

dated 6/21/78

SECURITIES AND EXCHANGE COMMISSION

REPORT TO CONGRESS ON

THE ACCOUNTING PROFESSION AND THE
COMMISSION'S OVERSIGHT ROLE

July 1, 1978



OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

June 30, 1978

The Honorable Walter F. Mondale
President
United States Senate
Washington, D. C. 20510

Dear Mr. President:

I am pleased to transmit herewith the "Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role." The report consists of three parts:

- (1) The Commission's conclusions and expectations.
- (2) The staff's description and analysis of the profession's progress during the past year.
- (3) Documentary exhibits relevant to the foregoing.

This report, the first of its kind prepared by the Commission, fulfills a commitment which I made in testimony before the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs on June 13, 1977.

Sincerely,

A handwritten signature in black ink, appearing to read "Harold M. Williams", written over a horizontal line.

Harold M. Williams
Chairman



OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

June 30, 1978

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

Dear Mr. Speaker:

I am pleased to transmit herewith the "Report of the Securities and Exchange Commission on the Accounting Profession and the Commission's Oversight Role." The report consists of three parts:

- (1) The Commission's conclusions and expectations.
- (2) The staff's description and analysis of the profession's progress during the past year.
- (3) Documentary exhibits relevant to the foregoing.

This report, the first of its kind prepared by the Commission, fulfills a commitment which I made in testimony before the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs on June 13, 1977.

Sincerely,

A handwritten signature in black ink, appearing to read "Harold M. Williams", written over a horizontal line. The signature is stylized and includes a large loop on the left side.

Harold M. Williams
Chairman

TABLE OF CONTENTS

INTRODUCTION	1
INDEPENDENCE	8
. Introduction	8
. Audit Committees	10
. Scope of Services	12
REGULATION AND OVERSIGHT	15
. Introduction	15
. Peer Review	21
THE ACCOUNTING STANDARD-SETTING PROCESS	27
. Introduction	27
. Recommendations of the FAF Structure Committee	29
. FASB Conceptual Framework Project	30
. The Concepts of Uniformity, Preferability and Comparability	31
. Development of Accounting Standards for Small Businesses	32
. Accounting by Oil and Gas Producing Companies	33
. Accounting Matters Related to Particular Industries and the Accounting Standards Executive Committee	36

THE AUDITING STANDARD-SETTING PROCESS	38
. Introduction	38
. Assessment of Structure of AudSEC	40
. The Foreign Corrupt Practices Act of 1977	41
CONCLUSION	44

INTRODUCTION

During the past several years, public and Congressional attention has been focused to an unprecedented degree on the accounting profession and on its role in promoting public confidence in the integrity of financial reporting. The Federal securities laws, since their enactment in the aftermath of the economic crisis of the early 1930's, have authorized the Commission to require that independent accountants audit the financial statements of publicly-held corporations. Thus, those laws have placed upon the accountant unique and important responsibilities in facilitating the proper functioning of this nation's capital formation processes and, more broadly, of our economic system as a whole.

Further, the incidence of significant unexpected failures by major corporations and the disclosure of widespread questionable payments and illegal acts in the 1970's, among other events, have raised concerns about the integrity and credibility of financial controls and reporting of publicly-owned companies and, consequently, the role and responsibility of the accounting profession has come under

Careful scrutiny. A broad examination of the nature and structure of the accounting profession has resulted. That examination began in 1976 with the report of the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, chaired by Congressman John Moss. It was continued, a little over one year ago, by the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs ("Senate Subcommittee"), chaired by the late Senator Metcalf, which held public hearings ("Metcalf hearings") concerning the accounting profession. Those hearings were preceded by the staff report of the Senate Subcommittee and were followed by the Senate Subcommittee report issued in November 1977.

The Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce held public hearings in February and March, 1978 on the accounting profession's efforts to develop a self-regulatory program. Recently, the Chairman of that subcommittee, Congressman Moss, introduced legislation to create a self-regulatory organization for accountants patterned after the National Association of Securities Dealers ("NASD").

The responsibilities of the Senate Subcommittee have been transferred to a new subcommittee, chaired by Senator Thomas Eagleton. Senator Eagleton has informed Chairman Williams that, as Chairman of this subcommittee, he intends to continue the work begun under Senator Metcalf's direction and to expand it to include various other areas of concern. He concluded a recent letter to Chairman Williams by stating:

Appropriate committees of Congress have recently spent substantial time and effort developing sound public policies for improving the accountability of publicly-owned corporations and their auditors. We are serious about seeing them implemented. I look forward to working with the SEC toward meeting that objective in a timely manner.

The Metcalf hearings conveyed clearly a sense of expectation and urgency for the profession and the Commission to take action which will result in public confidence (i) in the independence of accountants, (ii) in the profession's resolve and ability to develop and maintain a viable system of self-regulation and self-discipline and (iii) in the processes by which accounting and auditing standards are promulgated. The hearings also conveyed a second message -- that many people in and out of Congress are critical of the

Commission for what it is, or is not, doing in the discharge of its oversight responsibilities with respect to the auditing and financial reporting of publicly-held companies.

The Commission undertook at the Metcalf hearings in June 1977 to report periodically to the Congress on the profession's response to the challenges which Congress and others had placed before it and on the Commission's own initiatives in this area. This document is the first such report.

The issues which the accounting profession is facing are numerous and complex. In order to give a comprehensive picture, the Commission has found it necessary to divide this report into three parts:

- . The Commission's conclusions concerning the profession's progress during the past year and its expectations concerning the objectives toward which the profession must work in the coming months.
- . The Commission staff's description and analysis of the profession's progress. The staff's presentation is divided into four specific topics -- independence, regulation and oversight, and the accounting and auditing standard-setting processes -- and two appendices. The staff report also contains an issues summary which for the convenience of the Senate Subcommittee is keyed to the recommendations in its report.
- . A volume of exhibits containing documentary material relevant to the staff's analysis.

The Commission has set forth in this overview report its conclusions concerning the profession's initiatives and its expectations concerning the objectives toward which the profession should be working. Because of the range and complexity of the issues facing accountants, the staff's description and analysis -- the section which comprises the body of this report -- is necessarily lengthy and detailed. The reader should recognize that the factual predicates for the Commission's conclusions are embodied in the staff description and analysis and that an understanding of that material is essential to a meaningful evaluation of the changes which are taking place in the accounting profession. Reference to the issues summary in the staff report will provide the reader with a condensed view of the developments during the past year and the staff's assessment of these developments, keyed to the recommendations of the Senate Subcommittee.

The central issue in the debate over the accounting profession's future is whether the profession should continue to be primarily and essentially self-disciplined and self-regulated or whether government should become more directly involved in its regulation

and in the setting of the accounting and auditing standards under which the profession operates. The report of the Senate Subcommittee indicated its belief that ". . . the existing framework of the accounting profession and the SEC should be given an opportunity to fulfill their pledges promptly." It further concluded that "self-initiated action by the private sector in cooperation with the SEC is the method of reform preferred . . ." Chairman Williams, in his testimony at both the Metcalf and Moss hearings, expressed the support of the Commission for this goal, indicating that the Commission would exercise an "active oversight" of the accounting profession.

During the past year, the American Institute of Certified Public Accountants ("AICPA") has taken certain initiatives. Specifically, in September, 1977, it created a new Division of CPA Firms ("Division") and, within that Division, an SEC Practice Section ("Section") which includes a Public Oversight Board ("Board"), composed of distinguished individuals from outside the profession. The Commission continues to believe that the potentially best approach to developing governance mechanisms to enable the profession to meet

the challenges facing accountants today and in the future is for the profession to remain under essentially private direction, but with active oversight from the Commission. The Commission is not wholly satisfied with the profession's efforts at self-regulation and it is too early to assess whether those efforts will prove effective over the long-run, but based on its review of events during the past year, the Commission believes that the profession's initiatives show sufficient promise to be permitted to continue to evolve. The Commission has not concluded, at the present time, that comprehensive direct governmental regulation would be a superior means of ensuring that accountants discharge their responsibilities with proper regard for the public interest.

As articulated in the staff report, the role of the Commission in overseeing the efforts of the private sector has been extensive and active during the past year. In that regard, the Commission has set forth below a synopsis of the profession's progress and of the objectives toward which it must work in assuring the independence of accountants, in establishing meaningful self-regulation and self-discipline and in improving the accounting and auditing standard-setting processes in the ensuing months.

INDEPENDENCE

Introduction

The critical importance of the concept of "independence" to the public accountant in his role as an auditor has been recognized for many decades. The Federal securities laws recognize this important concept in referring specifically to "independent public accountants" and in giving the Commission authority to define "independence". Independence is the essential attribute of the auditor. Absent independence, his skills and services are of little value.

In the view of many of its critics, the profession has lost sight of the importance of avoiding circumstances which reasonable people might believe likely to influence independence. This in turn is seen as endangering the role of the auditor and threatening the utility of his attest function.

The most obvious factor which erodes independence -- or, at least, its appearance -- is that the continued utilization of the auditor's services is largely dependent upon the company's management, the same group toward which the auditor is expected to be independent. The

ultimate test of independence is the amount of pressure that management can bring to bear on an auditor and the ability of the auditor to withstand that pressure.

In a fundamental sense, professionalism and independence are goals which can be addressed only by individual accountants in their day-to-day activities. Professional responsibility is not an attribute which can be mandated by rule or compelled by statute. There are, however, clearly some steps which accountants, as a body, can take to enhance the caliber of, and respect for, their profession. In considering such actions, the profession must work toward three major objectives: (i) prohibitions against relationships which may, in fact, jeopardize the auditors' objectivity and independence in performing the audit; (ii) avoidance of conduct which would depreciate the profession's credibility and respect in the eyes of the public; and, more broadly (iii) the encouragement of conduct, on the part of both accountants and managements, which will enhance the overall integrity and credibility of corporate financial reporting. While, in general, the implementation of these goals is a task highly appro-

appropriate to the profession, there are two issues -- establishment of independent audit committees and the scope of services which accountants should be permitted to perform for their audit clients -- which the staff's analysis appropriately highlights for immediate attention.

Audit Committees

The formation by public companies of audit committees composed of independent directors is one of the keys to strengthening auditor independence. In companies where the auditors report to an independent audit committee, a potentially important buffer is provided to insulate accountants from inordinate management pressures and to strengthen the auditor in his relationship with management -- and hence his independence.

At the Commission's suggestion, the New York Stock Exchange recently adopted a requirement that listed companies have an audit committee which meets certain specified criteria by June 30, 1978 and the NASD is currently considering a rule proposal in this area. In addition, the AICPA has formed a special committee to study whether and in what form the AICPA should promulgate a standard which would require that an audit committee be established as a condition to an independent accountant's accepting an audit engagement. While the

Commission recognizes that there are legitimate questions to be considered concerning whether the profession is the proper instrument for accomplishing this end, it believes that the profession can and should establish appropriate requirements in this important area. This initiative of the AICPA will contribute to the resolution of these questions. In view of the critical importance of independence to the profession, the Commission believes that the profession itself should take whatever actions are available to it to ensure its independence. Therefore, should the profession conclude that an audit committee requirement is beyond its capability, the burden is on it to so demonstrate. Should the initiative not be effective or sufficiently timely, the Commission has the authority to mandate audit committees in appropriate circumstances, and is prepared to do so.

The priority to be given this issue is high and the time frame for resolution is short. Audit committees which meet appropriate criteria appear to be central to addressing many independence related matters and of significant value in determining the approach to other issues.

Scope of Services

Another important issue requiring immediate attention is the question of the appropriate range of services -- other than the performance of the audit itself -- which accounting firms should be permitted to offer to their audit clients. This issue is exceedingly complex and, except in general terms, the objectives which limitations on the scope of auditors' services should meet have not yet been fully articulated.

In considering this issue, it will be necessary to resolve three basic questions:

- . Are there situations in which the magnitude of the potential fees from management advisory services are so large as to affect adversely an auditor's objectivity in conducting an audit?
- . Are there some services which are so unrelated to the normal expertise and experience of auditors that it is inconsistent with the concept of being an auditing professional for auditors to perform those services?
- . Are there, conversely, some services so closely linked to the accounting function that, for the auditor to perform those services for his client means that, the auditor will, in conducting the audit, be in a position of reviewing his own work?

A further consideration underlying these overall issues is whether a prohibition against auditors performing certain services for their audit clients will have

a disproportionately adverse effect on smaller companies and smaller accounting firms.

In Securities Act Release No. 5869, issued in September 1977, the Commission requested public comments on whether the non-audit services offered by accounting firms affect the fact or appearance of independence of accountants and, accordingly, should be prohibited for their audit clients.

Commentators who opposed proscribing non-audit services stated that there are benefits from having such services performed by the auditors who have an in depth familiarity with the client's business and accounting operations and that there is no evidence that providing such services impairs their independence. Commentators who supported proscription of certain non-audit services stated that performing certain of these services (e.g. actuarial services) result in accountants auditing their own work, that some may result in conflicts of interest (e.g. executive recruiting), and that performing such services may result in an impairment of independence in fact and in appearance.

While that request for comments was outstanding, the SEC Practice Section of the AICPA Division of

CPA Firms proposed to establish a membership requirement that would prohibit member firms from performing services which impair their independence or are not accounting or auditing related. However, the services that cannot be offered are defined in a manner which caused the Commission staff to question the adequacy and scope of the prohibition. After extensive discussions with the staff as to what management advisory services should be performed for clients by independent auditors, the AICPA has requested the advice of the Public Oversight Board on the matter. The Board has indicated that it is considering holding public hearings on the issue this summer. The Commission believes that the Board should be given an opportunity to add its views to the deliberative process.

Securities Act Release No. 5869 also proposed rules which would have required disclosure of, among other things, the services provided by a company's independent auditor and the related fees. In June 1978, the Commission adopted a rule requiring disclosure of the nature of services rendered by auditors to their audit clients, the percentage relationship of the fees for the non-audit services rendered expressed as a percentage of the audit fee and a state-

ment of whether an audit committee, or in the absence of an audit committee, the board of directors had approved all services provided by auditors, giving appropriate consideration to their effect on auditor independence.

REGULATION AND OVERSIGHT

Introduction

As mentioned above, in September 1977, the AICPA created a new Division of CPA Firms and, within that Division, an SEC Practice Section. The Section is intended to serve as the primary vehicle for professional self-regulation. As set forth below, both the structure and the operations of the Section contain important limitations. Nonetheless, the Commission regards the Section's creation as a major accomplishment and as a potentially viable foundation for a meaningful program of self-regulation. Indeed, it is the establishment of the Section which forms the primary basis for the Commission's conclusion that there is promise for successful voluntary self-regulation. Therefore, the Commission believes that it would be inappropriate for the Commission to recommend legislation designed to impose comprehensive direct governmental regulation of the accounting profession at this time.

The Commission believes that the self-regulatory structure must meet three objectives to be effective. First, because the regulation of the practice of public accountancy and the responsibility for formulation of accounting and auditing standards are so thoroughly involved with the public interest, they should not be left exclusively to those engaged in the profession. Second, because the environment within which the profession practices is continually changing, 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. Third, the self-regulatory structure must be firm, timely, even-handed and fair in both its administration and its disciplinary procedures.

As noted, the establishment of the Section was a significant accomplishment and one for which the profession deserves substantial credit. There are, however, several factors which may threaten the Section's ability to meet these objectives.

The first uncertainty which may impair the Section's achievement is the effectiveness of the Public Oversight

Board. Although the Board is capable of bringing a broad public perspective to the Section's work, the AICPA has not afforded the Board -- nor has the Board sought -- any direct authority over the activities of the Section. Instead, the Section's Executive Committee, comprised of practicing members of the profession, has formal control over the Section. The Commission is not prepared to conclude that this lack of "line" authority will necessarily be fatal to the Board's effectiveness. However, if, the Section is not responsive to the Board's recommendations, the Commission will be forced to conclude that the self-regulatory effort should be modified or terminated.

The competence, commitment, dedication and independence of the Board will determine its effectiveness as an overseer of the program. The Board members must devote sufficient time and must have adequate funds and staff at their disposal to perform their functions and responsibilities. They must be actively involved in the disciplinary process of the program. Similarly, the Board must be actively involved in overseeing the peer review process and its results. Finally, the Board must communicate in an open and effective manner with the profession, the

public and, of course, the Commission so that the Commission can, in turn, fulfill its own oversight responsibilities.

The AICPA has apparently experienced difficulty in filling the Board membership -- perhaps because of the magnitude of the responsibility involved -- and, accordingly, the Board has been slow in beginning its work. Despite this fact, the Board has been very active during the past few months.

Another uncertainty is that, while membership in the Section in concept is voluntary, it is clear that if the program is to be successful it should embrace all accounting firms auditing publicly-owned companies. Virtually all of the larger accounting firms have become members and the AICPA anticipates that firms who have not joined will do so. As a practical matter audit committees and investment bankers will probably exert pressure on auditors to be members of the Section to assure themselves that they have adequately fulfilled their responsibilities. Closely associated with the voluntary aspect of this program is the uncertainty over the Section's disciplinary mechanism. The Section's sanctioning power

is still untested, and thus its timeliness, fairness, evenhandedness, and effectiveness remain to be demonstrated. Questions have been raised concerning whether the disciplinary mechanisms of a voluntary organization -- regardless of the quality of those mechanisms -- can be effective. However, should a firm's membership in the Section be suspended or revoked or should a firm elect to withdraw from the Section, the Commission would make its own independent inquiry and take whatever action appeared appropriate, if any. This practical reality could "lend" sufficient authority to the organization to make it effective.

A corollary issue which the Peer Review and Executive Committees of the Section and the Board are studying is whether the Section should proceed with disciplinary action, through the conduct of special peer reviews and sanctions following a particular audit failure, even though litigation is involved or threatened. The program as contemplated presently permits excluding these cases from the examination. The Commission recognizes the complexities of this issue, but believes that some approach must be found to deal with such situations.

The Commission's support of the profession's self-regulatory efforts is premised on representations by the AICPA that it can, in fact, institute viable self-regulation. The procedures followed by the AICPA in establishing the Section have been challenged in a pending law suit instituted by certain members of the AICPA, and questions have also been raised as to the applicability of the anti-trust laws to the activities of the Section. These challenges are as yet unresolved. The Commission will evaluate future developments in determining the need to take appropriate action, including consideration of alternative forms of regulation or legislation.

Alternative forms of regulation or legislation which could be considered include (i) an expansion of present Commission activities, including an increase in the scope, nature and depth of its review of financial statements filed with it and an expansion of its investigative activities with respect to accountants; (ii) registration of accountants practicing before the Commission, including a requirement for peer review; and (iii) the

creation of a comprehensive self-regulatory body. If the profession's present self-regulation efforts fail, then the Commission will need to understand the underlying reasons for the failure before recommending an appropriate alternative approach. It is difficult to determine currently what that approach, if needed, should be.

As an issue somewhat related to regulation and oversight, questions have also been raised as to whether private rights of action under the Federal securities laws should be expanded, and whether the liability of accountants in such private actions should be limited. These are broad, important issues of legislative policy, and accountants represent only one category of persons affected by them. These issues, which are under separate consideration, are therefore not addressed in this report.

Peer Review

In the Commission's view, the single most important element in the AICPA's self-regulatory initiative is the proposed peer review program. The underlying concept of peer review is to provide a regular examination and eval-

uation of the work of each accounting firm which audits publicly-held clients in order to assess whether that firm's work conforms to the high standards expected of those who assume the responsibilities of independent accountants under the Federal securities laws. To be successful, the peer review program must satisfy three objectives. First, it must incorporate and apply meaningful standards of quality control to both the work of the reviewers and of the reviewed firm. Second, it must be structured in such a manner as to assure independence in fact and to promote public confidence in the credibility of the peer review process. Third, the peer review process must be sufficiently open to examination by both the Board and the Commission so that each may discharge its oversight responsibilities.

The Commission recognizes that the establishment of a meaningful peer review program entails a host of organizational, conceptual, and legal problems. The profession's deliberations to date concerning the structure of the peer review system leave open several key questions which must be satisfactorily resolved if the program is to meet the objectives articulated above.

First, effective Board oversight of the peer review process requires that the Board have an adequate opportunity to observe peer reviews in the field as well as to review both the overall program and specific findings. Correspondingly, the Commission must have sufficient access to the process to permit it to make an objective evaluation of its adequacy. The proposed structure of the peer review program contemplates that only the Board would be accorded access to certain information. Other persons would be accorded access only as required by law. While the Commission can depend on the Board's supervision of the peer review process to a great degree, clearly it would not be possible for the Commission to arrive at an independent judgment as to the adequacy of the program without the opportunity to sample the quality of the process and the Board's supervision.

Second, the profession is considering whether a peer review program in which one accounting firm is in the position of reviewing the work of another firm can achieve the objectivity and credibility the profession is seeking. Reliance on that concept would

clearly require that certain corresponding safeguards be instituted. Such a review process would benefit from the efficiencies of utilizing the resources of a single firm in performing the peer review. But, if firm-on-firm review is to be credible and acceptable, the performance review panel should determine the acceptability of the reviewing firm, take steps to satisfy itself as to the quality of the review, and issue its own final report without merely expressing reliance on a report prepared by the firm engaged to perform the review. Stated differently, the performance review panel report ideally should be based on its own independent evaluation of the materials developed in the peer review process and the firm conducting the review should be limited to a "staffing" function.

Third, credibility of the peer review program depends on affording the public access to the results of the process. The Commission believes that the peer review process cannot attain the desired degree of credibility if the "letter of recommendations" setting forth the reviewers' recommendations and suggestions for improvement in the reviewed firm's

system and the reviewed firm's response thereto are not available to the public.

Finally, the peer review process must not be arbitrarily restricted in scope. Among possible limitations on the scope of reviews which have been discussed are the exclusion of cases in litigation and the exclusion of engagements at the request of either the reviewed firm or its client. While valid reasons may exist for certain limitations, the ultimate decision to exclude these engagements should rest with the reviewers, under Board oversight, and should depend on whether they are satisfied that the reviewed firm's personnel and the procedures utilized in those engagements can be adequately examined in other ways.

Another important question bearing on the scope of peer reviews is the extent to which work performed outside of the United States should be encompassed. Where American investors are asked to rely on an audit report based upon work performed overseas, they are entitled to expect, and should receive, the same level of professionalism and judgment in both the foreign and the domestic phases of the audit. While recognizing that there may be legal

and other difficulties unique to peer reviews performed outside of this country that will not be easily resolved, the Commission has urged the Board to address this need to satisfy itself as to the quality of engagements performed outside the United States. Although a task force to consider this has been formed by the AICPA, this issue is extremely complex and an early resolution is not expected.

John McCloy, Chairman of the Public Oversight Board, wrote Chairman Williams on June 16, 1978 indicating that specific revisions of the proposed peer review program are under study and will be submitted to the Executive Committee for action in July 1978. In that letter, John McCloy further stated that he is rather confident that some definitive solutions can be reached on questions regarding "selection of reviewing firms, functions of the performance review panel, peer review papers to be made public and those to be made available for review by the Commission." The Commission recognizes that each problem area entails difficult and sensitive issues. Nonetheless, the Board and the Executive Committee must realize that a self-regulatory effort

which fails to incorporate a system of peer review which meets the objectives described above would compel the Commission to withdraw its support for the profession's program.

THE ACCOUNTING STANDARD-SETTING PROCESS

Introduction

The roles of the Financial Accounting Standards Board ("FASB") and the Commission in the process of promulgating accounting and disclosure standards have received an increasing amount of attention from both government and the business community. The primary question is where the initiative belongs for establishing and improving accounting standards -- in the private sector or the public sector. In connection with this basic issue, observers have raised other questions concerning the timeliness, openness, structure and effectiveness of the FASB in setting accounting standards, whether public and non-public companies should be governed by the same set of accounting and disclosure standards, how standards can be developed to achieve uniformity and comparability in financial

statements for similar facts and circumstances and how accountants can determine the circumstances under which one particular accounting principle is more appropriate to use than an alternative accounting principle.

The Commission, since Accounting Series Release No. 4 was issued in 1938, has believed that the initiative for establishing and improving accounting standards belongs in the private sector, subject to Commission oversight, principally because of the private sector's greater resources, its expertise, its ability to detect emerging accounting problems at an earlier stage and because its standards can be applicable to all companies whether or not publicly-owned. The Commission continues to believe that the initiative for standard-setting belongs in the private sector. In that regard, the Commission believes that the performance of the FASB generally has been satisfactory and that it has been responsive to recommendations for improvement in its performance and procedures. The Commission's primary role should remain one of oversight, to ensure that

the private sector addresses the challenges facing it in a manner which meets the objectives of self-governance and harmonizes with the Commission's responsibilities under the Federal securities laws, including the setting of accounting standards.

This relationship of the FASB and the Commission has worked reasonably well. A part of that relationship is the ability of the Commission to request the FASB to consider adopting standards in particular areas, as the Commission did when the appropriate accounting for the gain or loss on early extinguishment of debt was at issue.

Recommendations of the FAF Structure Committee

In December 1976 the Board of Trustees of the Financial Accounting Foundation ("FAF") established a Structure Committee to review comprehensively the FASB and the Financial Accounting Standards Advisory Council ("FASAC"). In April 1977, the Structure Committee issued its recommendations which included opening all aspects of the FASB to public view, increasing involvement in the FASB from all segments of its broad constituency, strengthening the organization

of the FASB and accelerating its work pace, establishing planning goals, issuing documents explaining proposed standards in layman's language before public hearings are held, systematically reviewing existing standards, and broadening the base of FASB financial support.

The FASB has taken expeditious action to implement the Committee's recommendations. The structural changes have created a greater degree of openness and effectiveness in the process of setting accounting standards.

FASB Conceptual Framework Project

The Commission supports the efforts of the FASB to establish a conceptual framework for financial reporting of profit-making enterprises. Accountants must give serious and careful thought to the theoretical underpinnings of financial reporting. The FASB project to develop a conceptual framework from which to address emerging accounting problems is possibly the most important matter confronting the profession in the area of financial reporting. A conceptual framework would also provide for increased comparability of the information contained in financial statements and foster consistency of treatment of similar facts or transactions, thereby adding credence to financial reporting.

The FASB is actively moving forward on the development of a conceptual framework. It issued an exposure draft in late 1977 on "Objectives of Financial Reporting" and held a public hearing in early 1978 on the measurement issues involved in such a framework. It is expected that final statements concerning objectives and elements of financial statements will be issued in 1978. The FASB hopes to issue an exposure draft dealing with alternative forms of supplemental disclosures of the effects of changing prices on business enterprises in the fourth quarter of 1978, with a final statement to be adopted in 1979.

In addition, the FASB has recently issued a discussion memorandum concerning the objectives of financial reporting for nonbusiness organizations.

The Concepts of Uniformity, Preferability
and Comparability

The thrust of the conceptual framework project supports the concepts of uniformity and comparability. The current exposure draft on objectives of financial reporting calls for comparability of financial reporting among enterprises. The work product of the FASB demonstrates adherence to the concept of comparability as a major goal of standard setting.

The Commission has traditionally supported the concepts of preferability and comparability and

currently requires companies which file reports with it pursuant to the Securities Exchange Act of 1934 to file a letter from their independent accountants discussing the preferability of any change in accounting principles made by the company. The Commission's requirements are designed to prevent arbitrary changes in accounting methods and to discourage shifts in accountants simply to obtain approval of an alternative accounting approach. When the FASB determines that a particular accounting standard is preferable for a given set of circumstances, the use of alternatives in that area will cease since only one method will be adopted as the standard.

Development of Accounting Standards for Small Businesses

The FASB has taken substantive steps in addressing the financial reporting problems of small businesses and small accounting practitioners. A Small Business Advisory Council has been established as a permanent committee of FASAC, to be responsive to the needs of small businesses and practitioners in the standard-setting process. The FASB has also added a project to its technical agenda to consider establishing

guidelines for distinguishing between information that all enterprises should disclose and information that only certain enterprises (e.g. large businesses) should disclose.

The Commission has also taken steps to recognize the disclosure problems of small companies. It has just concluded public hearings concerning the effects of its rules and regulations on the ability of small businesses to raise capital and the impact on small business of the disclosure requirements of the Federal securities laws. The comments received at these hearings are now being reviewed and analyzed to determine what actions, if any, should be taken.

Accounting by Oil and Gas Producing Companies

In 1975 Congress enacted the Energy Policy and Conservation Act ("EPCA"), which, for purposes of developing a reliable energy data base, required the Commission to assure the development and observance of accounting practices for oil and gas producers.

In response to Congressional consideration of the issue of accounting for oil and gas producers, the FASB undertook a project to develop financial

accounting standards for this industry and on December 6, 1977, issued Statement of Financial Accounting Standards No. 19 ("FAS No. 19") prescribing a single accounting method for all companies engaged in oil and gas producing activities by requiring a form of "successful efforts" accounting for exploration and development costs.

The Commission closely followed the deliberations of the FASB and, after the FASB issued its tentative conclusions in July 1977, the Commission proposed rules which essentially reflected the FASB's conclusions. The Commission took action in proposing rules for public comment to assure itself that it could meet the provisions of the EPCA that the accounting practices it required be developed by December 1977 unless the FASB promulgated practices by that date. With the issuance of FAS No. 19 in December 1977 the Commission was able to extend this statutory deadline to determine whether it should rely on the FASB's determinations.

In addition, the Commission proposed rules in 1977 to supplement the disclosures in financial statements prescribed by the FASB with the presentation

of information on the present value of future net revenue from estimated production of proved oil and gas reserves. This proposal represented a continuation of the Commission's efforts to achieve reporting of current economic information to assist investors in understanding the effects of changing economic conditions and followed a year-long joint effort between the Commission and the industry.

Following issuance of FAS No. 19, the Commission announced that it would solicit further public comment on the issues and, as contemplated by the EPCA, undertake an independent assessment of the FASB's determinations. After receiving written comments and conducting extensive public hearings on this matter the Commission and its staff are now in the process of analyzing the complex issues involved in this proceeding. The results of these deliberations will be published in the near future. The Commission's proceeding on this issue reflects circumstances unique to the oil and gas industry, primarily the legislative requirements of the EPCA, and is thus distinguishable from the usual Commission oversight relationship with the FASB.

Accounting Matters Related to Particular Industries
and the Accounting Standards Executive Committee

The Commission recognizes that the issues on the current technical agenda of the FASB all have a high priority and have an impact on the resources available to address other issues. The Commission has been satisfied in most respects with the technical agenda and work product of the FASB during the past year, but notes that resources have not been available for the development of an effective mechanism for addressing matters unique to particular industries on a timely basis. Closely associated with this issue is the role of the Accounting Standards Executive Committee of the AICPA ("AcSEC") in the setting of accounting standards. AcSEC, the senior technical committee of the AICPA with respect to financial accounting and reporting matters, has, as its principal function, the issuance of Statements of Position ("SOPs") concerning financial accounting and reporting in specialized areas or industries. SOP's are issued as recommendations to the FASB, and represent the considered judgment of the accounting profession as to the pre-

ferable method of accounting on narrow issues and in particular industries.

Establishment by the FASB of a mechanism for dealing with particular industry matters probably would require a significant increase in the use of outside research resources and some increase in its own staff since the required industry expertise might not be readily available and the efforts of the FASB and its staff are currently being devoted to broader issues such as the establishment of a conceptual framework. Until such time as the FASB undertakes a program in this area, accounting practices set forth in SOPs will be considered to be preferable accounting, unless the FASB or the Commission has taken other action. Therefore, AcSEC should take steps to ensure that there is adequate representation in its task forces and subcommittees from all elements of the private sector including preparers and users of financial statements.

It is necessary to be realistic as to how quickly accepted accounting alternatives for similar facts and circumstances concerning particular accounting matters and particular industries can be eliminated. Establish-

ment of a framework of accounting standards applicable to all industries is a project of major proportions. As a long-run objective, it is a goal that the standard-setting bodies must strive to achieve. Until such a framework is established, interim refinements to current reporting practices are and will continue to be necessary.

THE AUDITING STANDARD-SETTING PROCESS

Introduction

One of the most important initiatives regarding auditor professionalism culminated in March 1978, in the issuance of the final report of the Commission on Auditors' Responsibilities ("Cohen Commission"). The Cohen Commission's final report included a broad range of conclusions and recommendations aimed at improving accountability and the audit function. The AICPA has responded to that report by assigning virtually all of the issues identified by the Cohen Commission to various existing or newly established committees with responsibility for particular matters raised in the report.

The Commission generally endorses the recommendations in the Cohen Commission report. A few of the Cohen Commission recommendations have already been addressed

by the profession, others are well on their way to being implemented and still others are in the early stages of consideration. The progress to date has been satisfactory.

Consideration of these issues has fallen principally to the Auditing Standards Executive Committee ("AudSEC"), the AICPA's senior technical committee with traditional responsibility for establishing auditing standards and for most other auditing matters. Although at times the Commission has had disagreements (which were eventually resolved) on whether AudSEC dealt adequately with particular matters, in general, the Commission has been satisfied with the final work product of that committee. In recent years, the Commission has authorized the issuance of letters of comment to AudSEC on such matters as "The Independent Auditor's Responsibility for the Detection of Errors or Irregularities", "Illegal Acts by Clients", and the "Auditor's Report When There Are Contingencies". In addition, the Commission has exercised its oversight role where it believed that the private sector was not developing appropriate auditing standards and procedures in a timely manner. For example, in Accounting Series Release No. 177, the

Commission indicated its intention to finalize proposed rules relating to standards and procedures to be followed by independent accountants in the review of interim financial data unless the accounting profession adopted acceptable rules of its own prior to a specified date. AudSEC subsequently adopted procedures concerning the involvement of auditors with interim financial data closely paralleling those proposed by the Commission.

Assessment of Structure of AudSEC

One of the principal issues identified by the Cohen Commission related to the structure of AudSEC itself. In response to the recommendations of the Cohen Commission and the concerns of various persons, the AICPA formed a special committee to evaluate and propose recommendations concerning the structure of AudSEC. At its May 1978 meeting the AICPA Council adopted the recommendations of the special committee, with certain modifications, but rejected the proposal of the Cohen Commission that a full-time paid body be established.

The special committee recommended that AudSEC be reduced to fifteen members; that membership be open to any AICPA member, whether or not currently engaged in auditing practice; that one member be designated as a research director; that task forces provide for inclusion of non-AICPA members; and that an advisory council be established which would issue an annual public report on the activities of AudSEC.

At the Metcalf hearings, the Commission supported a small, full-time, appropriately staffed board to streamline the standard-setting process and lend enhanced credibility through the involvement of persons from outside the profession. Although the Commission does not necessarily agree with the committee's conclusion to reject a full-time board, their reasons have merit and the newly adopted structure appears to have enough of the attributes necessary to provide the process with the enhanced objectivity it needs. The new auditing standards board will need to demonstrate that it can perform effectively.

The Foreign Corrupt Practices Act of 1977

On December 19, 1977, the Foreign Corrupt Practices Act was signed into law, and its requirements became

effective upon signing. Along with prohibiting companies from engaging in certain corrupt practices with respect to foreign officials, the Act amends Section 13(b) of the Securities Exchange Act of 1934 to require reporting companies to make and keep accurate books and records and to establish and maintain a system of internal accounting controls which meet certain objectives.

Although rules have not yet been proposed, the Commission is likely to require, in reports filed with it, a representation that an issuer's system of internal accounting controls is in compliance with the provisions of the Act. This could be accomplished through a representation from management that the issuer's system of internal accounting controls meets the objectives set out in the Act, together with an opinion of the independent public accountant as to management's representation or through an opinion, similar to management's representation described above, from the issuer's independent public accountant. In addition to the Commission's considerations, the AICPA has formed a task force to study the issues related to such reports.

It can be expected that managements of many issuers will look to their independent accountants for guidance concerning their systems of internal accounting control. The AICPA has formed an advisory committee, consisting primarily of financial executives and internal auditors, to recommend objective criteria against which to measure such systems. Although the existence or non-existence of such criteria does not affect the requirement that the issuer comply with the Act, the criteria are expected to be helpful in assuring compliance with the objectives of the Act. The Commission is monitoring these efforts.

Finally, the Commission has pending rule proposals which would supplement certain of the provisions of the Act. These rules, if adopted, would make it unlawful for any person to falsify corporate books and records and for any officer, director, or shareholder of a publicly-owned company to mislead an accountant in connection with his examination of corporate financial statements. The Commission intends to act on its rule proposals -- which predate the Act's enactment -- in the manner best suited to furthering the Act's objectives.

CONCLUSION

The Commission has concluded that the progress during the past year has been sufficient to merit continued opportunity for the profession to pursue its efforts at self-regulation. Consequently, the Commission cannot responsibly recommend legislation to supersede or control self-regulation of accountants at this time. It is too early to reach any definite conclusions with respect to possible future legislation. If, for example, the profession's initiative is not successful, a legislative alternative may well be required. If, on the other hand, the profession's program develops in a generally satisfactory manner, as we hope it will, consideration should be given to any need for legislation for the purpose of providing a more adequate legal foundation for the structure, or to confirm its place in the regulatory system. We are not at this time, however, 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.

The Commission is aware that Congressman Moss very recently has introduced legislation which would create a comprehensive, statutory self-regulatory scheme for accountants. Although, based on the conclusions set forth herein, the Commission cannot support the enactment of such legislation at this time, it will provide comments on the bill. Because of the importance of the subject matter, the Commission has a special responsibility to ensure that Congress has the benefit of the full range of both its technical and policy views concerning any possible legislation in this area.

During the past year, the Commission has worked with the accounting profession to define the objectives of the self-regulatory program, to assure that the profession's proposed implementation is consistent with those objectives, and to suggest ways in which to achieve the objectives without imposing specific methods. As described in the staff report, the Commission has monitored the profession's efforts in this area closely. In addition, the Commission has been active during the past year in overseeing the profession's initiatives concerning the indepen-

dence of auditors and the accounting and auditing standard-setting processes. While the Commission does not believe that it is necessary to catalogue all of its initiatives, it has been instrumental in maintaining the momentum for progress in such areas as audit committees, scope of services performed by auditors, and the work of the FASB and of the AICPA. The Commission has criticized the profession where necessary, complimented it when deserved, and in general, has offered its views and insights concerning the self-regulation effort on which the profession has embarked.

It is crucial, however, that accountants understand that this report is not in any sense the termination of the process begun by Senator Metcalf's Subcommittee, Congressman Moss' Subcommittee, and others who have directed attention to the profession. On the contrary, the process of demonstrating that accountants themselves rather than government should (i) retain primary authority to regulate their profession, (ii) ensure and instill confidence in their 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 commitment for many years to come. If the profession or the Commission lose sight of these objectives, the public generally and accountants specifically will, in the long run, be the losers.