

SEC ROUNDTABLE
FINANCIAL REPORTING AND THE ROLE OF THE INDEPENDENT AUDITOR
JUNE 3, 1986

U.S. SECURITIES AND EXCHANGE COMMISSION
450 FIFTH STREET, N.W.
WASHINGTON, D. C. 20549

The members of the Commission attending the Roundtable were Chairman John Shad and Commissioners Aulana L. Peters, Joseph A. Grundfest, and Edward H. Fleischman. Participants from outside the agency were:

Michael F. Barrett Jr., Staff
Director
Subcommittee on Oversight &
Investigations
Committee on Energy and Commerce
Washington, DC

John C. Burton, Dean
Graduate School of Business,
Columbia University
New York, NY

Philip B. Chenok, President
American Institute of Certified
Public Accountants
New York, NY

Joseph E. Connor, Chairman
Price Waterhouse
New York, NY

J. Michael Cook, Chairman
Deloitte Haskins & Sells
New York, NY

Anthony T. Cope, Chairman
SEC Liaison Committee, Financial
Analysts Federation
Wellington Management Co.
Boston, MA

Eugene M. Flegm, Assistant
Comptroller
General Motors Corporation
Detroit, MI

SEC staff participants included:

Clarence Sampson
Chief Accountant

Linda C. Quinn, Director
Division of Corporation Finance

Gaylen N. Larson, Group
Vice-President & Controller
Household International
Inc.
Prospect Heights, IL

David Norr
Lieber & Co.
Harrison, NY

James J. O'Neill, Partner
Hausser & Taylor
Cleveland, OH

Fred S. Schulte, Vice-
President and Corporate
Controller
Tracor, Inc.
Austin, TX

James C. Treadway, Jr.
Chairman
National Commission on
Fraudulent Financial Reporting
Washington, DC

Fred D. Wolf, Director
Accounting and Financial
Management Division
General Accounting Office
Washington, DC

Robert J. Kueppers
Professional Accounting
Fellow

INTRODUCTION

The SEC Roundtable on Financial Reporting and the Role of the Independent Auditor was convened to discuss current issues related to the auditor's involvement in financial disclosure under the securities laws. Many believe that the United States has today the most sophisticated financial reporting system in history, and that the accounting profession is subject to the most pervasive systems of checks and balances of any profession. Alleged audit failures are reported to amount to a fraction of 1% of the audits performed each year. Nonetheless, misleading financial disclosures by some companies, and the dramatic impact of those audit failures which have occurred, impugn the integrity of the securities markets and harm hundreds of thousands of shareholders. Therefore, regulations and auditing standards are constantly being reviewed for cost-effective improvements.

Several initiatives have recently been put forth to improve the system, including (1) a number of projects by the AICPA and others; (2) proposals by Price Waterhouse; (3) recommendations of seven major accounting firms; and (4) a bill currently pending before Congress, entitled the "Financial Fraud Detection and Disclosure Act of 1986" (H.R. 4886). The purpose of the Roundtable was to afford members of the Commission and senior staff the benefit of the views of outside experts on these important issues.

ISSUES

The following issues were discussed:

- * Fraud and Illegal Acts: Whether existing standards for auditors to identify material fraud or illegal acts should be revised.
- * Reporting on Internal Controls: The impact of auditor review and reporting on internal controls.
- * Disclosure of Risks and Uncertainties: Whether modification of existing SEC rules and auditor association with disclosure of risks and uncertainties would produce improved disclosures at a reasonable cost.
- * Structure of the Accounting Profession's Quality-Control Efforts: Whether the current structure of the profession's quality-control efforts should be changed.
- * Limitation on Accountants' Liability: Recent proposals to reduce accountants' legal liability.

FRAUD AND ILLEGAL ACTS

Issue

Whether existing standards require auditors to identify material fraud or illegal acts. Whether existing standards should be revised. The costs and benefits associated with recent proposals.

Views

Participants indicated that an unqualified auditor's opinion implicitly states the belief that the financial statements are free from material fraud. In their opinion, however, the standards could be clearer. They also indicated that it is important to consider the primary importance of the roles of management and the audit committee in fraud prevention and detection, as the auditor represents only one facet of a broad system in this area.

While certain participants believed that it may be appropriate for accountants to take on some increased responsibilities for fraud detection, most felt H.R. 4886 represents an extreme answer, and has significant deficiencies. Cost of compliance with the bill was identified as an important problem. Specific areas of concern included the lack of a materiality standard, a change in the auditor's role, limits in the auditor's expertise and impact on the SEC workload.

Discussion

Mr. Treadway introduced the topic, stating that quantification of financial fraud is not possible. It is evident that fallout from identified cases of financial fraud is widespread, affecting

not only the company, lenders and stockholders, but also many third parties. The National Commission on Fraudulent Financial Reporting has concluded that the issue cannot be addressed by looking solely at the role of the independent auditor. All influences and forces must be considered together to develop effective methods to minimize fraudulent financial reporting.

Chairman Shad asked if under the current standards an audit should identify fraud material to the financial statements.

Mr. Chenok answered in the affirmative, replying that the objective of an audit is to see that financial statements are fairly presented. Therefore, an auditor does search for material errors and irregularities. He stated that illegal acts are more difficult to identify because the auditor is required to make legal judgments. In addition, detection of illegal acts is hampered when collusion or forgery exists, and such difficulty increases when illegal acts are not directly related to financial reporting.

Mr. Connor noted that much of the literature emphasizes the limitations in the auditor's abilities to detect such activities rather than affirmative statements of responsibility to search for fraud.

Mr. Cook noted that instances of non-detection of fraud are quite few. As a user, Mr. Norr noted that the impact of any audit failure is very serious, particularly in terms of confidence in

the securities laws. He voiced his belief that auditors should find fraud, particularly when top management is involved.

Mr. Flegm pointed out that there is a significant difference between management fraud and employe fraud. Management fraud would almost always have a significant effect on the financial statements and thus be of major concern to the public auditors. On the other hand, employe fraud usually does not materially affect the financial statements and is more the concern of the internal auditors and the internal control system. He further pointed out that collusion could circumvent virtually any control system.

In discussion of what constitutes an audit failure, Mr. Cook reminded the Roundtable participants that a business failure is not necessarily an audit failure. Conversely, according to Mr. Barrett, audit failures can occur other than in the context of a business failure. If management is guilty of fraud, even if it is not material to the financial statements, and such fraud is not detected, Mr. Barrett would consider it an audit failure.

Several concerns regarding H.R. 4886 were expressed. Mr. Connor stated that the absence of a materiality standard would make for an impractical and unworkable reporting framework for auditors and preparers. Mr. Larson agreed. Mr. Barrett indicated that the Subcommittee on Oversight and Investigations (many of whose members co-sponsored the bill) is attempting to identify a

materiality provision which would exclude very minor items but include management fraud which was not material to the financial statements.

The change in the auditor's role to a policeman function was raised as a concern by Mr. Connor. Mr. O'Neill also believes that distortion of the role of the CPA would be unfortunate. If the system is to be restructured, it would be best, in his opinion, to concentrate on management's responsibilities.

Mr. Larson stated his belief that primary responsibility for the financial statements should remain with management. Mr. O'Neill further stated that fraud prevention and detection is basically management's responsibility. Dean Burton believes that the role of the Board of Directors has been and continues to be highly significant in this regard. Mr. Schulte emphasized that his company employs several devices for fraud prevention and detection, including internal and external auditors, and management control systems.

Many possible violations of laws are foreign to the auditor's areas of expertise, according to Mr. Connor. For example, according to Mr. Larson, auditor searches for violations of traffic or ERISA laws would not be effective.

Dean Burton is concerned about the impact of H.R. 4986 on the Commission's workload. Given that auditors will be given a safe harbor from good faith incorrect reporting of illegal and irregu-

lar acts, he indicated that the Commission may be overloaded with information which requires follow-up.

Dean Burton expressed the view that while H.R. 4886 represents an extreme answer, there is a legitimate concern that auditors should go further in searching for fraud. Mr. Connor seconded the idea, stating that Price Waterhouse has proposed that an audit have an independent purpose to identify conditions, fraud included, that make financial statements misleading.

Under current standards, an auditor is required to consider resignation if he is aware of errors, irregularities or illegal acts which are not appropriately followed up by management. Mr. Connor noted that if resignation occurs, such acts would be reported to successor auditors. Whether or not the auditor resigns, under current standards, reporting of such acts to management would take place, according to Mr. Connor. Furthermore, for SEC companies, Form 8-K disclosures would bring these matters into the public arena. Mr. Flegm supports a continuation of the current system whereby auditors report irregularities to the Audit Committee or Board or Directors, rather than direct reporting to the regulators.

REPORTING ON INTERNAL CONTROLS

Issue

The impact of auditor review and reporting on internal controls.

Views

Participants expressed views that there can be value in auditor

association with internal controls, and that support may exist for a requirement to review controls in every audit. Views were mixed with regard to public reporting by auditors on controls. Some participants said that such reporting would enhance investor confidence; others stated that public reporting would not be cost-beneficial.

Discussion

Mr. Connor explained his view that recent highly publicized business failures have not involved a collapse of lower-level internal accounting controls, but rather management or administrative controls. */ Increasingly, Mr. Connor believes, auditors review management controls even when there is no professional requirement to do so. Mr. Connor explained that the Price Waterhouse proposals advocate a requirement to test management controls in every audit.

Mr. Cook also stated that in the vast majority of audits, management controls are reviewed. While agreeing that it may be beneficial to revise auditing standards to require increased controls reviews, he has concerns about requiring review of those management controls which are not relevant to preparation of financial

*/ Under current auditing standards no auditor review of controls is required unless reliance is planned in order to reduce audit testing. When an auditor performs a controls evaluation, he is primarily concerned with accounting controls, and is required to evaluate administrative controls only when he believes that such controls may have an important bearing on the reliability of the financial records.

statements. Mr. Cope believes that further auditor review of controls would be beneficial, but is unable to assess the level of associated costs.

Roundtable participants discussed the probable cost of an increased review of controls. Mr. Connor's view is that the costs will be relatively low. According to Mr. Connor, this is borne out by the development of EDP auditing in recent years, which has not caused massive cost increases. Mr. Connor further has heard positive comments from senior financial personnel of various companies as to the benefits of an auditor review of controls. Mr. O'Neill also stated his support for a required controls review, based on his belief that such a review is very beneficial for smaller companies.

In contrast to the above discussion of a review of controls, views were mixed as to the benefits of public reporting on controls by accountants. In 1979, when the SEC proposed a management report on controls, ^{*}/ accompanied by an auditor report on the management report, significant opposition was voiced by commentators. Mr. Treadway expressed his opinion that opposition to the proposal, if issued today, would be minimal. Mr. Cope believes that such a proposal would lead to increased investor confidence. Mr. Wolf noted that the Single Audit Act, enacted in 1984, requires public reporting on the controls of state and

^{*}/ See Release No. 15772 under the Exchange Act (April 30, 1979), ASR 278 (June 6, 1980), and ASR 305 (January 28, 1982).

local governments and that it has received good public acceptance. He also stated that cost was not a major issue in the debate on the Single Audit Act. He believes that the Act can serve as an instructive guide on how to deal with many of the issues being discussed at the Roundtable.

However, Mr. Connor sees no incremental value in public auditor reporting on controls so long as the scope of the audit is well understood. His view is based on current standards, which require auditors to report identified material weaknesses in controls to senior management and the Board of Directors and Audit Committee. Identified weaknesses could lead to expanded audit work or a determination that the auditor can not render an opinion on the financial statements. Further, Mr. Larson voiced his belief that public reporting by auditors on controls would be expensive, and of limited value. He believes that mandated auditor reporting on controls to management and the company's Audit Committee would be a preferable approach. While he believes a detailed review and lengthy formal report on adequacy or inadequacy of internal controls is not likely to be cost-effective, he strongly supports requiring that auditors issue letters to management and audit committees containing constructive recommendations on ways to improve control processes.

Dean Burton suggested two possible forms of public reporting related to the controls environment: first, a statement as to whether material inadequacies in controls were identified; and second, disclosure of any extension of audit scope beyond normal

levels. As an alternative to the second suggestion, Dean Burton suggested public disclosure of the audit fees. Mr. Connor, while agreeing that a risk environment caused by material control inadequacies should be disclosed, disagrees with disclosure of audit scope extension, because a quantification of the audit scope extension is impracticable.

DISCLOSURE OF RISKS AND UNCERTAINTIES

Issue

Whether existing SEC rules on disclosure of risks and uncertainties should be modified. Whether auditor association would produce improved disclosure at a reasonable cost.

Views

Participants noted that Management's Discussion and Analysis ("MD&A"), which provides disclosure of risks and uncertainties, is the responsibility of management. Participants disagreed about whether MD&A requirements, which are currently broadly drawn, should be changed. Some felt that more specific rules would elicit more frank disclosure of downside risks facing a company. Others felt that rule changes would result in defensive or boilerplate disclosure; these individuals believed that continued improvement to disclosure made pursuant to current rules is preferable to rule changes.

Several participants believed that additional auditor association with MD&A disclosure would be beneficial. However, others expressed concerns as to whether the qualifications of auditors were appropriate to review the disclosure, much of which is not

directly associated with the historical financial statements. In addition, the nature of possible auditor association must be further defined.

Discussion

Mr. Connor noted that the public expects that a company will not fail shortly after financial statements accompanied by an unqualified audit report are issued. He stated that MD&A is an appropriate vehicle for early warning of risks, and includes discussion of changes in trends, future prospects and other information key to an understanding of the company. Mr. Cook concurred, stating that MD&A includes disclosure of problems which could cause a future business failure, and information which enhances the predictive value of financial statements.

Mr. Cope disagreed, stating that while there has been some improvement, MD&A still all too often consists of obvious facts, inadequate for a financial analyst's needs. Mr. Connor, Mr. Wolf and Mr. Cook concurred that the discussion often has not focussed enough on the warning signs and red flags.

Ms. Quinn pointed out that MD&A requirements were changed several years ago, and that an MD&A limited to boilerplate is clearly inadequate under current rules. She stated that, in the review of disclosure documents, the Division of Corporation Finance requires changes when MD&A disclosure appears inadequate.

Participants discussed possible changes in MD&A rules. The two analysts, Mr. Norr and Mr. Cope, believe that quarterly segment

reporting and additional forecasting information would be very useful. Mr. Cook described the changes to MD&A disclosure recommended to the AICPA Board of Directors by seven major accounting firms. The firms recommended an expanded requirement to include disclosure of certain other risks and uncertainties not specifically included in current MD&A requirements.

Chairman Shad and Commissioner Grundfest discussed their concern about possible defensive disclosure which would arise from more specific requirements, leading to a laundry list of risks disclosed in a boilerplate fashion. Mr. Flegm agreed, believing that requiring improvements in disclosure made under the current rules is preferable to changes in the rules. Dean Burton also discussed his belief that the key to useful MD&A disclosure is SEC monitoring of substantial changes in year to year reported results and investigation as to whether prior MD&A's gave adequate indication of the change.

Participants discussed the value of increased auditor association with MD&A. Mr. Cook explained the nature of auditor responsibilities for MD&A under current standards. MD&A is not part of the financial statements and thus is not covered by the auditor's opinion. However, according to Mr. Cook, the auditor has a responsibility to read the entire SEC filing, including MD&A, to determine that it is not materially inconsistent with the financial statements. Further, Mr. Cook indicated that if the auditor is aware that MD&A has material misstatements or significant

omissions, steps would be taken to ensure the deficiency is addressed. While several participants favor additional auditor association with MD&A, it was stressed that MD&A should remain primarily a management responsibility.

Mr. Connor discussed his belief that increased auditor association with MD&A is consistent with Price Waterhouse's recommendation that auditors look at management controls such as the profit planning process. Dean Burton voiced his belief that increased auditor association is worthwhile, but was unsure how that could best be accomplished. Mr. Cook suggested that MD&A might be brought into the financial statements and covered by the auditor's report. The audit work which would then be required to be performed is a matter to be addressed more fully by auditing standards-setters, according to Mr. Cook.

Commissioner Peters asked whether auditors have the experience and knowledge about particular industries to effectively judge the reasonableness of management judgments included in MD&A disclosures. Mr. Cook and Mr. Connor both believe that this area is within the competence and training of the auditing profession. Mr. Schulte noted that auditors could engage third party experts if necessary to conclude as to the reasonableness of particular judgments. While Mr. Wolf believes that auditors should identify situations where a company is on the brink of bankruptcy, Commissioner Grundfest pointed out that there are many situations in which an auditor is not equipped to do so. For example, an

auditor may not be qualified to determine whether a particular product will be successful.

Mr. Larson doubts the profession's ability to give the absolute assurances that are sought by many users regarding MD&A. Therefore, Mr. Larson believes that auditor reporting on MD&A to management and audit committees, in a form similar to that which he suggested for reporting on internal controls, is a more viable alternative than public reporting.

STRUCTURE OF THE ACCOUNTING PROFESSION'S QUALITY CONTROL EFFORTS

Issue

Whether the current structure of the profession's quality-control efforts should be changed. Costs and benefits of recent proposals.

Views

It was noted that the accounting profession's self-regulatory efforts are but one part of a broad regulatory framework. Participants believe that the peer review process of the AICPA's Division for Firms has served an important and effective role in the regulatory system for the past ten years. Nevertheless, various participants voiced recommendations for improvement, including mandatory membership, increased involvement by the SEC, and more effective disciplinary actions.

Discussion

Mr. Chenok explained how the profession's quality control system functions in the regulatory environment, which includes civil liability, state licensing of accountants, state societies, and

private standards setting bodies such as the FASB and AICPA.

Mr. Chenok explained that the AICPA's Division for Firms, consisting of the Private Companies' Practice Section and SEC Practice Section ("SECPS"), has several programs, most significantly peer review. Peer reviews are performed to determine whether firms' quality control systems are effective in ensuring audits are done in conformity with professional standards. Letters of comment resulting from peer reviews are public. In addition, if a peer review identifies deficiencies in a particular audit, the deficiencies are required to be corrected. The emphasis of the program is on remedial action, not punishment. Formal sanctioning powers would usually be invoked only when firms refuse to cooperate or take necessary remedial actions.

Mr. Chenok further explained that the SECPS operates under the oversight of a Public Oversight Board ("POB"). In turn, the SEC oversees the POB. As a complement to the peer review process, SECPS member firms are required to report instances of alleged audit failures involving public companies. This prompts a review to determine if the quality control system of the member firm needs significant change.

Mr. Connor, while lauding the positive results achieved in the past ten years by the peer review program of the SECPS, also noted recent criticisms of the program. The major criticism, according to Mr. Connor, is that the same group makes the rules,

investigates to ensure rules are followed, acts as advocate for the profession, and passes judgment on infractions. Mr. Connor identified key aspects to Price Waterhouse's recent proposals to change the profession's quality control program to a statutory self-regulatory organization ("SRO"). These include making participation mandatory (membership in the Division for Firms is currently voluntary), and increasing the SEC's role in the program but without undermining confidentiality of client information. He further explained that the increased government presence would improve the effectiveness of the disciplinary process. For example, under the current structure, a firm could be expelled from the SECPS, but could continue to practice before the SEC.

Mr. Cook disagrees with the need for a statutory SRO. He stated that although such an arrangement would make the relationship with the SEC more formal, it is already close. Likewise, in his view, suspending a firm from practice would be a compelling penalty, but presently available sanctions are adequate. However, he believes that mandatory membership would be worthwhile, and noted that an AICPA committee is currently working to achieve this goal.

Mr. O'Neill noted that peer reviews have significant benefits to smaller audit firms, even those with no SEC clients. Although mandatory peer review would be beneficial, he doubts that a statutory SRO would be responsive.

Dean Burton believes that more emphasis should be placed on whether individual engagements are performed in accordance with standards. Mr. Chenok responded that the system already emphasizes individual engagements, and when a deficiency is found the firm is required to perform additional procedures or withdraw the opinion, as appropriate. Mr. Larson suggested that audit committees might report engagements about which they had concerns as to the quality of work, to the Division for Firms.

Dean Burton observed that the peer review program has been salutary but expressed concern about the wholly remedial focus. In his view, the programs would have more public credibility if punitive actions were taken. He noted however that legal protections would be necessary to enact such a system; thus, a legislatively sanctioned SRO would be more likely to be effective. Mr. Wolf also questioned whether the program has made effective use of discipline. In response, Mr. Cook reemphasized that the program is only one aspect of a broad regulatory scheme. He believes that the focus is properly remedial.

Dean Burton then suggested that more referrals be made by peer reviewers to groups responsible for punitive actions. He observed that the current program has the opposite focus, and through the confidentiality given to certain of its reviews, protects firms and their clients from authorities with punitive powers.

Mr. Barrett noted that the Subcommittee on Oversight and Investigations has not taken a final position on the idea of a self-

regulatory organization, but it sees some merit in the idea. He observed that internal auditors might be able to be incorporated into the program at a later date. Commissioner Peters asked whether a self-regulatory organization could address the work of internal accountants as well as auditors. Mr. Chenok noted that the AICPA's Code of Ethics is currently being revised to comprehend CPAs working in industry. Mr. Larson noted that many accountants and chief financial officers in industry are not CPAs.

LIMITATION ON ACCOUNTANTS' LIABILITY

Issue

Recent proposals to reduce accountants' legal liability.

Views

Participants expressed significant concern about the impact of a lack of availability of affordable insurance coverage for auditors, as well as officers, directors and others. For an expansion in the auditor's role to be feasible, the liability problem must be eased. Various possible solutions were discussed which require further study.

Discussion

Mr. Connor described the impact of expanding liability and shrinking insurance availability on audits. In his view, auditors are focusing on defensive auditing, which could lead to inefficiencies and overauditing. Mr. Larson believes that excessive liability causes an increased emphasis to be placed on detailed audit steps, the unfortunate by-product of which can be

less emphasis in obtaining a basic understanding of the business and consequent risks. According to Mr. Connor, the economic position of the accounting profession will deteriorate, which could lead to problems in attracting sufficiently qualified people to the profession. Chairman Shad pointed out that corporations pay for increased liability through increased audit fees. According to Mr. Schulte, customers ultimately pay the price of high audit fees caused by auditors' increased exposure to legal liability.

Mr. Flegm was sympathetic to the auditors' problem and noted that the liability crisis extends to many aspects of society. For example, he noted that officer and director coverage is very difficult to obtain.

Mr. Connor, while noting that the profession does not want to eliminate the public's right to appropriate redress, detailed some of the Price Waterhouse Proposals relating to reductions in auditor liability. These proposals, according to Mr. Connor, include a cap on liability. For example, in some countries, auditor liability is limited to a multiple of audit fees.

Mr. Connor also supported a move to proportional liability in order to alleviate the liability crisis. He indicated that auditors are often the only party left after a business failure, however, even if auditors fail in their responsibilities, they generally are not 100% at fault. Mr. Larson agreed that proportional liability may be appropriate for audits of some failed

businesses. If a true audit failure occurs, however, he believes that a limitation on auditor liability is not appropriate.

Mr. Connor also believes that the privity rule should be tightened. Some years ago, according to Mr. Connor, accountants were liable to persons who used the accountants' report, if the accountant was either in privity, or had a similarly close relationship with that person. He noted that, more recently, the privity standard has been broadened. Mr. Norr and Dean Burton questioned whether a tightening of the privity rule to those situations with a direct relationship between the auditor and user would be appropriate.

Mr. Flegm stated that he did believe that a plaintiff should have to establish reliance on the auditor's report in order to pursue a claim for damages. Mr. Connor also recommended that the British rule whereby losers pay legal costs be adopted. According to Mr. Connor, an expanded role for auditors will be possible only if the liability issue is resolved. Mr. Barrett suggested that tort reform is needed. Mr. Barrett also believes that the partnership concept may be outdated and should be reconsidered.