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Remarks of

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CONCERNING THE REPORT OF THE  
NATIONAL COMMISSION ON  
FRAUDULENT FINANCIAL REPORTING

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The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

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I. Introduction

Good afternoon and thank you for the opportunity to speak before the SEC and Financial Reporting Institute.

One of the purposes of this Institute since its inception has been to promote better financial reporting, a goal long shared by both the Commission and the accounting profession. As you are no doubt aware, there have been several suggestions recently by Congress and others for improvement of the reporting and disclosure system in this country. One highly respected body of recommendations is contained in the Report of the National Commission on Fraudulent Financial Reporting chaired by former SEC Commissioner James Treadway.

During the last week in April the Commission met to consider the Treadway recommendations calling for SEC action, and on May 2nd I testified concerning those recommendations before the House Oversight and Investigations Subcommittee chaired by Congressman Dingell. The Commission and the accounting profession have taken and are taking positive actions in response to the Treadway recommendations. I would like to outline some of these actions for you today.

II. Treadway Commission -- General Support

At the outset may I emphasize the importance of the Treadway Commission's work. Complete and accurate financial reporting by public companies is fundamental to the disclosure

system underlying the stability and efficient operation of our capital markets. Investors need reliable financial information when making investment decisions, and corporate officials require such information in order to perform their duties effectively.

The Treadway Report identifies three important elements in the detection and prevention of financial fraud: the independent accountant, internal control systems, and audit committees. It also emphasizes the important role played by the Commission in the reporting and enforcement areas.

### III. Role of the Independent Accountant

The accounting profession is a critical part of the process for assuring reliable and complete financial reporting. It was in recognition of this role that professional accounting organizations came together to sponsor the Treadway Commission. Since then they have also supported the auditing standards recently adopted by the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA"). These standards emphasize the central role played by the independent public accountant in the financial reporting system, and are responsive to several of the Treadway Commission's recommendations.

It is the independent accountant who brings to the financial information the necessary technical expertise and objectivity. Additionally, since users of financial

information depend on the independent accountant's review of the company's financial statements, it is crucial that the independent accountant be alert to possibilities for fraud and misstatement. I am pleased that the accounting profession has recently developed standards to accomplish these goals, and at the risk of concentrating on subject matter already familiar to you, I want to describe the nine new auditing standards contained in Statement on Auditing Standards or "SAS" numbers 53 through 61 and comment on them.

SAS 53, The Auditor's Responsibility to Detect and Report Errors and Irregularities, requires auditors to design all audits to provide reasonable assurance of detecting material errors and irregularities. A direct statement that a search must be conducted for both inadvertent errors and intentional irregularities provides important assurance regarding the goals of the auditing process.

SAS 54, Illegal Acts by Clients, clarifies the auditor's responsibility for detecting and reporting illegal acts other than those that have a direct and material effect on the financial statements, which are covered by SAS 53. The obligation to report to management and the audit committee and to pursue any identified illegalities to a satisfactory conclusion, or to modify the audit report or resign, enhances the validity of the auditing process as to fraud detection.

SAS 55, Consideration of the Internal Control Structure in a Financial Statement Audit, requires the auditor to gain

an understanding of the entity's control environment, its accounting system, and its control procedures in order adequately to assess the risk of inadequate internal controls in planning each audit. This standard requires the auditors to review internal controls and is coupled with SAS 60, Communication of Internal Control Structure Related Matters Noted in an Audit, which requires the auditor to report significant deficiencies in the control structure to management and the board of directors or audit committee.

SAS 56, Analytical Procedures, requires auditors to use analytical procedures in the planning and review stages of all audits, and provides guidance on designing, applying and evaluating results of those procedures. In other words, the auditor must be systematic in making inquiries regarding controls and other aspects of the financial reporting process.

SAS 57, Auditing Accounting Estimates, provides guidance to help auditors evaluate the reasonableness of accounting estimates in financial statements.

SAS 58, Reports on Audited Financial Statements, is intended to improve communications between the auditor and the public by amending auditors' reports to clarify the responsibility the auditor assumes, the procedures performed, and the level of assurance provided.

SAS 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, requires the auditor to evaluate the entity's continued existence in all audits and

to modify the audit report if substantial doubt exists about an entity's continued existence. This "solvency" function provides important assurance to the public, since when doubts about the entity's going concern status are not expressed the continued solvency of the entity is implied.

Finally, SAS 61, Communication with Audit Committees, requires the auditor to be sure that certain matters (such as the initial selection of accounting policies or disagreements with management) are reported to the audit committee or to those with equivalent responsibilities when there is no such committee.

These nine standards are important steps in furthering the reliability of financial information provided to the public and filed with the Commission, and should enhance the public's confidence in the auditor's report.

#### IV. Role of the Internal Control System

It is important to note that two of the new auditing standards (SAS 55 and SAS 60) emphasize the importance of the company's internal control structure. The Treadway Commission emphasized the need for good internal controls and recommended that the Commission require annual reports to shareholders to include a report by management on its internal controls. Although the Commission did not adopt a similar suggestion in the past, it has decided to propose a rule to accomplish this objective.

The management report on controls would have several benefits for shareholders. By evidencing the specific attention of the company's most senior management to the company's internal control system, the report would reflect the "tone at the top," which Treadway characterizes as "the most important factor contributing to the integrity of the financial reporting process."

Additional benefits will come from the auditor's review of the report in accordance with professional auditing standards and the consequential association of the auditor with the reported status of the company's internal controls. The auditor becomes associated with the management report through the application of both new and previously-existing auditing standards. As already noted, under new Auditing Standard 55 auditors are required to gain an understanding of a company's internal control structure in all audits, regardless of whether they intend to rely on the controls in conducting the audit. This knowledge is communicated in two ways. First, as noted earlier, a new standard, SAS 60, requires auditors to communicate to management and to the audit committee significant deficiencies in the design or operation of the control structure, including material weaknesses that come to the auditor's attention during an audit of the financial statements.

Second, armed with knowledge of the control system, the auditor will have a better background with which to approach

its responsibilities under SAS 8. Pursuant to SAS 8, adopted in 1975, auditors are required to read information contained in documents that contain audited financial statements and they will therefore be required to read the management report on controls. When doing so they will be able to identify material inconsistencies between the report and the information regarding internal controls which they obtained in exercise of their responsibility to review the internal control system mandated by SAS 55.

In the event the auditor notes a material inconsistency or misstatement, the auditor is required to inform the company. 1/ If the issuer fails to correct the inconsistency or misstatement, SAS 8 requires the auditor to take appropriate steps. Those steps can include disclosure of its concerns or, failing that, other actions, including withdrawal from the audit. 2/ Should the company's failure to make appropriate disclosures result in the termination of the auditor's engagement (either through resignation or discharge) the existence of such a disagreement would be reported under amendments recently adopted by the Commission to Form 8-K and related regulations concerning the reporting of changes in accountants. 3/ Notice of the lack of adequate internal

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1/ SAS 8.

2/ See Accounting Series Release No. 278 (June 6, 1980).

3/ Financial Reporting Release No. 31 (April 12, 1988).



controls would therefore reach the Commission through the combined operation of auditing standards and the Commission's disclosure requirements.

The interplay between the proposed management report, the auditor's professional requirements, and the 8-K reporting requirement is a good example of the interrelationship between the Commission's disclosure requirements and the profession's auditing standards as a means of protecting the public.

V. Role of the Audit Committee

Another principal topic of the Treadway Commission was the role of audit committees. The Treadway Report acknowledges that, according to one of the Treadway Commission's studies, 85% of all public companies currently have audit committees. It also describes the New York Stock Exchange's listing requirement that each registrant have an audit committee composed solely of independent directors, and the requirement of the National Association of Securities Dealers that all national market system companies establish and maintain audit committees that have a majority of independent directors. 4/ The Treadway Commission concluded that all public companies should be required by Commission rule to establish audit committees composed solely of independent directors. It acknowledged, however, that

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4/ See Report of the National Commission on Fraudulent Financial Reporting at 40 (October 1987).

exceptions should be available when there is particular difficulty in locating qualified individuals willing to serve as directors.

While the Commission generally supports the concept of audit committees, some differences exist regarding the means that should be used to promote their use. In preparation for testimony on the Treadway Report, the Commission voted to communicate with the exchanges and the NASD to encourage them to consider upgrading and expanding the scope of their audit committee requirements. Although the Commission has direct rulemaking authority, it believes it better to accomplish the goal of improving requirements by permitting the exchanges to consider the difficulties faced by smaller companies and the need for appropriate exemptions.

#### VI. Role of the Commission

Opinion shopping. Significantly, some of the Treadway Commission's recommendations already have been acted on by the Commission. Last month the Commission adopted rules regarding disclosures by companies of changes in independent accountants in potential opinion shopping situations. These revisions identified two instances in which a company must disclose information concerning consultations with its newly-engaged accountant that occurred during the two fiscal years and any subsequent interim period preceding the accountant's engagement. First, disclosure would be required if those

consultations involved or should have involved the accountant in providing specific advice on the type of audit report that may be issued on the company's financial statements or the accounting treatment applicable to a specific completed or proposed transaction. <sup>5/</sup> Second, disclosure would be required if those consultations concerned the subject matter of a disagreement or reportable event with the former accountant. In such situations, the company must disclose the issues discussed, provide a brief description of the new accountant's views on those issues, and include a statement by the company indicating whether it consulted the former accountant on those issues and, if so, a summary of the former accountant's views. The new accountant has an opportunity to review the company's summary of its views and to provide additional information to clarify those views. The company is also required to request the former accountant to review the disclosure and to provide a statement as to whether the former accountant agrees with the company's summary. Both accountant letters are required to be filed as exhibits.

In addition to adopting these changes, the Commission has proposed for comment amendments that would reduce from fifteen to five calendar days the time period for a company's filing of a Form 8-K disclosing a change in independent accountants and would also reduce the time period in which companies are

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<sup>5/</sup> As required by the performance and reporting standards of SAS No. 50.

required to file letters provided by their former accountants. In proposing these changes, the Commission has indicated that accelerated disclosure of concerns by the former accountant would aid in the protection of investors.

During my testimony last week, Congressman Wyden was very concerned about the Form 8-K reporting system for changes in accountants and the fact that the responsibility for filing the auditor's letter falls on the company, rather than on the accountant. In cases of egregious fraud the company clearly has incentives to refrain from disclosing the auditor's letter. I do not believe that the Commission has the statutory authority to require the auditor to file such letters directly with the Commission, but I indicated to Congressman Wyden that I would support appropriate legislation authorizing the Commission to require such direct reporting.

In connection with the direct reporting issue, Ed Coulson, the Commission's Chief Accountant, recently wrote to Philip Chenok, President of the AICPA, asking that the profession examine ways to require auditors to notify the SEC directly when a required Form 8-K or a responding letter from the accountant has not been filed. This requirement could be incorporated into generally accepted auditing standards, the professional code of ethics, or other professional standards. An AICPA initiative might mitigate the need for legislation. We are awaiting a response.

Peer review. A second important area implementing Treadway recommendations is dealt with in the Commission's 1987 peer review rule proposal. 6/ As you are undoubtedly aware, the Commission has proposed for comment a requirement that accountants certifying financial statements filed with the Commission be subject to an objective review by other independent accountants. Under this proposal, an accountant would be required either to undergo a "peer review" under the auspices of an acceptable peer review organization, or to have its review supervised directly by the Commission. The Commission's staff is currently reviewing the comment letters received on the proposal and preparing a recommendation which should be considered by the Commission in the near future.

VII. Enforcement Recommendations

With regard to enforcement remedies contained in the Treadway Report, the Commission supports the recommendation that the Commission be provided with the authority to impose civil money penalties in administrative proceedings, and that courts be authorized to impose such penalties in Commission injunctive actions.

In addition, although the Commission has successfully obtained court orders barring or suspending individuals from serving as officers or directors of public companies, the

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6/ Securities Act Release No. 6695 (April 1, 1987).

Commission supports legislation specifically authorizing courts to provide such relief, as well as a Congressional grant of authority to bar or suspend corporate officers and directors in administrative proceedings.

Although the Treadway Commission has recommended that the Commission seek cease and desist authority, the Commission believes that its authority under Exchange Act Section 15(c)(4) makes cease and desist authority unnecessary. Under Section 15(c)(4), the Commission has the power to issue orders requiring persons who violate or cause a violation of Exchange Act Sections 12, 13, 14, 15(d), or the rules thereunder, to comply with the violated provisions. Most cases that involve allegations of fraudulent financial reporting are also likely to involve a violation of one or more of these statutory provisions or rules for which the Section 15(c)(4) remedy is available. However, the Commission would support expanding its current authority by adding Exchange Act Section 16(a) to the provisions for which a proceeding under Section 15(c)(4) is authorized.

I have directed the Commission staff to develop legislative proposals regarding all of these areas.

#### VIII. Support for the Accounting Profession

The Treadway Report as a whole expresses concerns over the reliability of financial disclosures. Concern with disclosures inevitably leads to focus on the accuracy,

completeness, and presentation of the financial information disclosed. Here, the accountant occupies center stage. As noted in the Treadway Report, both inside accountants and external auditors bear responsibility for the accuracy of financial information. And it is the certification process that tells the public at large that a responsible, independent third party has reviewed the data presented and tested its accuracy. 7/

The Commission is the agency charged with the responsibility to oversee the accuracy and completeness of financial disclosure and it has also accepted responsibility for oversight of the accounting profession. Happily, over the years the Commission has been able to fulfill its responsibilities by looking to the private sector and its standard setting process. It is the private accounting profession, acting with Commission guidance, that helps to assure the integrity and credibility of financial disclosures. The expertise and professionalism in the private sector standards-setting bodies have earned the SEC's respect and support and has engendered a favorable working relationship.

I was particularly pleased by the prompt efforts by the ASB in developing standards responsive to the Treadway Report. In the future the Commission will continue to rely on the

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7/ 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.

Auditing Standards Board in the development of auditing standards. The ASB must be constantly alert to areas where improved guidance will help ensure that independent auditors meet public expectations. It must continue its efforts to implement and fine-tune auditing standards.

The Commission will also continue to rely on the Financial Accounting Standards Board in setting accounting principles. <sup>8/</sup> In the latter regard, it is essential that the FASB continue its efforts to improve the usefulness of financial reports. In particular, among the many important projects now being considered by the FASB, improvements in the financial instruments and off balance sheet financing areas are particularly important.

#### IX. Conclusion

The recommendations of the Treadway Commission were an important effort by the private sector to improve financial reporting by public companies. Those recommendations challenge all of us with responsibility for financial reporting to take appropriate steps to produce these improvements. I am pleased we are moving forward to do so.

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<sup>8/</sup> 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).