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**News
Release**

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SECURITIES AND EXCHANGE COMMISSION
AT THE 1988 FIFTEENTH ANNUAL
AICPA NATIONAL CONFERENCE

CONCERNING THE COMMISSION'S FULL DISCLOSURE PROGRAM
AND THE ACCOUNTING PROFESSION --
CURRENT ISSUES AND ONGOING IMPROVEMENTS

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THE COMMISSION'S FULL DISCLOSURE PROGRAM
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I. Introduction

It is a pleasure to address a group dedicated to the principle of full financial disclosure. The importance of financial disclosure was recognized at the time the Securities Act of 1933 was enacted; its significance continues under our current integrated disclosure system. My remarks today will focus on the accountant's role in disclosure, on current proposals for enhancement of that role, and on current challenges for the financial disclosure system.

The disclosure system administered by the Securities and Exchange Commission is essential to healthy and strong capital markets. In particular, accurate and complete financial information enables investors to evaluate past performance and to form reasonable judgments about future performance. As you know, full financial disclosure includes not only the contents of financial statements, 1/ but other components as well. For example, the narrative information contained in management's discussion and analysis 2/ is important for evaluating and comparing company performance.

1/ See Subpart 300 of Regulation S-K, 17 CFR 229.300.

2/ See Item 303 of Regulation S-K, 17 CFR 229.303.

II. The Accountant's Role

Concern with financial disclosures inevitably leads to focus on the accuracy, completeness, and presentation of the information disclosed. Here, the accountant occupies center stage. Within the company, the accountant supervises the recording of financial data and the initial preparation of financial statements. Both inside accountants and external auditors bear responsibility for accuracy and presentation of financial information. Finally, the certification process tells the public at large that a responsible, independent third party has reviewed the data presented and tested its accuracy. 3/

As the agency charged with the responsibility to oversee the accuracy and completeness of financial disclosure, the Commission has also accepted responsibility for oversight of the accounting profession. Happily, over the years the Commission has been able to do so by recognizing the guiding principle of private sector standard setting. It is the private accounting profession, acting with Commission guidance, that assures the integrity and credibility of the disclosure system.

Integrity and credibility arise first from the quality of the accounting standards used to develop financial

3/ Rules concerning the qualifications and reports of auditors are set forth in Article 2 of Regulation S-X, 17 CFR 210.2-01 et seq.

information. The Commission applauds the development of quality accounting standards by the Financial Accounting Standards Board, and we will continue our partnership with the private sector in setting accounting standards. 4/ Although the Commission has its own accounting rules, contained in Regulation S-X, 5/ the primary functions of these rules are to supplement FASB standards and sometimes to serve as interim guidance.

A second important key to the integrity and credibility of financial reporting is auditor examination of financial information under auditing standards set by the American Institute of Certified Public Accountants. Objective testing of compliance with accounting and disclosure standards is essential if disclosures are to be reliable, and perceived as reliable.

The quality and honesty of the auditors themselves are also essential. The accounting profession must maintain the high ethical standards expected by those who rely on the accountant's work. This expectation was forcefully articulated by the Supreme Court in 1984, in Arthur Young v. the United

4/ The Commission has long supported the FASB's efforts. See, e.g., Accounting Series Release No. 150 (December 20, 1973); Securities and Exchange Commission Fifty-Second Annual Report to Congress 22 (1986).

5/ 17 CFR 210.

States, when it stated that "the independent auditor assumes a public responsibility transcending any employment relationship with the client." 6/ This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. 7/

III. Oversight of the FASB and the AICPA

The key to the Commission's confidence in the accounting profession lies in its cooperation with the FASB and the AICPA. These two private sector organizations play crucial roles in meeting financial disclosure objectives. Each in turn reflects the feasibility of private sector standard setting.

A good example of our relationship with the FASB is that organization's current effort to develop better accounting standards for new financial instruments and related transactions. It is increasingly common today to read about exotic new types of securities in the financial press. The financial markets are trading repurchase and reverse repurchase agreements, 8/ collateralized mortgage obligations and other asset backed

6/ 465 U.S. 805, 817 (1984).

7/ Id. at 818.

8/ Also known as "repos" and "reverse repos."

securities, financial guarantees, interest rate swaps, common stocks with put features, loan strips, and other novel instruments.

The emergence of many significant questions about appropriate accounting treatment of financial instruments ultimately led the Commission in June 1985 to direct its Chief Accountant to ask the FASB to consider disclosure policies regarding financial instruments and related transactions. The FASB responded by establishing a project on accounting for financial instruments and, just a month ago, issued an exposure draft. 9/ The draft calls for increased disclosures about all financial instruments, whether they are recognized in an entity's financial statements or carried "off-book." The proposals would require information about future cash flows, interest rates, market values, and risk exposures. These proposed disclosures represent an initial step in a major FASB project that could have broad implications across industry lines for the measurement and recognition of complicated transactions and instruments.

The Commission's relationship with the AICPA includes its oversight of auditing standard setting by the AICPA's Auditing Standards Board. Over the years, the Commission staff has

9/ Proposed Statement of Financial Accounting Standards, Disclosures about Financial Instruments (November 30, 1987).

encouraged and monitored the Board's efforts to provide additional guidance to auditors, and to improve communications among auditors, registrants, and the auditor's true client, the public. This year, a group of new standards, part of the ASB's so-called "expectation gap" project, are expected to be finalized. 10/ The project is designed to explain more clearly to the investing public the auditors' areas of responsibility and to expand upon those areas in response to public comment.

Examples of proposals from the "expectation gap" project include, among other things: a proposal to make the standard auditor's report more explicit and to remove overly technical language; a proposal to clarify the auditor's responsibility to detect and report financial fraud; and a proposal to require auditors to consider in each audit the question whether the entity will continue to exist.

10/ In February 1987, the Auditing Standards Board published for comment exposure drafts of ten auditing standards: (1) The Auditor's Responsibility to Detect and Report Errors and Irregularities; (2) Illegal Acts by Clients; (3) The Auditor's Consideration of an Entity's Ability to Continue in Existence; (4) The Auditor's Responsibility for Assessing Control Risk; (5) Analytical Procedures; (6) The Communication of Control-Structure Related Matters Noted in an Audit; (7) Communication with Audit Committees or Others With Equivalent Authority and Responsibility; (8) The Auditor's Standard Report; (9) Auditing Accounting Estimates; and (10) Examination of Management's Discussion and Analysis.

Standards alone, however, will not meet the public's expectations. Rather, it is the performance of individual auditors and accounting firms in adhering to professional standards -- by insisting that clients prepare accurate financial statements -- that will ultimately shape the public's perception of whether accountants are adequately performing their "public watchdog" functions.

IV. Commission Rule-Making and Private Sector Initiatives

The role of the accountant in enhancing the full disclosure system is currently subject to both Commission and private sector initiatives. The Commission is currently considering three rule-making proposals that, if adopted, would directly affect the accounting profession. These proposals concern mandatory peer review, opinion shopping, and the Commission's Rule 2(e). In addition, the Report of the National Commission on Fraudulent Financial Reporting (the Treadway Commission) contains many thoughtful recommendations concerning the profession.

Mandatory Peer Review

The Commission's mandatory peer review proposal, if adopted, would require an independent assessment of auditing quality control systems, including a judgment regarding the system's protections against inferior audits. 11/

11/ Securities Act Release No. 6695 (April 1, 1987) [52 FR 11665].

The Commission staff is currently preparing a recommendation regarding peer review, which the Commission expects to consider early this year. Peer review is an extremely important concept, and although I believe the present program conducted by the AICPA's SEC Practice Section has helped to improve the quality controls of its member firms, much remains to be accomplished in the peer review area.

Opinion Shopping

A second proposed Commission rule, if adopted, would increase disclosures concerning changes in accountants and possible "opinion shopping" situations. 12/ The term "opinion shopping" is not defined in either the accounting or auditing literature. Nevertheless, it is generally understood to involve the search for an auditor willing to support a proposed accounting treatment designed to help a company achieve its reporting objectives even though that treatment might frustrate accurate reporting. 13/

If the perception exists that an auditor's opinion can be influenced by competitive "business-getting" pressures, great doubt will be cast over these opinions, regardless of the individual circumstances surrounding them.

12/ Securities Act Release No. 6719 (June 18, 1987) [52 FR 24018]. This proposal was preceded by a concept release, Securities Act Release No. 6594 (July 1, 1985) [50 FR 28219].

13/ Securities Act Release No. 6719 at 1.

Currently, the Commission's Form 8-K requires disclosure of the resignation or dismissal of an independent accountant; 14/ and information regarding the existence and nature of disagreements is required in annual reports and other filings. 15/ Even under current rules, the Commission staff carefully reviews all disclosures concerning changes in accountants, focusing particularly on the nature of reported disagreements. And, of course, when opinion shopping results in false or misleading financial disclosures, the Commission will pursue appropriate enforcement actions. 16/

Because of our concern about opinion shopping, we have welcomed the AICPA's Auditing Standards Board Statement on

14/ See Item 4 of Form 8-K, 17 CFR 249.308.

15/ See Item 304 of Regulation S-K, 17 CFR 229.304.

16/ See, e.g., In the Matter of Frantz, Warrick, Strack & Associates (This Rule 2(e) proceeding, in which respondents neither admitted nor denied any reported findings or conclusions, concerned the engagement of an accounting firm based on its support of a hypothetical sales transaction that was alleged not to have been recorded in compliance with GAAP), Accounting and Auditing Enforcement Release ("AAER") No. 86 (February 10, 1986); In the Matter of Broadview Financial Corporation (In this proceeding under Section 15(c)(4) of the Securities Exchange Act of 1934, in which respondents neither admitted nor denied any reported findings or conclusions, a registrant changed to an accounting firm willing to accept a particular accounting treatment alleged to be in contravention of GAAP), AAER No. 54 (April 17, 1985).

Auditing Standards No. 50 17/ as guidance for accounting policy consultations, and we believe that its guidelines have been helpful. However, the Commission believes that enhanced disclosures may be necessary and therefore has issued its current rule proposal. The proposed rule would require new disclosures in Form 8-K (and Form N-SAR for investment companies) when a registrant changes its outside auditor. It also would identify more clearly circumstances that would constitute a reportable disagreement between the registrant and the auditor. Under the proposal, the term "disagreement" would be interpreted broadly to include any difference of opinion which, if not resolved to the auditor's satisfaction, would have been referred to in the auditor's report.

The proposed rule also provides that if an auditor is not reengaged, the registrant must disclose whether the registrant or the auditor made the decision not to reengage, and whether the decision was discussed with the registrant's audit committee or board of directors. If there were any disagreements, the registrant must describe them, state whether the former auditor discussed them with the audit committee or board, and whether the former auditor was

17/ Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles (July, 1986).

authorized to discuss the matter candidly with the new auditor. 18/

I will not speculate on the outcome of the Commission's deliberations, other than to say that the issues will be examined very carefully.

Rule 2(e)

A third rulemaking initiative concerns the clause in Rule 2(e) (7) of the Commission's Rules of Practice 19/ that certain Rule 2(e) proceedings be private rather than public. Through Rule 2(e) the Commission protects the integrity of its processes by disciplining professionals, including accountants, who practice before it. Actions may be brought based upon, among other things, violations of the securities laws or improper professional conduct. For accountants,

18/ In addition, these three items would be disclosed:

- (1) material financial statement-related issues discussed with the new auditor during the last two years and any subsequent interim period;
- (2) any positions taken on those issues by the former and new auditors; and
- (3) the names of other accountants consulted on the issues, and any significant differences between their positions on the issues and those of the new auditor.

The registrant also would have to file a copy of any written reports on the material financial statement-related issues provided by the new auditor.

19/ 17 CFR 201.2(e) (7) .

improper professional conduct may involve participation in an audit that is not conducted in conformance with generally accepted auditing standards (GAAS) or generally accepted accounting principles (GAAP). Although controversial, Rule 2(e) has consistently been upheld by the courts. 20/

Original Rule 2(e) proceedings (that is, those proceedings not derived from court-ordered injunctions or findings of violations) generally are conducted in private unless the Commission, on its own motion or at the request of the party involved, specifically directs that there be a public hearing. The matter becomes public at such time as an administrative law judge issues an initial decision, if that decision is adverse to the accountant. 21/ By contrast, Commission administrative proceedings other than Rule 2(e) proceedings are virtually always public. 22/

The Commission's Rule 2(e) proposal contains three suggestions

20/ E.g., Davy v. Securities and Exchange Commission, 792 F.2d 1418 (9th Cir. 1986); Touche Ross v. Securities and Exchange Commission, 609 F.2d 570 (2d Cir. 1979); cf. Polydoroff v. Interstate Commerce Commission, 773 F.2d 372, 374 (D.C. Cir. 1985).

21/ Securities Act Release No. 5572 (March 4, 1975).

22/ The Commission's general rule is contained in Rule 11(b) of its Rules of Practice, 17 CFR 201.11(b), which states that "... All such hearings [for the purpose of taking evidence]... shall be public unless otherwise ordered by the Commission."

favoring public hearings: 23/ First, that such hearings be public unless the Commission directs otherwise; second, that hearings in specified classes of cases be public; or third, that the Commission determine whether a hearing is to be public or private on a case-by-case basis. The Commission has received numerous comments on the proposal. The staff currently is considering these comments and will make a recommendation for the Commission to consider in the near future.

Treadway Commission

As you know, the National Commission on Fraudulent Financial Reporting issued its final report in October of 1987. 24/ The Commission was funded by various private sector groups, including the AICPA, and was headed by James Treadway, a former SEC Commissioner. The report includes many positive suggestions for corporate managers, for accountants, for the Commission, and for the Congress, including recommendations favoring mandatory peer review and regulating opinion shopping. Our staff is currently studying the recommendations contained in the report. The Commission is pleased that your profession, along with others, has formulated a group to monitor and

23/ Securities Act Release No. 6662 (September 29, 1986) [51 FR 35653].

24/ Report of the National Commission on Fraudulent Financial Reporting (October 1, 1987).

encourage the implementation of the recommendations contained in this report.

V. Review and Comment Process and Enforcement

Of course, the activities of private professional organizations that set standards and provide guidance are not the entire answer to effective disclosure policy oversight. The Commission has an oversight responsibility to ensure that fair presentation of transactions and of the financial results of entities is made by individual accountants on a company-by-company and transaction-by-transaction basis. This function is most critical for new transactions, for novel financial instruments, and in times of economic difficulties.

In recognition of the importance of fair presentation, the Division of Corporation Finance is increasing substantially the number of accountants on its staff. Our goal is to have accountants comprise half of the professional staff of the operating branches of that Division. The increase in the accounting staff will enable the Division to better address the increasing frequency of sophisticated, complex, and novel accounting issues, as well as to review more issuer's financial statements.

In addition to encouraging the accounting profession to improve financial disclosure and to strengthening its own review process in the Division of Corporation Finance, the Commission has also enhanced its enforcement program. The Commission

devotes substantial resources in its Division of Enforcement to uncovering and prosecuting instances involving accounting and financial reporting abuses. When the Commission's staff discovers instances of financial fraud or other abuses by registrants, it also examines the role of the auditor to determine whether the auditor has aided and abetted issuer violations of the federal securities laws or engaged in improper professional conduct.

Over the past few years, the Commission has brought an increased number of cases against both issuers and their accountants for failures in the financial disclosure process. These will be discussed by others on the program today, so I will not dwell on them here. I would note, however, that a number of these cases emphasize the significance of auditor independence as a means of preventing fraud and other misconduct. 25/ I consider these cases to be of particular importance since they emphasize to the profession that where auditors fail in their role the Commission will take vigorous enforcement action.

25/ See, e.g., SEC v. Jose L. Gomez, Cir. Act. No. 85-6227 (S.D. Fla.), Lit. Rel. No. 10747 (May 8, 1985); SEC v. Grant Thornton, Civ. Act No. 86-6832 (S.D. Fla.), Lit. Rel. No. 11263 (October 16, 1986); In the Matter of Marvin D. Havey, Accounting and Auditing Release No. 126 (January 28, 1987); In the Matter of Louis Pokat, Accounting and Auditing Release No. 2 (August 18, 1982).

VI. Internationalization

Although I have been discussing enhancement of the accountant's role in disclosure, I want to add a word about an important area which will affect the accounting profession for years to come. The internationalization of the securities markets poses significant challenge to this country's financial disclosure system, a challenge that inevitably will involve the accounting profession.

As foreign issuers expand their use of U.S. capital markets and domestic issuers seek access to foreign markets, our capital markets are undergoing significant changes. In 1986, for example, foreign purchases of U.S. stocks reached \$148 billion, and U.S. purchases of foreign stocks totalled \$51 billion, as compared with \$82 and \$25 billion in 1985. 26/ In addition, there has been a surge in multinational debt and equity offerings. For example, between 1980 and 1986, offerings in the international bond markets, including the Eurobond markets, grew from \$38 billion to \$227.1 billion. International bond trading volume in 1986 was more than \$3.5 trillion, 27/ and total international bond offerings equalled \$102 billion

26/ See Department of Treasury Bulletin, various issues.

27/ See Report of the Staff of the U.S. Securities and Exchange Commission to the Senate Committee on Banking Housing and Urban Affairs and the House Committee on Energy and Commerce (July 17, 1987) ("SEC Staff Study"), Chapter II.

in the first half of 1987. International equity markets have also shown remarkable recent growth. Euroequity offerings grew from \$220 million in 1983 to almost \$12 billion in 1986, 28/ and in the first half of 1987 totalled \$7.5 billion.

There is no doubt that this internationalization of the markets brings great benefits to issuers and investors. But it also presents difficult new challenges. Foremost among these challenges is the development of adequate disclosure standards. Given the importance of financial disclosure, a key element of international disclosure standards will be to develop mutually acceptable international accounting and auditing standards. 29/

The Commission already has taken a number of important steps to facilitate this process. Since 1982, for example, the Commission has had a separate integrated disclosure system for offerings of foreign securities registered under the

28/ SEC Staff Study, Chapter II.

29/ The International Organization of Securities Commissions and Similar Agencies ("IOSC") recently adopted recommendations calling for exchange among regulators of information on prospectus, interim reports and continuous disclosure requirements; an examination of practical means of promoting the use of common standards in accounting and auditing principles; and consideration of a study on responsibility for information disseminated in the prospectus or through other means in view of the increasing number of multi-national issues, within the framework of reciprocity. See BNA Securities Regulation and Law Report, Vol. 19, No. 37, at 1399 (September 18, 1987).

Securities Act. 30/ Under this system, financial statements do not have to be prepared in accordance with U.S. GAAP if they comply with GAAP in the home country, as long as the net income and balance sheet totals are reconciled to what they would have been if U.S. requirements had been followed. 31/

Additionally, the Commission's staff is developing a proposal with other countries for reciprocal disclosure for the registration of certain specified securities. The goal is to allow the offering document from an issuer's home country to be used as the prospectus for offerings in the United States. 32/

One of the difficult reciprocity issues being examined by the staff concerns financial statements. Since accounting principles, auditing standards, and auditor independence are critical to the integrity and credibility of the U.S. disclosure system, it is essential that any cooperative approach emphasize the importance of these well-established standard setting systems in financial statements.

30/ See Securities Act Release No. 6437 (November 19, 1982) [47 FR 54764] adopting Forms F-1, F-2 and F-3; Securities Exchange Act Release No. 16371 (November 29, 1979) [44 FR 70132] adopting Form 20-F.

31/ See, e.g., Items 17 and 18 of Form 20-F, 17 CFR 249.220f, incorporated into Item 11 of Form S-1, 17 CFR 239.31.

32/ For a preliminary discussion of these issues, see Securities Act Release No. 6568 (February 28, 1985) [50 FR 9281]. A comprehensive examination of a number of areas related to internationalization is contained in the SEC Staff Study.

Regarding accounting standards, an important objective in the international area is the identification of reliable reciprocal accounting standards. True reciprocity would allow an issuer to prepare only one set of disclosure documents for world-wide use and would not have a reconciliation requirement. We hope that the continued development and refinement of international accounting standards will result in movement toward similar accounting standards and will lessen the need for country-to-country reconciliation.

In contrast to accounting standards, auditing standards differences are not susceptible to accommodation through reconciliation. We have urged compliance with U.S. GAAS, and we believe progress in the development of international auditing standards is taking place. We are encouraged that these standards may be relied upon for reciprocity in the future.

The Commission will continue to work with international organizations, such as the International Accounting Standards Committee, the International Federation of Accountants, and the International Organization of Securities Commissions and Similar Agencies, in order to further efforts to bring about greater reconciliation and reciprocity. I encourage your participation in these efforts.

VII. Conclusion

May I conclude my remarks by emphasizing the significance of the accounting profession to the economy of the United States. The economy depends on the capital markets, and those markets depend on a first-class financial disclosure system. As auditors and accountants you are responsible for the credibility of the financial disclosure system.

The Commission has been a partner with your profession for over fifty years, and the partnership has worked well. As with every partnership, however, effort must be invested to assure that the terms of the partnership are fulfilled. The Commission will continue to monitor the profession's activities and will proceed through oversight, rule making, and enforcement action to seek excellence in our nation's full disclosure system.