to make its programs more effective. The SIC [Special Investigations Committee] will have the opportunity to develop surveillance and investigatory procedures. The increased activity in peer reviews will require a major expenditure of time by the profession and the Board. The Board believes, however, that the experience thus far gained will enable the profession to make continued progress in 1980 and the years ahead.

As stated in its 1979 Report, the Commission believes that the conceptual and practical obstacles to a successful self-regulatory program necessitate strong leadership to the self-regulatory effort. That leadership should come from the POB. The POB should serve as the conscience and critic of the self-regulatory effort.

Largely, because of the early stage of development in which the self-regulatory effort finds itself, the effectiveness of the POB as an overseer of the profession's initiatives is not yet completely evident, but the Commission continues to believe that the POB has the potential for achieving the substantial credibility that is expected of it. In this connection, the Commission is encouraged by the role performed by the POB with respect to the resolution of the very difficult question of Commission access to peer review working papers and by the POB's efforts with respect to the Section's establishment of the Special Investigations Committee. The Commission is somewhat disappointed, however, that in connection with its monitoring of the Section's peer review activities, the Commission's staff -- and not the POB and its staff -- identified certain problems with the peer reviews conducted during the past year which suggested the need for certain refinements to the Section's standards for performing and reporting on peer reviews. In addition, although evidence of active oversight by the POB staff was substantial, the Commission staff's 1979 review efforts did indicate need for improvement in the consistency of the POB as an overseer of the Section's peer review program. Based on their own experience with the 1979 peer reviews and partly in response to suggestions from the Commission's staff, the Section and the POB staff indicated their intention to take

necessary steps to improve control and oversight over the peer review process.

The Peer Review Program

Commitment to meaningful, in-depth peer reviews by independent and objective reviewers is a prerequisite to the success of the profession's self-regulatory program. Accordingly, any delay in the effective implementation of the peer review program is a serious threat to the whole structure of self-regulation.

In its 1979 Report, the Commission indicated that its staff had reviewed the work of the POB and its staff with respect to ten peer reviews conducted in 1978. Of those, two were mandated by Commission or court order. */ Of the remaining eight firms reviewed, only two had publicly-held clients. While this limited number of peer reviews and their nature made it impractical to reach any but limited conclusions, the Commission stated that the POB appeared to have functioned effectively as an overseer of the Section's peer review activities. Thus, the Commission remained cautiously optimistic that the process would ultimately prove effective. The Commission stated, however, that the central test of the POB's effectiveness will be the thoroughness with which it continues as an effective overseer.

*/ One additional review (also conducted pursuant to Commission order) was subsequently accepted by the Section as meeting its peer review requirements.

At the time of its July 1979 Report, the Commission expected a significant number of peer reviews would be conducted during 1979. Indeed the Section had reported that as of March 31, 1979, 110 member firms had tentatively agreed to peer reviews during 1979. In fact, however, only forty peer reviews were conducted. */ The pace must be accelerated and the first cycle of peer reviews completed by the end of 1981.

One of the more difficult issues confronting the profession and the POB during the past year was the question of Commission access to peer review working papers. As indicated in its 1979 Report, the Commission continues to believe that it must have sufficient access to the peer review process to permit it to make an objective evaluation of its adequacy, and that total reliance on the POB and its staff in this regard would not be consistent with this objective or the Commission's responsibilities. The Commission further stated that a satisfactory arrangement for access to the working papers of the peer reviewers must be established, and that the POB and the Executive Committee of the Section should accord this issue the highest priority.

*/ The POB's second annual report indicates that approximately 200 member firms have been assigned to have their initial peer reviews in 1980 with the approximately 220 remaining member firms scheduled for peer reviews during 1981. Under this schedule, substantially all firms with SEC clients will have undergone a peer review by the end of 1980 since only about ten percent of the firms scheduled for peer review during 1981 have any SEC clients.

The Commission appreciates the profession's concern for client confidentiality and during the past year the Commission's staff has worked with representatives of the Section to develop an acceptable arrangement for Commission access to peer review working papers. It was largely through the efforts of the POB that an agreement was ultimately reached which provides for Commission staff access to certain of the working papers of the peer reviewers. The Commission's staff believes that these recently developed procedures (which will be effective for peer reviews conducted during 1981) should be sufficient to provide the Commission with reasonable assurance that it will be able to fulfill its oversight responsibilities while at the same time being responsive to the profession's concerns regarding client confidentiality.

The Commission is encouraged by the agreement for Commission staff access to peer review working papers and by the POB's efforts in ensuring the satisfactory resolution of this issue. Of course, the agreed upon arrangement can only be evaluated with the benefit of actual experience, and we expect the POB to monitor the implementation of the access arrangement and provide the Commission and the profession with its objective views on the necessity for any changes. In this connection, the Commission considers the access procedures to be experimental in nature and acceptability is predicated on their effective functioning and the willingness of the Section to make changes if necessary.

A. Oversight of the Peer Review Process

In its previous reports, the Commission identified the peer review program as the single most important element in the AICPA's self-regulatory initiative and set forth three objectives that the program must meet in order to be effective:

- The peer review process must incorporate and apply meaningful standards of quality control to both the work of the reviewers and of the reviewed firm.
- The peer review process must be structured in such a manner as to assure independence in fact and to promote public confidence in its credibility.
- The peer review process must be sufficiently open to examination by both the Board and the Commission, and their respective staffs, so that each may discharge its oversight responsibilities.

The Commission's oversight responsibility referred to in the third objective above is basically to satisfy itself as to the profession's progress toward meeting the first two objectives -- that is, that the process incorporates and applies meaningful quality control standards and that the process is structured to assure independence and credibility. In addition, the Commission's oversight responsibility extends to the work of the POB and its staff. The oversight responsibilities of the Commission and the POB are interrelated since the extent of the Commission's oversight activity is directly dependent upon the Commission's evaluation of the effectiveness of the POB as an overseer of the profession's self-regulatory program. In essence, the greater the Commission's confidence in the effectiveness of the POB as an overseer of the profession's peer

review activities, the less need for extensive direct oversight on the part of the Commission and its staff.

The Commission's peer review oversight responsibilities are fulfilled in a number of ways. The Commission's staff frequently discusses issues with representatives of the Section and the POB. The purpose of these discussions is to gain an understanding of the conceptual and practical problems that the profession has encountered during the course of developing the program. The Commission's staff has generally offered its ideas, insights and constructive criticisms in an effort to assist and encourage the profession toward achieving its goals.

The Commission's staff reads the reports, comment letters and the responses to the comment letters issued in connection with peer reviews. Except with respect to peer reviews which are conducted pursuant to Commission or court order as well as under the Section's guidelines, ^{*}/ the staff's review of the peer review process has been limited to a review of the oversight files of the POB which include various memoranda, checklists, programs, notes, etc., evidencing oversight work performed.

While the Commission hopes that ultimately it should be able to rely heavily on the POB's oversight of the peer

^{*}/ With respect to Commission or court ordered reviews, the Commission's staff is able to review the working papers of the peer reviewers.

review process, we are not presently in a position to make a determination that such reliance -- taken alone -- is sufficient to permit the Commission to reach a conclusion concerning the efficacy of the peer review process. The peer review program is new and is evolving on a trial and error basis. Similarly, the POB's role as overseer of the Section's peer review activities must be viewed as evolutionary. For the peer review program to be effective, the POB must achieve the substantial credibility that is expected of it by consistently demonstrating its independence, commitment, and ability to exercise effective oversight. Whether the POB can effectively fulfill this role depends not so much on the mechanics of the Board's oversight operation, but rather on the commitment of the Board and its members as well as the capabilities and commitment of the Board's staff. The demonstration of its independence, commitment and ability to exercise effective oversight will take time and will probably not become fully evident until the peer review program has been refined and a full cycle of peer reviews has been completed.

In the meantime, the Commission must satisfy its oversight responsibilities and be in a position to evaluate the progress of the profession's self-regulatory efforts. Reports and letters of comment are presently being issued in connection with the Section's peer review program. Investors, registrants and others have the right to assume that this information provides a basic level of assurance of quality

audits. Particularly in view of the early stage of development of the peer review program and the fact that the Commission is not yet in a position to be able to reach an informed judgment as to the extent of reliance which can be placed on the POB, the Commission needs sufficient access to peer review working papers to be able to test the application of the quality control review standards being developed by the Section and the efficacy of the steps taken by the Section to ensure the independence and credibility of the peer review program. This is, of course, consistent with the Commission's oversight responsibility and the basis for the Commission's assertion, in its July 1979 Report, that it must have sufficient access to the peer review process to permit it to make an objective evaluation of its adequacy.

The objective of Commission access to the peer review process is to enable the Commission to fulfill its oversight responsibilities by: (i) evaluating the adequacy and testing the application of the quality control review standards developed by the Section as well as the efficacy of the steps taken by the Section to ensure the independence and credibility of the peer review program; and, (ii) testing the oversight activities of the POB with respect to the peer review program to determine the POB's effectiveness, and developing a basis for reaching a judgment as to the extent

of reliance which can be placed on the work of the POB consistent with the Commission's oversight responsibilities.

It should be recognized, however, that review by the Commission staff of peer review working papers will not enable us to reach a judgment as to the quality of practice of individual firms reviewed. To reach such a judgment would require a total duplication of the work of the peer reviewers and this would not be consistent with self-regulation, nor would it be feasible in view of the Commission's limited resources. Rather, the Commission's purpose in reviewing peer review working papers is to form an opinion concerning the efficacy of the peer review program on an overall basis, and of the POB as an overseer of that program.

B. Results of Current Years' Reviews

During the past year, forty peer reviews (including one which also constituted a peer review conducted pursuant to Commission order) were conducted pursuant to the peer review program. The reviewed firms consisted of the following:

<u>Type of Firm</u>	<u>No. of Firms</u>	<u>No. of SEC Clients</u>
Firms with 5 or more SEC clients	7	1,731
Firms with 1 to 4 SEC clients	7	11
Firms with no SEC clients	<u>26</u>	<u>0</u>
	<u>40</u>	<u>1,742</u>
	----	-----

6
 1
 2
 3
 4
 5
 6
 7
 8
 9
 10
 11
 12
 13
 14
 15
 16
 17
 18
 19
 20
 21
 22
 23
 24
 25
 26
 27
 28
 29
 30
 31
 32
 33
 34
 35
 36
 37
 38
 39
 40
 41
 42
 43
 44
 45
 46
 47
 48
 49
 50
 51
 52
 53
 54
 55
 56
 57
 58
 59
 60
 61
 62
 63
 64
 65
 66
 67
 68
 69
 70
 71
 72
 73
 74
 75
 76
 77
 78
 79
 80
 81
 82
 83
 84
 85
 86
 87
 88
 89
 90
 91
 92
 93
 94
 95
 96
 97
 98
 99
 100

Of the reports issued in connection with these reviews, thirty were unqualified and ten were modified. The modified reports relate to deficiencies in the quality control policies and procedures prescribed for the firm's accounting and auditing practice or lack of compliance with such policies and procedures, and/or lack of compliance with membership requirements of the Section. In connection with substantially all of the reviews, the reviewers issued letters of comment in which they discussed those matters which they believed may require action by the firm in order to effect substantial improvement in the reviewed firm's quality control policies and procedures and/or its compliance with them, or with membership requirements of the Section. These reports, letters of comment and the reviewed firm's written response to the letter of comment are included in the Section's public files.

The Commission's staff has reviewed the working papers of the POB and its staff with respect to most of the forty peer reviews performed in 1979. In addition, since one of the reviews also constituted a peer review conducted pursuant to Commission order, the Commission's staff was also able to directly review the working papers of the peer reviewers.

Based on the review of the POB oversight files, it appears that the POB staff is generally complying with the

POB's established program for monitoring of peer reviews. These files document that the POB staff is reviewing the working papers of the peer reviewers, and, in an appropriate number of instances, observing the conduct of peer reviews in progress and attending closing conferences between reviewers and reviewed firm personnel at which the results of the peer review are discussed. The POB's documentation indicates that the POB staff is focusing on: (i) the qualification of individuals serving as reviewers; (ii) the scope of the review, including excluded engagements; */ (iii) the way in which the review was conducted; (iv) the documentation (evidence) of the work performed and; (v) the report(s) and letter(s) of comment issued. In addition, the POB's files include, in many instances, objective evidence that the POB staff is substantively challenging the reports being issued, the letters of comment and the reviewed firm's response thereto, as well as the adequacy of the scope and documentation of the work of the peer reviewers.

Although evidence of active oversight by the POB staff was substantial, the Commission staff's 1979 review efforts

*/ As a result of its monitoring of 1979 peer reviews, the POB determined that the provision in the Section's standards that a reviewed firm may exclude certain engagements from the scope of peer review under certain circumstances was not a substantive problem.

JUDICIAL

9

did indicate need for improvement in the consistency of the POB as an overseer of the Section's peer review program. The Commission staff's findings during the course of its review work also pointed to the need for certain refinements to the Section's standards for performing and reporting on peer reviews. These questions and the steps taken to resolve them were considered by the Commission in determining the necessary degree of access to peer review working papers.

The specific matters which came to the attention of the Commission's staff as a result of its work relate, for the most part, to the adequacy of documentation of the work of the peer reviewers and to the candidness of comment letters issued by the reviewers. As a result of the questions raised, the Section has begun implementing certain changes to its peer review standards:

- . The development of peer review documentation standards to assure that the peer review working papers provide appropriate support of the work performed, and the report and comment letter issued. */
- . The refinement of the Section's comment letter guidelines to help assure consistent format and content of comment letters. **/

*/ No such standards existed for the 1979 peer reviews.

**/ Although "Guidelines for Preparing Letters of Comments" are presently included in the Section's Peer Review Manual, experience has indicated that they need to be strengthened and clarified.

- . A requirement that comments communicated orally to the reviewed firm be documented in the peer review working papers */ so as to provide a basis for follow-up.

In addition, based on their own experience with 1979 peer reviews and partly in response to suggestions from the Commission's staff, the Section and the POB staff indicated their intention to take necessary steps to improve the control and oversight over the peer review process.

In view of the fact that the peer review program is still developing, the Commission believes that the steps being taken by the POB and the Section should serve to strengthen the profession's program. The profession's willingness at this stage to react appropriately and promptly to identified problems in the peer review process through implementation of necessary changes is particularly important since over 400 peer reviews are expected to be conducted during 1980 and 1981. Additionally, experiences to date should serve to heighten the sensitivity of the POB with respect to its role in the peer review process, and thus further strengthen the program.

*/ No such requirement existed for the 1979 reviews. Many of the comments provided to a reviewed firm may be important but nonetheless, in the judgment of the reviewers, not significant enough to warrant inclusion in the comment letter. The Commission believes that comments communicated to the reviewed firm (whether orally or in writing) should be clearly documented in the peer review working papers so that the responsiveness of the reviewed firm to the overall results of the peer review process can be judged during that firm's next peer review.

C. Review of Audit Work Performed Outside the United States

In its first two reports, the Commission raised the question of the extent to which audit work performed outside the United States should be encompassed in the scope of peer reviews. The Commission stated that this is a complex issue, and continuing efforts must be made to seek an effective resolution. While a worldwide peer review process concentrating on each firm's quality control system -- regardless of the physical location of that firm -- may be the ideal way to provide investors with assurance of audit quality, the Commission recognizes that differing legal and professional environments make progress toward this goal difficult. As the Commission staff has discussed with the staffs of the Section and the POB, one way to address the issue of worldwide peer review would be an engagement oriented focus. That is, a U.S. firm, as part of its quality control or audit standards, could be required to perform certain additional procedures where a significant portion of the audit work was performed outside the U.S. These procedures -- which would be documented -- should be designed to provide assurance, at least to the extent of that particular engagement, that: (1) the quality of financial reporting is consistent, (2) audit quality with respect to all phases of the audit is uniformly high, and (3) all aspects of the audit were conducted by independent accountants based on professional and regulatory standards

applicable to U.S. firms. Using this approach, the peer review process would concentrate on the U.S. firm's overall policies and procedures for reviewing audit work done outside the U.S. The Commission believes this would be a satisfactory interim resolution to a difficult issue.

During 1979, the Section studied this matter in depth. Meetings were held with representatives of the profession in other countries. In addition, representatives of the Section met with representatives of the International Auditing Practices Committee ("IAPC") of the International Federation of Accountants, which was considering publication of an international auditing guideline dealing with reliance on other auditors. IAPC has recently published an exposure draft on this subject.

The POB reports that the Section has adopted in principle an approach for review of audit work done outside the U.S. which the Section believes will be supported by the professions in other countries and which is consistent with U.S. auditing standards and with the proposed international standard. The Section has also agreed to adopt a similar approach for review of audit work done by domestic affiliates. The approach focuses on the supervision and control of segments of engagements performed by domestic or foreign affiliates or correspondents. To enable peer reviewers to test compliance, a firm will be required to document certain specified matters relating to supervision and control. The

Section amended its standards accordingly, effective for audit engagements beginning after June 30, 1980.

The POB has indicated that it supports the Section's actions in this respect and concludes that the Section's approach achieves all that can be done at this time.

The Commission generally agrees with the POB's assessment in that the Section's approach appears to be a satisfactory interim resolution to a difficult issue. However, as with all other aspects of the peer review program, its effectiveness will depend on how the new standard is implemented. Thus, the POB and its staff should closely monitor this aspect of peer review during the coming years, and should continue to encourage the profession toward the ultimate goal of a worldwide peer review process.

Actions Resulting from the Special Investigations and Peer Review Processes

In both its previous reports to Congress, the Commission noted that the Section's sanctioning process and procedures were not yet in place and were untested. Thus their timeliness, fairness, evenhandedness and efficacy remain to be demonstrated.

The Section's sanctioning process and procedures, as they have been formalized during the last year in conjunction with the POB's active participation, are intended to protect users of audited financial statements through appropriate

responses to alleged or possible audit failures ^{*}/ and to quality control or other deficiencies uncovered by peer reviews. There are two significant features to the mechanism as it has been formulated by the Section. The Peer Review Committee may recommend to the Executive Committee of the Section that actions be taken with respect to member firms on the basis of this Committee's administration of the peer review program. In addition, the Special Investigations Committee monitors alleged or possible audit failures involving member firms to determine whether to recommend action to the Section's Executive Committee. The Executive Committee has the authority to impose sanctions on member firms on its own initiative or on the basis of recommendations of the Peer Review or the Special Investigations Committees. ^{**}/

^{*}/ In its 1978-79 Annual Report, the POB noted that one of the first matters as to which the Section's Executive Committee had consulted it was the Section's investigative and disciplinary process. The Commission's staff stated in the Commission's 1979 Report to Congress that it supported the POB's conclusions that the Section's objective with respect to an alleged or possible audit failure of a firm should be the protection of users of audited financial statements and that the Section should assure that future harm from the auditing work of a firm or one of its offices is not likely.

^{**}/ The following types of sanctions may be imposed on member firms by the Section's Executive Committee for failure to maintain compliance with the requirements for membership in the Section:

- (a) Require corrective measures by the firm including consideration by the firm of appropriate actions with respect to individual firm personnel.

(Footnote cont'd. on next page.)

The procedures applicable to all proceedings by the Peer Review, Special Investigations and Executive Committees relating to the imposition of sanctions by the Section are set forth in a document entitled Rules of Procedures for the Imposition Of Sanctions ("Procedure Document") which was adopted by the Executive Committee on November 29, 1979. On that same date the Section's Executive Committee adopted a resolution amending the Organization Document **/ to authorize the establishment of a Special Investigations Committee and adopted a document entitled The Special Investigations Committee of the SEC Practice Section of the AICPA Division for CPA Firms ("SIC Document") setting forth the procedures to govern the operations of this committee. The Peer Review Committee's responsibilities had been established earlier and are articulated in the Section's Organization Document.

*/ (Footnote cont'd. from previous page.)

- (b) Additional requirements for continuing professional education.
- (c) Accelerated or special peer reviews.
- (d) Admonishments, censures, or reprimands.
- (e) Monetary fines.
- (f) Suspension from membership.
- (g) Expulsion from membership.

**/ The Section's organization document, "Organizational Structure and Functions of the SEC Practice Section of the AICPA Division for CPA Firms," sets forth the structure and functions of the Section.

The Peer Review and the Special Investigations Committees may conduct hearings to determine whether to recommend sanctions to the Executive Committee. Any hearings conducted are not open to the public and all matters relating thereto are confidential until the Executive Committee authorizes public disclosure. Documents setting forth sanctions imposed on a member firm will be placed in the Section's public file.

The SIC Document lists the Special Investigations Committee's primary objectives as follows:

- . Assist in providing reasonable assurance to the public and to the profession that member firms are complying with professional standards in the conduct of their practice before the Securities and Exchange Commission by identifying corrective measures, if any, that should be taken by a member firm involved in a specific alleged audit failure.
- . Assist in improving the quality of practice by member firms before the Securities and Exchange Commission by determining whether facts relating to specific alleged audit failures indicate that changes in generally accepted auditing standards or quality control standards need to be considered.
- . Recommend to the Executive Committee, when deemed necessary, appropriate sanctions with respect to the member firms involved.

The SIC Document requires member firms to report to the Committee, within 30 days of service on them of the first pleading in the matter, any litigation (including criminal indictments) against them or their personnel, or any proceedings or investigations publicly announced by a regulatory agency, commenced on or after November 1, 1979, that involves clients or former clients that are SEC registrants and that

allege deficiencies in the conduct of an audit or in reporting thereon in connection with any required filing under the federal securities laws.

On the basis of the information reported and any information obtained from other sources, the Special Investigations Committee will determine whether to (1) monitor further developments without undertaking an investigation, (2) investigate the firm (without investigating the "case," i.e., the specific alleged failure) in order to review certain of the firm's quality control policies and procedures or to review other engagements by the personnel involved in the case or other engagements in the same industry as the case, (3) recommend investigation of the case to the Executive Committee, or (4) close its files on the case. The SIC Document states that the purpose of any investigation of a firm or of a case will be to determine whether:

1. The firm's quality controls are inadequate;
2. There has been a material departure from generally accepted auditing standards or a material failure to comply with quality control standards by the individuals responsible for the engagement in question; or
3. There is a need for reconsidering the adequacy of certain generally accepted auditing standards or quality control standards.

The POB will monitor and evaluate the regulatory and sanctioning activities of the Peer Review Committee, the Special Investigations Committee and the Executive Committee.

The Procedure Document provides that the POB or its representative may have access to all briefs, memoranda, documentary evidence, and stenographic transcripts of hearings conducted. The POB is required to maintain the confidentiality of all such information; however, the POB may make public any information "which it deems necessary in the interest of the profession or the public," after giving the firm concerned an opportunity to present its views and after consultation with the Executive Committee.

In its second annual report, the POB noted that it had consulted with the Executive Committee on all important aspects of the procedures outlined above and concluded that the procedures embody a reasonable framework for self-policing and disciplinary measures to protect the public and the profession. The POB further stated that because the accounting profession has been the subject of substantial litigation in recent years, it should be recognized that the task of preparing the SIC Document and the Procedure Document involved issues of extreme importance to the profession. The POB stated that, all things considered, a balanced and practical result has been achieved, but because the procedures developed provide broad discretion to members of the profession, the success or failure of the overall program can only be judged by results which may require several years of experience.

The Commission believes that the Section's investigative and monitoring procedures are essential features of the AICPA's

self-regulatory program. The Commission's oversight objectives with respect to the Section's sanctioning process and procedures are to assess whether the Section's mechanisms are designed to improve the quality of accountants' practice and to evaluate whether the implementation of such mechanisms contributes to the goal of protection of users of financial statements.

It is too early to judge any aspect of the Section's sanctioning process. The Commission believes, however, that the two features of the sanctioning process -- the responsibilities of the Peer Review and the Special Investigations Committees -- may represent an adequate framework. The peer review process should help minimize future audit failures because a peer review should reveal major deficiencies in a firm's quality control policies or procedures and should enable timely corrections. */

*/ Although the sanctioning process is in a preliminary stage of implementation, the Commission did see one example of the way in which the peer review process fits within the Section's sanctioning framework during its staff's review of the 1979 peer reviews. The peer review of a sole practitioner revealed significant problems with this accountant's practice. The practitioner agreed to take and did take certain remedial steps; in addition, he consented to undergo another peer review in 1980 and to remain a member in the Section. As a result of the practitioner's actions, the Peer Review Committee decided against recommending that the Executive Committee impose additional sanctions at that time.

Since the Special Investigations Committee has only recently been established the Commission cannot evaluate its performance. As a result of the way in which the Committee's operations and objectives have been articulated in the SIC Document, however, the Commission believes that this Committee will be more likely to investigate accounting firms which are the subject of alleged professional deficiencies than to investigate particular alleged audit failures of firms. The bias against investigations of specific alleged audit failures appears to reflect concern that the Section's investigative files and conclusions might be used against the investigated firm in civil or criminal proceedings and recognition that there are other regulatory, self-regulatory and private responses to alleged audit failures.

The Commission believes that the Special Investigations Committee's role in the Section's responses to alleged audit failures may be reasonable as long as this Committee and the Section's Executive Committee use their authority effectively, expeditiously, fairly and conscientiously. The Section's focus on firms and their individual partners and managers rather than particular alleged audit failures is appropriate as long as that approach contributes to the ultimate goal of protection of users of audited financial statements by achieving improvements in firms' quality controls.

The procedural aspects of the Special Investigations Committee's functions appear to be adequate to safeguard the interests of all concerned. It remains to be seen, however, whether the Committee will obtain the information necessary to fulfill its functions in view of the parameters established to safeguard the firm and its partners and employees against "prejudice." Member firms may cooperate fully with the Committee's requests for information when they believe there has been no audit failure, but may avoid providing information when the allegations may have merit. If member firms do not cooperate consistently with the Special Investigations Committee, the remedial effects of the Committee's initiatives could be impaired.

The POB has indicated that it will report on the activities of the Special Investigations Committee. This action by the POB is consistent with its undertaking to play an active role in the Section's self-regulatory efforts.

The Voluntary Aspect of the Program

In its first two reports, the Commission stated that the success of the profession's self-regulatory efforts is dependent upon the membership of all accounting firms which audit publicly-held companies in a self-regulatory structure. As of the date of our 1979 Report, a substantial number of accounting firms which have clients with securities registered under Section 12 of the Securities Exchange Act of 1934 were not yet members of the Section.

As of a recent date, the Section reports only a small increase in membership. Out of 574 member firms, only 245 have SEC clients as defined by the Section. On the positive side, however, it appears that these 245 member firms audit almost 9,000 public companies -- including virtually all companies listed on the national stock exchanges and a significant portion of NASDAQ-traded companies. Indeed, the Section reports that member firms audit the financial statements of 92% of the estimated 9,700 companies required to file financial statements with the Commission under various sections of the Securities Act of 1933 and the Securities Exchange Act of 1934.

Unfortunately, however, approximately 600 accounting firms that have at least one SEC audit client have still not yet joined the SEC Practice Section. The AICPA has undertaken to identify these firms and to ascertain the reasons why they are not yet Section members. In response to concerns raised about cost, particularly for smaller firms, the Section has reduced

its insurance and dues requirements. The effects of these changes remain to be seen.

Some smaller firms, however, appear concerned about their ability to exercise influence over the activities of the Section, and, in fact, some have asserted that the AICPA and its self-regulatory effort are dominated by the larger accounting firms. The Commission has urged greater participation by smaller firms in the self-regulatory effort. However, it does not seem inappropriate that the larger accounting firms have taken the lead in the self-regulatory effort because they audit an overwhelming majority of public companies. Of course, these firms must not abuse their leadership to the detriment of the smaller members. The Section's Executive Committee must also remain sensitive to the concerns of this segment of the profession and ensure that its interests are fairly represented.

The Commission recognizes that many smaller firms which audit only one or a few small registered companies may honestly be concerned that the increased costs of participating in the self-regulatory effort -- either to themselves or to their clients in the form of higher fees -- may exceed the benefits to the public interest. Perhaps they have other concerns as well. In this connection, smaller firms are encouraged to express their views, including the reasons for their positions and any suggestions as to how any unjustifiable burdens could be alleviated.

If, however, the Section functions as it is intended to, there will be increasing pressure on all firms with public clients, regardless of size, to become members of a recognized and effective self-regulatory organization. Membership in such an organization -- with attendant peer review requirements -- should provide a basic level of assurance of quality audits. Accordingly, the firms with SEC clients will probably have to explain to their clients why they have elected not to participate in a self-regulatory program. Moreover, it may be important for investors to be informed whether a registrant's auditors are members of a self-regulatory program having the attributes of the Section or whether the auditor has been subject to a peer review. The Commission's staff is presently considering this issue and may recommend that the Commission propose rules which would require registrants to disclose this information. The POB, in its current annual report, has endorsed the concept of this type of disclosure by registrants and stated that this would recognize the benefits accruing to the public from membership in such a self-regulatory organization and, more particularly, from the requirement that member firms undergo triennial peer reviews.

THE ACCOUNTING STANDARD-SETTING PROCESS

As indicated in its previous reports, the Commission continues to believe that the initiative for establishing and improving accounting standards should remain in the private sector, subject to Commission oversight. The Commission believes that the Financial Accounting Standards Board ("FASB") must continue its efforts to provide leadership and take appropriate action in controversial areas, and that members of the accounting profession and the corporate community must continue to support the FASB's decisions and join more actively in the standard-setting process.

During the past year, the Commission has continued to actively oversee the FASB's standard-setting initiatives. While the Commission has some concerns with respect to the delays that have been experienced in the FASB's conceptual framework project as well as the lack of clarity as to which phase or phases of the project will address certain fundamental conceptual issues, the Commission is generally satisfied with the FASB's overall efforts during the past year. Indeed, the FASB (i) has made a significant contribution to the evolution of supplemental disclosure of the effects of changing prices on business entities and (ii) has made additional progress in developing a conceptual framework for financial reporting. The Commission believes that the FASB's new standard dealing with the complex area of accounting for the effects of changing prices represents positive leadership on the part of the FASB, and, further, provides the accounting profession and

the corporate community with an excellent opportunity to participate actively in the standard-setting process.

Despite this progress, the need for continued commitment and leadership by the FASB has not lessened; neither has the need for continued support, encouragement, and participation in the standard-setting process from the accounting profession and the business community. It would, for example, be difficult to overstate the importance of the FASB continuing aggressively and with deliberate speed to pursue development of its conceptual framework since the need for an effective and adaptive framework within which coherent financial reporting standards can be established has never been clearer. While the conceptual framework project will not provide answers to all difficult accounting and financial reporting problems, it should help to provide direction for the resolution of problems in a timely, effective, and consistent manner.

The coming decade will surely witness innovative and important financial reporting developments. There is an unmistakable trend -- recognized in the FASB's first statement of financial accounting concepts -- toward an increasing emphasis on the needs of users of financial information. To be useful, financial reporting must assist in an assessment of the amounts, timing, and uncertainty of prospective cash flows. It must be relevant to the needs of users in making business and investment decisions. While the traditional financial model -- that is, historical, cost-based accounting -- provides assistance in

making these assessments and decisions, there exists a growing recognition of the need for more relevance in financial reporting, even if it means some sacrifice in the reliability of the information reported -- an issue appropriately raised by the FASB in its qualitative characteristics document. The decision as to what information is relevant and which of that data should be included in the primary financial statements will be influenced by, among other things, the problems of measurability.

This trend toward more useful information should lead to the reporting of financial information that is more relevant, but perhaps less reliable; more future-oriented information; and more disaggregated financial information. Consequently, there should be less emphasis on the "bottom line" and its surrogate, earnings per share, and more emphasis on the key components of operating performance and cash flows of a business entity.

To accomplish this, a framework is slowly being developed -- in terms of accounting, financial reporting and auditing. With respect to accounting and financial reporting issues, to accommodate reporting of more "relevant" information, recognition now exists in the FASB's first concept statement that the domain of financial reporting should extend beyond the financial statements. The FASB's recently-issued changing prices standard represents the first time that a private sector standard-setting body has established a standard for financial information to be reported outside the primary financial statements. An increasing use of this medium for the reporting of financial information is expected.

The Commission believes that the FASB is capable of dealing effectively with the challenges presently confronting it. In the remainder of this section of the report, the Commission discusses the FASB conceptual framework project, financial reporting and changing prices, and accounting for oil and gas producing companies.

FASB Conceptual Framework Project

The Commission continues to believe that the development of a conceptual framework as a basis for addressing accounting problems is the most important financial reporting matter confronting the FASB and its constituents. A conceptual framework should assist the FASB by providing structure and direction to financial accounting and reporting through an articulation of a coherent system of interrelated objectives and fundamentals leading to consistent standards, and through prescribing the nature, function and limits of financial accounting and reporting. The existence of such a framework should enhance the standard-setting process by accelerating the responsiveness of present and future boards to emerging accounting problems and should contribute to more timely, effective and consistent standards. In addition, a comprehensive conceptual framework should enhance the understanding of preparers and users of financial information as to the purposes, content and characteristics of such information.

One of the principal purposes of the conceptual framework project is a fundamental reconsideration of useful enterprise

financial information which should be furnished to users of financial reports. The project does not limit the scope of financial reporting objectives to financial statements, but rather sets forth those objectives in terms of the broader concept of financial reporting in general. In addition, its focus on users of financial information and their interest in evaluating future performance, including earnings, is a significant and worthwhile step.

The FASB is devoting a major portion of its resources (approximately 40% of its research staff) to this project. Further, the project is necessarily a long-term evolutionary effort, and although the latest "FASB Technical Plan" indicates that all phases of the conceptual framework will be completed by the end of 1982, several additional years may be required before the results of the project can be realistically assessed. However, as the framework develops during the next few years, it is important that the evolving principles and concepts contribute significantly to the accounting standard-setting process through the use of those principles and concepts in developing financial reporting standards that address the important fundamental issues presently confronting the FASB and its constituents. The Commission believes that it is important to recognize that the conceptual framework project will never be "completed." This effort must be ongoing

-- constantly being updated on the basis of experience and a changing economic environment.

The project is intended to produce "concepts," from which more specific standards or rules will logically flow. It is, of course, difficult to distinguish clearly concepts from standards. Nevertheless, as a "concepts" project it is not designed nor should it be expected to produce definitive answers [though it is entirely possible that rules or standards will flow from the project before its completion, as has Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices" ("FAS No. 33")].

The overall project is moving forward. The broader information objectives of Concepts Statement No. 1 and the expansion of "accounting" into "financial reporting" are becoming widely accepted. The experimentation under FAS No. 33 holds the potential for the resolution of the complex conceptual issues underlying the reporting of the effects of changing prices. These issues have the attention of the business community and the news media.

However, the Commission is concerned with the FASB's rate of progress in moving toward more concrete positions. Almost all of the planned phases of the project have experienced delays. Of equal importance, certain fundamental issues have not yet been addressed. For example, the definitions of the eight elements of financial statements identified by the FASB

do not define earnings and are very general in that they can accommodate historical cost, current cost or fair value measures. While the broadness of the definitions of the elements is not necessarily inappropriate, especially in view of the experimentation of the measurement phase, it is disappointing for some that these definitions do not provide an indication of a firm direction for effective resolution of significant accounting issues, but rather defer consideration of important issues such as which elements will be recognized in financial statements and when they will be recognized to subsequent phases of the framework (e.g., accounting recognition criteria). Additionally, the FASB's introduction of the concept of "comprehensive income" has had a collateral effect on other phases of the conceptual framework. In that regard, the Commission agrees with the FASB's determination of a need for a concepts statement which outlines the major components of comprehensive income since this phase is necessary to the eventual identification of the components of earnings.

Despite the concerns stated above, the Commission recognizes that the enormity of the difficult issues with which the FASB is grappling necessarily entails a laborious, time-consuming effort. The nature and complexity of the project leads to the need for frequent reassessment of its priorities and focus. In the final analysis, progress should be judged by results rather than by administrative targets.

Although the Commission recognizes the long-term, evolutionary nature of the project, the Commission also believes that there are certain basic issues that the FASB should address within the next few years -- perhaps within the maximum five-year experimental period established by the FASB for a comprehensive re-look at FAS No. 33 -- in connection with its conceptual framework project. The Commission believes that the resolution of the following two issues -- (i) development of measurement concepts ^{*}/ and accounting recognition criteria; ^{**}/ and (ii) determination and display of the key components of operating performance and cash flows, including progress on the funds flows and liquidity project in meeting

^{*}/ The objectives of the measurement phase are (i) to develop supplemental disclosures showing the effects of changing prices on business enterprises and (ii) to consider concepts for the measurement of elements of financial statements. While the FASB has made substantial progress toward the first objective, no formal attention has been given to the preparation of a concepts statement on measurement issues, which would deal with, among other things, measurement attributes (e.g., historical cost, current cost, purchasing power, fair value, etc.) and capital maintenance (including the treatment of net monetary adjustments and holding gains). The Commission believes that the measurement concepts set forth in FAS No. 33 are sound and that the FASB should develop these concepts in a general concept statement on measurement issues.

^{**}/ This phase of the conceptual framework is to develop criteria for recognition of elements (e.g., assets, liabilities, revenues, expenses, etc.) in the financial statements. Such critical questions as (i) what qualities must be present for an economic asset or liability to be afforded formal initial accounting recognition and (ii) what events or evidence must support the recognition of subsequent valuation changes and the related income effects, are to be addressed in this phase.

the objective of assessing the amounts, timing and uncertainties of prospective cash flows -- will be critical to the success of the conceptual framework project.

First, the development of measurement concepts and accounting recognition criteria will affect the utility of the conceptual framework in the standard-setting process and will (or should) affect directly the ultimate disposition of certain major projects (such as business combinations, consolidation policy and interim financial reporting) postponed by the FASB pending developments in the conceptual framework project. Development of these phases should also assist the Commission in its consideration of the appropriate accounting and financial reporting for oil and gas producing companies. Thus, the FASB should aggressively pursue the development of these two phases.

Second, the conceptual issues related to the determination and display of the key components of operating performance and cash flows are highly relevant in the current economic environment. A corollary issue is the nature of possible summary financial reporting indicators that might be developed from this project that would identify the key items which indicate the success of an enterprise. The FASB must make progress on the funds flows and liquidity phase whose objective is to determine the kinds of information about the enterprise's flow of funds and its liquidity position that should be provided in the context of objectives of financial reporting. The Commission believes that one of the ultimate results of this phase should

be a revision of the statement of changes in financial position to better reflect cash flows. The FASB should continue to give appropriate attention to the study and development of information of this nature.

* * * * *

The FASB faces an extremely important task in educating its constituencies as to the concepts and limitations of its conceptual framework project. Further, as the FASB has recognized, there is a need to assess what financial information users believe is important. Consequently, as mentioned earlier in this section, the Commission believes that the measurement concepts set forth in FAS No. 33 are sound and that the FASB should develop these concepts in a general concept statement on measurement. The Commission recognizes the importance of assessing the FAS No. 33 disclosures for some period of time before any judgments are reached concerning the possible disclosure alternatives. However, the Commission believes that serious consideration should be given to a provisional concepts statement on measurement which would clearly set forth an assessment of the FASB's views concerning these highly important measurement issues.

As the FASB indicated in its recent exposure draft of a proposed supplement to FAS No. 33, "Financial Reporting and Changing Prices: Specialized Assets," assessments of the maintenance of operating capability and assessments of overall enterprise performance -- two approaches which were important

to the conclusions in FAS No. 33 -- are particularly relevant in assessing the amounts, timing and uncertainty of prospective cash flows. Users must be educated as to the meaning and utility of the disclosures that emanate from these concepts articulated in FAS No. 33. The FASB described the importance of these concepts in its proposed supplement to FAS No. 33 as follows:

... The Board concluded that information about historical costs, adjusted by specific indexes of price changes, would be useful in providing a basis for the assessment of the effects of changing prices on the enterprise. It believes that there is an urgent need to provide such information to the users of financial reports. There is a serious gap in public understanding of the problem that income levels may appear large under historical cost measures and yet be inadequate to provide for the maintenance of operating capability. Current cost measures, even if they are subject to difficulties of estimation, are likely to be better than other measures, such as historical cost, in contributing to the development of public understanding.

* * * * *

The Commission will continue to work with the FASB by offering its comments and criticisms, where necessary, in an effort to ensure that the conceptual framework ultimately leads to a set of principles and concepts, as well as standards emanating from those principles and concepts, which will serve the needs of users of financial information in a constantly changing economic environment.

Financial Reporting and Changing Prices

The Commission continues to view the development of financial reporting to reflect the impact of inflation and changing prices as one of the most important ongoing challenges facing the FASB, the profession and the business community. Incessant changes in the economic environment in which business must operate makes it imperative for the financial reporting process to evolve into a mechanism capable of reporting the economic realities of doing business.

In partial response to this need for change in financial reporting, the FASB, in September 1979, issued Statement of Financial Accounting Standards No. 33, "Financial Reporting and Changing Prices"; its first standard to address the complex area of accounting for the effects of changing prices. Considered by the Commission to be a significant breakthrough in the private sector standard-setting process, Statement No. 33 represents an important addition to the historical cost-based accounting model and, perhaps more importantly, reflects the willingness to deal with difficult issues requiring innovative solutions.

Purported to be a first step in the evolution of reporting the effects of changing prices, the Statement represents an experimental effort by the FASB, requiring two fundamentally different approaches to be followed in preparing required disclosures. Large, publicly-held companies subject to the

provisions of the new standard are required to provide disclosure of both the effects of general inflation, using historical cost/constant dollar accounting (i.e., changes in the purchasing power of the dollar), and the effects of changing prices of specific goods and services using current cost calculations. Disclosures are to be provided as supplemental information to primary financial statements included in published annual reports.

The requirements in Statement No. 33 to provide disclosure of the effects of changing prices using two different approaches having differing objectives, and therefore differing responses to the problem, is indicative of the significant controversy and debate which have plagued the development of a standard in this area. Preparers and users of financial reports have not yet reached any consensus on the general, practical usefulness of constant dollar information and current cost information. In issuing Statement No. 33, the FASB concluded that "it seems unlikely that a consensus can be reached until further experience has been gained with the use of both types of information in systematic practical applications." The statement reflects clearly the FASB's recognition that the state of the art does not permit a definitive standard, that experimentation is necessary, and that the urgency of the need for disclosure of the effects of inflation cannot await a perfect solution. The Commission

understands the FASB's conclusion as to the need for experimentation and supports their continuing efforts in this area in seeking the most meaningful disclosures. As a result of the issuance of Statement No. 33, the Commission rescinded its replacement cost rule and extended its safe harbor provisions for disclosures required by the new standard.

The FASB believes that to present information using both a constant dollar basis and a current cost basis provides an important framework for studying the usefulness of both methods of disclosure. The FASB has committed to an ongoing study of the disclosure practices under the new standard and plans to amend or withdraw requirements when evidence justifies the need to revise its provisions. In this connection, the FASB intends to monitor the extent to which the information is used, the type of users who find the data useful, and the purpose for which it is used. At a minimum, the FASB has stated that Statement No. 33 will be given a comprehensive reconsideration after a period of not more than five years.

Ultimate success in achieving any final solution will, however, depend to a large extent on the efforts of the accounting profession and the business community in applying the new standard and experimenting with additional disclosures which may help users assess the impact of changing prices on particular entities and industries. In this

regard, the Commission believes that the new standard should be viewed as a minimum for disclosure and that the corporate community should strive to contribute to the private sector standard-setting process by volunteering additional information which may be necessary to make the reporting most meaningful and useful in the circumstances. In this connection, a meaningful "Managements' Discussion and Analysis" approach is an appropriate vehicle for providing helpful explanation as to the impact of inflation. The additional text could focus on translating what some believe to be complex and potentially confusing information into a meaningful discussion directed toward assisting investors in evaluating financial position and results of operations.

The FASB recognized that the measurement and use of information on changing prices will require a substantial learning process on the part of all concerned. In view of the importance of clear explanations to users of financial reports of the significance of the information called for by Statement No. 33, the FASB organized an advisory group to develop illustrative disclosures that might be appropriate as a guide to preparers in particular industries. While the illustrative disclosures published by that group are useful, they will not obviate the need for each company to determine the most appropriate disclosures in its own particular circumstances, including those additional disclosures that a meaningful presentation will entail.

In addition to beginning to fulfill the current need for disclosure regarding the impact of inflation on businesses, the new disclosures which will be generated by provisions of Statement No. 33 should contribute to resolving important issues which are fundamental to the broader conceptual framework project. Such issues might include, for example, whether the theory of capital maintenance should be premised on physical or financial capital; whether the appropriate measuring unit should be nominal or constant dollars; what attributes financial reporting should measure; and whether the income concept should be viewed from the sole perspective of equity owners or from that of creditors as well.

The Commission believes that experimentation with disclosures required by Statement No. 33 will provide needed practical experience and assist in the refinement of standards. Through aggressive pursuit by the FASB in seeking the development of the most meaningful disclosures concerning the effects of inflation and changing prices, combined with genuine support by the business community, the Commission is confident the private-sector standard-setting process can develop reporting standards which meet the needs of the investing public in a constantly changing economic environment.

Accounting for Oil and Gas Producing Companies

The Energy Policy and Conservation Act of 1975 ("EPCA") directed the Commission to assure the development and observance of accounting practices that would enable the Department of Energy to obtain the information necessary for a reliable energy data base. As more fully described in the 1978 and 1979 Reports, the Commission was permitted by EPCA to rely on accounting practices developed by the FASB only if assured that these practices would be observed to the same extent as would rules of the Commission and only after an opportunity had been given for public comment on the FASB's conclusions. The FASB effort, which commenced in 1975, to promulgate accounting and reporting standards for oil and gas producers resulted in the issuance of Statement of Financial Accounting Standards No. 19 ("FAS No. 19"), "Financial Accounting and Reporting by Oil and Gas Producing Companies," in December 1977. FAS No. 19 prescribes a form of the "successful efforts" method of accounting to the exclusion of the "full cost" method.

Following extensive public hearings in 1978, the Commission determined that the two traditional methods of accounting for oil and gas producers -- successful efforts and full cost -- are inherently limited because of their failure to provide timely recognition of oil and gas reserves in the assets and earnings reported in the primary financial

statements. In August 1978, the Commission announced its conclusion that significant improvement in the measurement of assets and earnings in the primary financial statements of oil and gas producing companies could best be achieved through the development and implementation of an accounting method that reflects proved oil and gas reserves as assets in the balance sheet; additions to proved reserves and changes in valuations of proved reserves in the income statement; and all costs associated with finding and developing additions to proved oil and gas reserves, together with all costs determined to be nonproductive during the current period, in the income statement. The Commission called the accounting method to be developed on this basis "reserve recognition accounting." Because of the difficulties involved in the development of sufficiently reliable measures of proved reserves, a minimum period of three years was indicated as being necessary to provide experience with supplemental disclosures of reserve valuations and with the proposed "reserve recognition accounting." During this period, the Commission is permitting registrants to follow the successful efforts method of accounting (as defined by FAS No. 19) or the full-cost method as set forth in rules adopted by the Commission. All public companies were required to conform to one of these prescribed methods not later than the first fiscal year ending after December 25, 1979.

requiring an audit of the reserve information. Accordingly, the audit requirement was further postponed until a decision is reached on adopting reserve recognition accounting as a uniform method of accounting in the primary financial statements. The postponement of the audit requirement does not represent a conclusion on the part of the Commission as to whether or not reserve recognition accounting is feasible as a uniform method of accounting in the primary financial statements. Additional experience with the disclosure of information regarding the quantities and values of oil and gas reserves will be necessary before such a determination can be made. During this period of evaluation, the unaudited data may be reported as supplementary information accompanying, but outside, the financial statements. These actions were taken in order to enhance the development of reserve information by encouraging experimentation with alternative types of disclosures.

The Commission staff is also coordinating its activities on oil and gas accounting with related efforts of the FASB. In April 1980, the FASB issued for public comment an exposure draft of a supplement to FAS No. 33 which addresses the application of current cost requirements to specialized assets, including proved oil and gas reserves. Although the proposal would have required disclosure as supplementary information of the estimated "fair value" of proved reserves and a reconciliation of beginning and end-of-year valuations, at recent meetings the FASB has shown a reluctance to require

such disclosure. That reluctance appears to be based at least partially on the fact that the Commission already requires a value disclosure which is slightly different from the FASB's notion of fair value. The FASB was concerned by a possible user confusion caused by presentation of two similar but different value disclosures. The Commission staff will continue to work with the FASB in order to reach agreement on a common approach to the disclosures in regard to these assets.

In making any final determinations on accounting practices for oil and gas producers, the Commission will also give careful consideration to progress made by the FASB in the development of a conceptual framework for financial accounting and reporting. In addition to the measurement issues dealt with in FAS No. 33, the FASB has tentatively identified the important qualitative characteristics of accounting information, with primary emphasis on relevance and reliability. It also has on its agenda a project to develop accounting recognition criteria for elements of financial statements. Major standard-setting initiatives such as reserve recognition accounting should be handled in the private sector, and the existence of a conceptual framework would help to assure that this is the case. However, if the FASB is unable to make sufficient and timely progress in the development of its conceptual framework to set the direction for accounting for oil and gas producers, the Commission may find it necessary to resolve related conceptual issues on its own.

The Commission continues to assign a high priority to the issue of accounting practices for oil and gas producing companies. A 21-member Advisory Committee on Oil and Gas Accounting is assisting the Chief Accountant of the Commission on various matters relating to the development of reserve recognition accounting. In September 1979, in Accounting Series Release ("ASR") No. 269, the Commission adopted rules for the supplemental disclosure of a summary of changes in the present value of estimated future net revenues from the production of proved reserves. Changes resulting from discoveries and extensions, revisions of prior estimates and accretion of discount, reduced by related estimated future development and production costs; purchases of reserves; and previously estimated future development costs incurred during the year shall be added and sales of oil and gas and value of transfers, net of production costs and proceeds from sales of reserves in place shall be deducted in such summary of changes from the beginning of year present value of estimated future net revenues. Also adopted was a requirement for a summary of oil and gas producing activities prepared on the basis of reserve recognition accounting, which compares the estimated present value added during the year from (1) new discoveries, (2) revision to previous estimates and (3) accretion of discount with the related acquisition, exploration and development costs associated with reserve additions plus all costs determined to be nonproductive.

The Commission anticipates that these supplemental disclosures, and previously adopted requirements for the reporting of reserve quantities, estimated future net revenues, and present value of future net revenues, will provide the basis for evaluating the feasibility of requiring reserve recognition accounting as a uniform accounting method in the primary financial statements.

Closely related to the question of appropriate financial statement disclosures of oil and gas reserve information is the degree of auditor association with the information. In September 1979, the Commission issued ASR No. 270 which permitted these disclosures to be presented as an "unaudited" footnote to the financial statements for fiscal years ending prior to December 26, 1980. This one-year postponement of the audit requirement was intended to provide additional time for the establishment and implementation of uniform guidelines and standards for reserve estimation and reporting by petroleum engineers and independent accountants.

In April 1980, the Commission in ASR No. 277, gave further consideration to the question of an audit requirement regarding oil and gas reserves. The Commission emphasized that it considers reserve quantity and value information to be extremely important to an understanding of the financial position and operations of an oil and gas producing company. At the same time, however, it acknowledged that uncertainty exists concerning the costs and related benefits of

THE AUDITING STANDARD-SETTING PROCESS

As indicated in the Commission's previous Reports, the Commission continues to believe that the initiative for establishing and improving auditing standards should remain in the private sector, subject to Commission oversight. The Commission believes that the Auditing Standards Board ("ASB") and its Advisory Council generally have performed in a satisfactory manner and generally have been responsive to changing public expectations concerning the role of the auditor.

As the business environment continues to change and new and different approaches to financial reporting evolve, increasing pressure is placed on the auditing profession to change and, in some cases, expand its role in society. It seems clear that auditors in the future will be required to become associated more and more with disclosures which are based on greater subjectivity and imprecise determination. Auditor involvement with certain supplementary financial information, such as the effects of changing prices and certain oil and gas reserve data, has already come to pass, and strong encouragement has been given for auditor involvement with management reports on internal accounting controls.

This trend in reporting and increased auditor involvement appears to be only at its beginning and, consequently, the profession must continue to strive to react in a timely fashion with innovative solutions to these new challenges and changes in public expectations. The following discussion addresses two areas which the Commission believes warrant the continued attention of the auditing standard-setting process.

Auditor Association with Required Supplemental Financial Information

The accounting profession today is facing new challenges over and above the traditional challenge of performing quality audits of financial statements. It is faced with the need for its members to become involved with supplementary financial information disclosed outside the confines of traditional financial statements. The FASB, as an important part of its conceptual framework project, has recently adopted a concept of financial reporting which is broader than the disclosure traditionally provided in the basic financial statements. This new concept of financial reporting recognizes that certain information, while relevant to an understanding of a company's financial position and results of operations, cannot be developed with the degree of reliability which has, in the past, been inherent in the preparation of financial statements. This distinction between "soft" and "hard" data and the decision by the FASB to include more soft data in the

financial reporting framework is a significant step in the accounting standard-setting process and one for which the Commission has expressed enthusiastic support.

The decision to bring soft data into the financial reporting framework, however, offers an interesting challenge to the auditing profession. Soft information is not generally subject to precise determination and the extent of the benefits of applying traditional audit procedures to such information is not apparent. Yet, because supplementary financial information most likely will become of increasing significance to the financial reporting process and the benefits of a review by an independent professional of its preparation are substantial, the accounting profession must accept some degree of responsibility for the presentation of such information through some type of association with it.

Recognizing this new responsibility, the Auditing Standards Board ("ASB") of the American Institute of Certified Public Accountants added to its agenda a project to develop general standards for the involvement of auditors with supplementary financial information measured and presented within guidelines established by the FASB. This project evolved during 1979 into the issuance by the ASB of Statement on Auditing Standards No. 27 ("SAS No. 27"), "Supplementary Information Required by the Financial Accounting Standards Board." This new standard requires an independent accountant to follow certain limited review procedures when supplementary

information is required to be presented pursuant to FASB pronouncements and to expand the report on the audited financial statements, if necessary, to call attention to an inability to complete the prescribed procedures, the omission of required supplementary information, or material departures from FASB guidelines on the measurement or presentation of such information.

The Commission believes that SAS No. 27 is a positive step toward providing the profession needed guidance in assessing the nature and extent of its association with supplementary information. However, the Commission is troubled by the ASB's decision to adopt requirements for exception reporting as opposed to explicit reporting on required supplementary financial information. An accountant's report on supplementary information which describes the nature of his review and states whether he is aware of any material modifications that should be made to the information for it to conform with the FASB's guidelines would provide an important channel of communication between the profession and users of financial reports.

The Commission understands that the ASB intentionally deferred requiring explicit reporting on supplementary information due to, among other matters, its uncertainty over the applicability of Section 11 of the Securities Act of 1933 to accountants' reports on supplementary information which are included in registration statements. Section 11(a)(4) of

the Securities Act of 1933 imposes civil liability for material misstatements or omissions in a registration statement on an accountant "who has with his consent been named... as having prepared or certified any report or valuation which is used in connection with the registration statement...." As a result of Section 11(b)(3)(B), however, accountants are not liable under Section 11(a) for omissions or misstatements in the financial statements they audited if they show that they had after "reasonable investigation," grounds to believe that the information was true. Under existing law, an accountant's liability under Section 11(a) has been limited to the financial statements which he has certified and which are included in a registration statement. Since these cases arose prior to the development of auditors' reviews of information based on procedures less extensive than audits, the accounting profession has been concerned about whether, and, if so, how, Section 11(a) would apply to reports on supplementary information.

The Commission recognizes that accountants' liability for reports on supplementary information must not be inconsistent with their responsibility with respect to such information. Accordingly, the Commission has proposed rules which would exclude accountants from liability under Section 11(a) of the Securities Act of 1933 for their reports on the two types of supplementary information now required in financial

reporting -- the effects of changing prices and data on oil and gas reserves. */ The Commission believes that these proposed rules represent important steps in encouraging the ASB to adopt requirements for explicit reporting by auditors. The Commission has already adopted a rule which is similar to the proposed rules which relates to reports on unaudited interim financial information.

The Commission intends to consider whether it would be more appropriate for the liability issue to be addressed generally in the context of all types of supplementary information rather than specific supplementary information which companies are now presenting in registration statements and other documents furnished to shareholders or investors. The inclusion by public companies of supplementary financial information in annual reports and other disclosure documents is a new and evolving area of financial reporting and one

*/ Adoption of these amendments would foreclose private actions against accountants pursuant to Section 11(a) of the Securities Act for their reports on required supplementary information as to the effects of changing prices and as to oil and gas reserves used in connection with registration statements; however, the Commission could take action against accountants for such reports pursuant to Section 17(a) of the Securities Act. Furthermore, accountants could be liable to investors and shareholders for their reports on this supplemental information under common law, state statutes, and general antifraud provisions of the federal securities statutes. Directors and underwriters who relied on the accountants' reports could bring actions under other applicable laws.

which the Commission desires to encourage. Further, the Commission believes that through continuing efforts by both the profession and the Commission, explicit reporting on supplementary financial information will evolve, and a proper link between accountants' liability and responsibility will be achieved.

Reporting on Internal Accounting Control

In its 1979 Report, the Commission indicated that in April 1979 it had proposed for comment rules which would require inclusion of a statement of management on internal accounting control in annual reports on Form 10-K filed with the Commission under the Securities Exchange Act of 1934 and in annual reports to security holders furnished pursuant to the proxy rules.

The amendments were proposed to be adopted in two stages. As of dates after December 15, 1979, and prior to December 16, 1980, for which audited balance sheets are required, the statement of management on internal accounting control would have been required to include the following:

1. Management's opinion as to whether, as of the date of such audited balance sheet, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that specified objectives of internal accounting control were achieved; and

2. A description of any material weaknesses in internal accounting control communicated by the independent accountants of the registrant or its subsidiaries which have not been corrected, and a statement of the reasons why they have not been corrected.

For periods ending after December 15, 1980, for which audited statements of income are required, the statement of management on internal accounting control would have been required to include management's opinion as to whether, for such periods, the systems of internal accounting control of the registrant and its subsidiaries provided reasonable assurances that the specified objectives of internal accounting control were achieved. In addition, the Commission proposed that the statement of management on internal accounting control be required to be examined and reported on by an independent public accountant for such periods.

The rule proposals met substantial opposition. Many commentators viewed the proposals as having the effect of requiring a report on compliance with the related internal accounting control provisions of the Foreign Corrupt Practices Act of 1977 (the "FCPA") rather than as providing a medium for meaningful disclosure to investors. Objections were also raised concerning the costs of compliance with the proposed rules and the scope and content of the proposed management statement. Commentators also pointed to the significant voluntary and private-sector initiatives which

have been undertaken in this area and urged the Commission not to preempt such efforts through the promulgation of formal legal requirements at this time. While the Commission does not agree with all of the concerns expressed by commentators, it decided nevertheless not to proceed with rulemaking at this time based upon its determination to allow existing voluntary and private-sector initiatives for public reporting on internal accounting control -- by both registrants and accountants -- to continue to develop.

Thus, although the Commission has withdrawn its rule-making proposals at this time, it continues to believe that a report containing management's assessment of the effectiveness of the issuer's system of internal accounting control would provide information important to investors, and that auditor involvement with such a report may be needed. Accordingly, in announcing the withdrawal of the rule proposals, the Commission stated its intention to monitor closely the results of voluntary efforts and private-sector initiatives in this area through the spring of 1982 and will consider the need to require:

1. Management statements on internal accounting control;
2. Comprehensive management reports in general; and
3. Public reporting by independent accountants on internal accounting control.

A. The Foreign Corrupt Practices Act

Management reporting on internal accounting control has received a substantial amount of attention since the enactment of the accounting provisions of the FCPA. These provisions require that certain issuers (a) "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer"; and (b) "devise and maintain a system of internal accounting control sufficient to provide reasonable assurances that --

- (i) transactions are executed in accordance with management's general or specific authorization;
- (ii) transactions are recorded as necessary (a) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (b) to maintain accountability for assets;
- (iii) access to assets is permitted only in accordance with management's general or specific authorization; and
- (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."

These statutory objectives of a system of internal accounting control which were also included in the Commission's rule proposals for reporting on internal accounting control, were taken almost verbatim from Section 320.28 of

SECURITIES

6

10

the AICPA's Statement on Auditing Standards No. 1. Thus, the enactment of the FCPA has transformed these objectives from professional auditing standards into explicit statutory requirements applicable to corporate management -- a change that has important implications for reporting companies.

The statutory objectives do not simply require that transactions be recorded in a manner that will permit preparation of reliable financial statements. The system of internal accounting control must also provide reasonable assurances that "transactions are executed in accordance with management's general or specific authorization"; that "transactions are recorded as necessary * * * to maintain accountability for assets"; that "access to [and use of] assets is permitted only in accordance with management's general or specific authorization"; and that "recorded accountability for assets is compared with existing assets at reasonable intervals and appropriate action is taken with respect to any differences." These latter goals are designed to improve the system of corporate accountability in response to evidence that some boards of directors and even corporate officers were unaware of, and hence unable to prevent, allegedly improper use of corporate assets, and that shareholders were also unaware and, thus, unable to remedy this situation.

B. Voluntary Initiatives for Reports by Management

At the time the Commission issued its rule proposals for reporting on internal accounting control, "management reports" regarding responsibilities of management for financial reporting and accountability were receiving increasing attention.

The Commission on Auditors' Responsibilities ("Cohen Commission") had recommended, among other things, that companies include with the financial statements a report that acknowledges management's responsibilities with respect to the financial information reported.

The Financial Executives Institute ("FEI") had responded to the Cohen Commission's recommendation by endorsing the furnishing of a management report and, in June 1978, had issued suggested guidelines for preparation of a management report. Those guidelines generally follow the recommendations of the Cohen Commission. In addition, the AICPA had formed a Special Advisory Committee on Reports by Management, consisting of financial executives, attorneys, a financial analyst, and other users of financial information, to consider the Cohen Commission's recommendations pertaining to management reports and to develop guidance on matters that should be included in a management report. In December 1978, the Special Advisory Committee had issued for public comment a report of its tentative conclusions and recommendations. Further, an increasing number of public companies had voluntarily included management reports in their annual reports to shareholders.

Subsequent to the issuance of the Commission's rule proposals, the FEI again recommended that its members voluntarily include a management report in their annual reports to shareholders, and the AICPA Special Advisory Committee on Reports by Management, after considering public comment on its tentative conclusions and recommendations, issued a final report in which it recommended that annual reports include a report by management.

The Cohen Commission's report, the FEI guidelines and the AICPA Special Advisory Committee's report each contain the suggestion that a management report include an assessment of the company's system of internal accounting control. Each also recommends that management reports include other matters which may be very directly related to the effectiveness of internal accounting controls, including:

- . Description of management's responsibility for preparation of financial statements and other reported financial information;
- . Description of the work of the company's audit committee of the board of directors;
- . Description of the work of the company's internal auditors; and
- . Description of codes of conduct and assessment of compliance therewith.

The Commission continues to believe that information about the effectiveness of an issuer's system of internal accounting control would enable investors to better evaluate the reliability of interim financial statements and other

unaudited financial information, as well as management's performance of its responsibilities to control the assets and transactions of the business. Additionally, it recognizes the ongoing voluntary private-sector initiatives that have been undertaken by registrants to evaluate and document their systems of internal accounting control so as to be in a position to provide such information, and it believes that voluntary development by issuers of management reports which include such information would be preferable to a Commission requirement.

Accordingly, the Commission intends to monitor the results of voluntary efforts to provide such reports. The Commission will evaluate on an ongoing basis the progress that has been made in reports filed in 1980 through 1982 and will consider whether it is necessary or desirable to require statements of management on internal accounting control and to propose more comprehensive management reports.

The Commission's determination in that regard will depend not only upon the extent to which issuers voluntarily provide such management statements or management reports, but also on the appropriateness and usefulness of the information included and the procedures used to develop such reports. As discussed above, in determining to withdraw the rule proposals, the Commission was influenced by the significant constructive

attention which the private sector has given to both management reports and related evaluation of internal accounting control. In addition, many commentators on the Commission's rule proposals addressed the content of a management report, as well as the procedures necessary to maintain an effective system of internal accounting control, and urged that the Commission not preempt private-sector initiatives in this area. In an effort to further encourage such voluntary initiatives, while permitting public companies a maximum of flexibility in experimenting with various approaches to public reporting on internal accounting control, the Commission in the withdrawing release (Accounting Series Release No. 278, June 6, 1980) provided some guidance regarding these developing matters.

C. Involvement of Independent Accountants

The Commission continues to believe that significant involvement of independent accountants in the process of evaluating and reporting on internal accounting control is important. The Commission's decision not to require, at this time, such public auditor involvement was influenced by commentator indications that the costs of such involvement would be substantial and would outweigh the benefits of reliability and user confidence which the Commission cited as possible justifications for such a requirement.

At the time the Commission issued the rule proposals for reporting on internal accounting control, a task force of the AICPA's Auditing Standards Board was considering the general issue of public reporting by auditors on internal accounting control. Subsequently, the Auditing Standards Board issued, for public comment, a proposed Statement on Auditing Standards on "Reporting on Internal Accounting Control." This statement was recently issued in final form and provides standards for an auditor's examination of, and public report on, an issuer's overall system of internal accounting control.

The Commission notes that, under the recently adopted Statement on Auditing Standards, the auditor's opinion on the system of internal accounting control would not be limited to controls relating to preparation of financial statements. Rather, it would also extend to the corporate accountability objectives of internal accounting control -- safeguarding of assets, authorization of transactions and comparison of actual assets with related records and acting upon any differences. However, it should be emphasized that such an opinion will not necessarily indicate whether an issuer is in compliance with the internal accounting control provisions of the FCPA since, for purposes of limiting the costs of the examination, the auditor's opinion would not extend to the sufficiency of

JUDICIAL
CLERK

accounting controls relating to the safeguarding of assets and authorization of transactions which would not be material.

As presented by the commentators to the Commission's rule proposals, the costs of auditor examinations of and reports on issuer systems of internal accounting control are presently uncertain but substantial. The Auditing Standards Board's new Statement on Auditing Standards should contribute to the framework within which the Commission can monitor and evaluate not only the voluntary efforts by registrants to engage independent accountants to examine and publicly report on their systems of internal accounting control but also the costs of such examinations. Such an ongoing Commission effort could, thus, provide it with more reliable current cost data reflecting, over time, both the developing theory and practice of internal accounting control, as well as the growing auditor experience with examinations of internal accounting control systems. Similarly, to the extent that future system failures evidence the possibility that benefits may accrue from enhanced auditor involvement over and above those which were presently anticipated by commentators, the Commission would have a further basis on which to reassess its decision on independent auditor involvement in light of the then indicated need for additional measures to ensure the credibility and assurances intended to be provided by issuers' systems of internal accounting control.

Accordingly, the Commission believes that its monitoring effort will make it possible for it to revisit this issue on the basis of greater certainty concerning costs and benefits than that which commentators asserted exists today, and the Commission can be expected to reevaluate its decision concerning independent auditor involvement with internal accounting control systems in light of the extent to which private-sector initiatives and voluntary auditor engagements have satisfied those Commission concerns which presently exist or which may exist at that time.

* * * * *

The Commission withdrew its rule proposals in response to commentators' encouraging assurances of developing voluntary and private-sector initiatives concerning management statements on internal accounting control and enhanced auditor involvement with such statements. Indeed, the Commission continues to believe that management disclosure concerning, and auditor involvement with, issuers' systems of internal accounting control have important values that can be achieved without undue cost or other burdens.

Accordingly, in withdrawing these rule proposals, the Commission stressed that it will monitor carefully voluntary and private-sector developments in this area, and that it fully expects those initiatives to continue. Based upon the assurances of further voluntary initiatives communicated by

JUDICIARY
10

so many commentators and others, the Commission expects that significant progress will be made in 1980 and over the next couple of years, and it presently intends to formally revisit these questions by the spring of 1982 based upon three years of analysis of such voluntary efforts.

In that regard, the Commission invited additional public comment on issues discussed in the withdrawing release. In order to supplement the Commission's own monitoring and analysis of the voluntary progress being made and the need for Commission action in this area, the Commission specifically encouraged commentators to provide it with any additional views and data which would be of use to the Commission over the course of the monitoring period. In addition, the Commission is also interested in hearing from issuers, accountants, and their counsel not only about questions relating to management statements on internal accounting control and auditor involvement with such statements, but also about the guidance which the Commission has set forth in the withdrawing release concerning the design, implementation and monitoring of internal accounting control systems, including the need for documentation, the importance of a proper control environment, and the concept of reasonable assurance, as well as data on actual costs incurred by issuers.

JUDICIAL ENFORCEMENT OF AUDITOR RESPONSIBILITIES

In addition to the profession's standard-setting mechanisms, effective and vigorous judicial enforcement of the federal securities laws is essential to assuring that auditors properly discharge their statutory and professional responsibilities. */ During the past five years there have been a number of judicial developments which alter -- and in many cases restrict -- the scope of private actions against accountants. Members of Congress have inquired of the Commission concerning the impact of these decisions on the Commission's oversight of the accounting profession and whether any legislative response appears necessary. While case law affecting the liability of auditors continues to unfold and the Commission cannot, therefore, formulate final recommendations at this time, set forth below is a brief discussion of the issues which would bear on any Congressional consideration of this issue.

At the outset, the Commission believes it is important to recognize that auditor liability is not an issue that can

*/ For example, the Commission has continued, where appropriate, to bring injunctive actions against accountants. See, e.g., SEC v Houston Complex, et al. (permanent injunction entered by consent against auditing firm and partner-in-charge); SEC v Richard L. Chatham (permanent injunction entered against auditor). In addition, the Commission has continued to institute proceedings, pursuant to its Rule 2(e) of its Rules of Practice, to determine the fitness of accountants to continue to practice before it. See, e.g., In the Matter of Lawrence J. Stern (auditor consents to order for permanent disqualification); In the Matter of Touche Ross & Co. (firm consents to censure; one partner consents to entry of order and one partner consents to suspension from practice for five months); In the Matter of Darrell L. Nielson (permanent disqualification ordered).

be divorced from the broader question of the liability of participants -- such as issuers, their officers and directors, financial institutions, securities professionals, attorneys and others -- in the corporate disclosure process mandated in the federal securities laws. Any legislative proposal designed to protect the role of private litigation in promoting full and fair disclosure should therefore confront comprehensively -- not on a piecemeal basis -- the issues underlying the scope of liabilities under the securities laws.

One major issue that any remedial scheme must deal with is the appropriate "state of mind" showing necessary to a finding of a securities law violation. The Supreme Court considered this issue in a landmark 1976 decision concerning the liability of an auditor for damages sustained by third persons as a result of negligence in performing an audit. In Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976), the Court held that a demonstration of scienter is a prerequisite of stating a cause of action for damages under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder -- the centerpiece antifraud provision of the securities laws. The Court recently extended this requirement to Commission injunctive actions under that section, as well as under Section 17(a)(1) of the Securities Act of 1933, in Aaron v. SEC, 100 S. Ct. 1945 (1980). The Commission continues to believe that a scienter requirement is fundamentally inconsistent with the remedial purposes of the federal securities laws, lessens investor protection, and

constitutes a significant obstacle not only to just compensation of investors injured by violations -- intentional or careless -- but also to effective Commission action with a view towards prevention of future violative conduct. */

The state of mind question, however, is only one part of a larger complex of liability issues. For example, a major problem confronting the courts has been the availability of implied private rights of action under the securities laws to redress violations of statutory provisions that do not contain express rights of action. Traditionally, the courts have shown a willingness to imply such remedies where necessary to effectuate the Congressional purpose behind particular statutory provisions. See, e.g., J.I. Case Co. v. Borak, 377 U.S. 426 (1964). More recently, however, the Supreme Court has substantially narrowed the availability of implied rights of action under the federal securities laws. The Court has made clear that, absent some affirmative indication of Congressional intent that there be such a right of action, it will not imply one -- regardless of whether it would otherwise appear to

*/ It should be noted that there are significant distinctions between the purposes of a Commission enforcement action and those of a private lawsuit. Unlike a private plaintiff seeking to recover damages he has incurred, the Commission, in seeking an injunction, endeavors to protect the public interest and the interests of investors from violations of the law by obtaining prospective relief that requires the defendant to obey the securities laws in the future. An injunction is designed to protect the public against conduct, not to punish a violator's state of mind.

further Congress' purposes in enacting the statutory scheme. This new philosophy concerning implied rights has had a direct impact on suits against accountants. Thus, for example, the Court refused to find a private right of action in Touche Ross v. Redington, 442 U.S. 560 (1979), which dealt with an accountant's liability for failing to discover a securities broker-dealer's violation of the recordkeeping provisions of the Securities Exchange Act. Cf., Transamerica Mortgage Advisors, Inc. v. Lewis, 100 S. Ct. 242 (1979) (investment advisor liability under the antifraud provision of the Investment Advisors Act of 1940). Any Congressional review of the scope and rule of private liability under the securities laws, therefore, must also come to grips with the fundamental question of the circumstances in which injured investors will be able to seek redress in the federal courts in the first place.

A related question is the issue of standing even where a right of action clearly exists. In Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), the Court ruled that offerees who were allegedly injured as a result of misrepresentations which induced them to refrain from buying securities could not bring suit for damages under Section 10(b) since they had not actually purchased or sold the shares in question as a result of the violation. Similarly, in Piper v. Chris-Craft Indus. Inc., 430 U.S. 1 (1976), the Court denied standing to a defeated bidder in a tender offer who alleged that a competing bidder had violated the antifraud provisions of the Williams Act.

Another area of concern is the relation between state and federal law in the investor protection field. In Santa Fe Indus. Inc. v. Green 430 U.S. 462 (1977), the Court refused to find a federal cause of action under Section 10(b) for an alleged breach of fiduciary responsibilities owed to shareholders on the theory that a showing of actual deception was necessary. In Burks v. Lasker, 441 U.S. 471 (1979), the Court again emphasized the deference to state law that federal courts must generally give in matters pertaining to business judgment -- even as it relates to dismissal by a board of directors of a pending derivative suit under federal law -- although indicating that express federal policy may be invoked to override state law in some limited instances. While state law does play an important role in the area of investor protection -- including issues relating to accountants' liability */ -- effective securities law enforcement requires a strong federal presence unrestricted by varying and inconsistent state laws and judicial precedent.

A further issue that has received substantial attention is what measure of damages should be awarded against securities law violators, including accountants and other professionals. Much concern has been expressed about the possibility of massive awards to large classes of plaintiffs, far out of proportion to the conduct complained of. On the other hand,

*/ See, e.g., White v. Guarente, 43 N.Y. 2d 356, 372 N.E. 2d 315, 401 N.Y.S. 2d 474 (1977); Dworman v. Arthur Andersen, 183 N.Y.L.J. 85 at 7, (Sup. Ct. 1980).

awards must compensate plaintiffs for actual injuries and act as a deterrent to unlawful activity. This is an issue plainly deserving of Congressional attention in the course of any reevaluation of the liability area.

There are other issues that would have to be resolved if a determination were made to revise the liability provisions. While not strictly a securities law issue, for example, the question of the availability of the class action device -- also recently restricted by the Supreme Court -- is also critical since most private enforcement of the securities laws proceeds by this route. So, too, are questions of appropriate statutes of limitations with respect to private actions, the scope of equitable relief available, and the liability of aiders and abettors of securities law violations, and so on.

In summary, any Congressional review of the liability issues which affect rights of action against accountants should not be limited to the accounting context, nor to any one specific issue that has arisen with respect to accountants' liability. In this vein, one effort that has been made to deal comprehensively with this area is the American Law Institute's proposed Federal Securities Code. The Code would, among many other things, create express civil liability for most of the rights of action heretofore implied under the present federal securities laws, including all of the antifraud provisions. In addition, the Code would give a court express power

to imply new private rights of action, under specific standards, if an express right was not otherwise created. For all of the civil liability provisions, the Code would establish specific statutory rules governing available defenses, standing to sue, measure of (and, where appropriate, limitations on) damages, and other questions that remain unaddressed under the present statutes.

The Commission is presently considering the Code's provisions, and will finalize its position on the proposed Code in the near future. In so doing, we are analyzing -- along with the many other issues the Code raises -- the appropriate content of any new statutory provisions dealing with private rights of action. Whether or not the Code proves to be the most desirable vehicle for Congressional resolution of these problems, the Commission believes that a systematic review of all the remedial procedures under the federal securities laws is a prerequisite to any legislation dealing with the specific problems surrounding the scope and nature of auditors' liability.