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Comments on Certain Aspects of the Special Report of the AICPA's Public Oversight Board of March 5, 1993

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The major firms in the public accounting profession say that they are in a crisis, a liability crisis. They say that, when there is a business failure, they are being asked by the government and by the courts to pay huge amounts of money to the government or to investors. Moreover, they say, they are being asked to pay, and forced to pay, amounts of money that are not in proportion to any fault that they may have had in reporting on the correct or incorrect financial statements of the business that failed.

Representatives of a number of accounting firms asked the Public Oversight Board of the American Institute of Certified Public Accountants [1] to consider whether that Board could support the profession's efforts to obtain relief from what the profession believes to be an excessive burden of litigation. In studying this issue, the POB became concerned that attacks on the accounting profession from a variety of sources suggested a significant public concern with the profession's performance. The POB, therefore, has issued a report addressing more than the isolated issue of litigation reform. The Report includes 25 recommendations that the POB believes, if implemented, would improve the usefulness and

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1 The AICPA determined in 1977 that public confidence in the profession's, then newly established, peer review program would be increased if an independent oversight board composed of prominent individuals oversaw and reported on that program. The Public Oversight Board, or "POB," was created to serve this purpose. The POB also reports on other matters bearing on the integrity of the audit process. The POB maintains its independence from the AICPA by selecting its members and staff, setting their compensation, and choosing the POB chairman. The current members of the POB are A. A. Sommer, Chairman of the POB and former SEC Commissioner, Robert Mautz, Professor Emeritus of the University of Illinois and the University of Michigan, Robert Froehlke, former Secretary of the Army, Melvin Laird, former Secretary of Defense, and Paul McCracken, former Chairman of the President's Council of Economic Advisers.

reliability of financial statements and enhance the auditor's ability to detect fraud and other illegal acts. [2]

It is time to begin the discussion and debate about the recommendations in the POB's Special Report, and I will address here today the three recommendations of the Board, out of 25 recommendations in total, that are addressed to the Securities and Exchange Commission. I wish to make clear that I have not discussed my analysis with any of the Commissioners and that the Commissioners have reached no conclusions, tentative or otherwise, about the POB's recommendations. What follows is my analysis and very, very tentative conclusions, and mine alone. I would not be surprised, if I were to change my mind about these matters as this discussion and debate goes forward in the upcoming months. As is often the case, as I learn more about something and as I think more about it, I change my mind.

Recommendation II-1: The SEC should amend its rules to require SEC registrants to disclose whether their auditors have had a peer review, the date of the most recent peer review, and its results.

In 1985, the Commission proposed such disclosure as part of a comprehensive review of the proxy rules. Securities Act Release No. 6592, Exchange Act Release No. 22195 (July 1, 1985). Specifically, the proposal would have required each registrant's proxy statement to include,

> "(i) a statement of whether or not the principal accountant ... is a member in a professional organization which has both a peer review program and independent oversight function, both of which are subject to review by the Commission and (ii) if such a member, a statement whether or not the principal

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[2] Public Oversight Board, In the Public Interest: A Special Report by the Public Oversight Board of the SEC Practice Section, AICPA (March 5, 1993) ("POB Report"), at 1.

> accountant has had such a peer review, and if so the date of the most recent peer review report."

While the proposed disclosure did not address the results of the peer review, the text of the proposing release stated,

> "(I)f the results of the peer review were other than unqualified, however, registrants would need to consider whether they should disclose the nature of any qualifications and the status of the principal accountant's efforts to correct deficiencies which were the basis for such qualifications. Such disclosure might be material to an informed voting decision, where, for example, the deficiencies uncovered were of a significant or pervasive nature and have not yet been corrected."

A footnote at the end of this paragraph stated,

> "See Rule 14a-9(a), which prohibits, inter alia, the use of proxy material that 'omits to state any material fact necessary in order to make the statements therein not false or misleading ....'"

Thirty-eight commentators addressed the proposal. Five supported the proposal, 13 suggested modifications, and 20 opposed it. Those suggesting modifications, and those opposing the proposal, stated that they were concerned with putting such information about the accountant in the registrant's "liability document." They stated that the proposal opened questions regarding a registrant's duty to inquire, verify, and evaluate any information provided by the accountant regarding its participation in the peer review program, its categorization of the peer review report, and the status of the accountant's efforts to correct deficiencies. Commentators emphasized that registrants were not experts in performing peer review evaluations. They said that the proposal would place a "compliance burden" on registrants without providing an equivalent benefit to security holders. The American Bar Association, in its opposition to the proposal, said that

requiring registrants to make judgments on disclosure of deficiencies noted in peer review reports, and to ascertain the status of corrective efforts by their accountants, "imposes burdens on registrants that border on the unseemly."

Other positions advanced by several commentators to show that the proposal would be an inappropriate burden on registrants were that (i) the proposal was superfluous (as most SEC registrants already had auditors who were members of the SECPS) and (ii) others were in a better position than registrants to review the peer review process. In addition, other commentators said that the disclosure was an inappropriate method of coercing membership in the SECPS, especially because, in their opinion, SECPS members were no better qualified to perform audits than non-members. Others said that the disclosure might give shareholders an unwarranted sense of confidence. Still other commentators said that the costs of membership in the SECPS were material to small and medium-sized firms and that the proposal therefore tipped the "competitive balance" in favor of large firms.

I question what benefit investors and potential investors would get from such a disclosure standing alone. Should the disclosure be accompanied by any "comments" that the reviewer had on quality controls of the firm being reviewed? Suppose the peer review report was not unqualified and that fact were disclosed--what would investors then do? Should the disclosure be accompanied by additional disclosure about litigation against the firm generally or about SEC Rule 2(e) proceedings against the firm or certain of its partners?

Recommendation V-10: The SEC should require registrants to include in a document containing the annual financial statements a statement by the audit committee (or by the board if there is no audit committee) that describes its responsibilities and tells how they were discharged. This disclosure should state whether the audit committee members (or, in the absence of an audit committee,

the members of the board): (a) have reviewed the annual financial statements; (b) have conferred with management and the independent auditor about them; (c) have received from the independent auditor all information that the auditor is required to communicate under auditing standards; (d) believe that the financial statements are complete and consistent with information known to them; and (e) believe that the financial statements reflect appropriate accounting principles.

The POB Report cites the 1987 Report of the National Commission on Fraudulent Financial Reporting (the "Treadway Commission") as support for this recommendation. In line with the Treadway Commission's "tone at the top" approach, the POB Report states, "The responsibility of corporate boards and their audit committees for the integrity of management and financial reports should be pinpointed and reinforced and the appropriate authorities should adopt measures to assure that it is." [3] The POB states, "in too many instances the audit committees do not perform their duties adequately and in many cases do not understand their responsibilities." [4] The proposed disclosure is intended to encourage audit committees (or boards) to fulfill the listed responsibilities. The POB cites the recent compensation committee reports as a precedent for this kind of reporting.

As noted by the POB, the Treadway Commission similarly recommended that all public companies should be required by SEC rule to include in their annual reports to stockholders a letter signed by the Chairman of the audit committee describing the committee's responsibilities and activities during the year.

When then-Chairman Ruder testified before Congress on the Treadway recommendations in 1988, he noted that companies that have securities registered under section 12 of the Exchange Act are

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[3] POB Report, at 49-50.

[4] POB Report, at 50.

subject to the Commission's proxy rules, and that these rules require disclosure concerning the existence of and the functions performed by audit committees. Specifically, pursuant to Item 7(e) of Schedule 14A companies making a proxy solicitation must state whether the company has an audit committee, and, if so, must "identify each committee member, state the number of committee meetings held ... during the last fiscal year and describe briefly the functions performed" by the audit committee. Chairman Ruder's testimony noted that the Treadway Commission report acknowledged that certain of the information in the proposed audit committee letter would duplicate existing proxy statement disclosures. The testimony then states, "The Commission believes that the proposed audit committee letter would not provide investors with significant additional information and is thus unnecessary." The disclosure described by Chairman Ruder continues to be required today.

Other information about audit committees, not mentioned in Chairman Ruder's testimony, that must be disclosed in Commission filings includes whether a registrant's audit committee recommended or approved a change in accountants, and whether it consulted with the former accountant concerning disagreements with management and certain other matters. [5]

The POB's analogy to the compensation committee report may not be on all fours. The compensation committee report disclosure item does not require any particular actions or procedures. It is designed to require a description of the rationale of the compensation committee for the reported compensation and its relationship to company performance. Even so, it attracted negative comment. [6]

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[5] Item 304 of Regulation S-K, 17 CFR 229.304.

[6] See Securities Act Release No. 6962 (October 16, 1992).

The audit committee disclosure proposed by the POB, essentially requiring the performance of designated procedures, surely would be more controversial than the compensation committee disclosure.

The POB admits that the proposed disclosure is designed primarily for its behavioral impact, and not for the relevance of the information being disclosed. [7] I understand that courts generally have opposed the Commission's imposing such corporate governance standards, and suggested that how audit committees operate should remain a matter of state law. The information already required to be disclosed about audit committees, the Commission's decision not to implement the Treadway recommendation in 1988, and the anticipated states' rights issues involved, will have to be reviewed carefully before the Commission makes any determination on whether to proceed with this recommendation.

Recommendation V-12: The SEC should require registrants to include in a document containing the annual financial statements: (a) a report by management on the effectiveness of the entity's internal control system relating to financial reporting; and (b) a report by the registrant's independent accountant on the entity's internal control system relating to financial reporting.

On July 19, 1988, the Commission published for comment proposed rules that would have required a report from management on its responsibilities for the registrant's financial statements and internal controls to be included in annual reports to shareholders, in Forms 10-K, and in investment companies' semi-annual reports. [8] The Commission received approximately 190 comment

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7 See generally, POB Report, at 49-51, which states, among other things, "In the Board's opinion, audit committees should assume defined responsibilities, as outlined in the recommendation set forth below."

8 Securities Act Release No. 6789 (July 19, 1988) [53 FR 28009].

letters in response to this release. A review of these comment letters indicated that a majority of the commentators supported a management report on its responsibilities for the preparation of the registrant's financial statements and for establishing and maintaining a system of internal controls for financial reporting.

Reservations, however, were expressed about other aspects of the Commission's proposed management report. Commentators noted concerns regarding proposals for a management assessment of the effectiveness of the registrant's internal controls, disclosure of how management has responded to significant recommendations concerning the registrant's internal controls made by its internal auditors and independent accountants, and a requirement that the report be signed by the registrant's principal executive, financial, and accounting officers. Some commentators questioned whether a report noting deficiencies in a registrant's internal controls would constitute an admission of a violation of the Foreign Corrupt Practices Act ("FCPA"). Commentators also expressed concerns about the potential for over reliance by investors on the proposed report. On April 16, 1992, the Commission withdrew this proposed rulemaking from its Regulatory Flexibility Act agenda. [9]

Although not included in the proposed rule, the Commission requested specific comments on whether independent accountants should be required to report directly on either the registrant's internal controls or the proposed management report. Almost all

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[9] See Securities Act Release No. 6935 (April 24, 1992) [57 FR 18424].

of the commentators addressing this issue opposed such direct auditor reporting. [10]

Under the Commission's 1988 proposal, the management report would have been included in an annual report of the registrant containing audited financial statements. Thus, the registrant's independent accountant would have been required, under current auditing standards, to read the management report and to inform the registrant of anything in that report that the accountant concluded constituted a material inconsistency with the financial statements or a material misstatement of fact or material omission. In the event an issuer would have failed to correct such misstatements or inconsistencies, Statement on Auditing Standards 8 would have required the auditor to take appropriate steps to ensure disclosure of its concerns or, failing that, to consider other actions including withdrawal from the audit engagement. If the audit engagement ended (through either the auditor's resignation or discharge), the accountant's concerns would have been reported publicly pursuant to the disclosure requirements regarding changes in accountants included in Form 8-K and Item 304 of Regulation S-K. [11]

Legislative proposals have been made in this area. On October 5, 1990, the United States House of Representatives passed an amendment to the then proposed Comprehensive Crime Control Act of

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[10] Congressional testimony by the Commission in February 1993 notes that mandatory auditing of internal controls could result in "enormous costs with relatively few real benefits." Statement of Richard C. Breeden, Chairman, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, Concerning H.R. 574, The Financial Fraud Detection and Disclosure Act, at 35 (February 18, 1993).

[11] 17 CFR 229.304. <u>See</u> Financial Reporting Release No. 31 (April 12, 1988) [53 FR 12924].

1990 that, among other things, would have required virtually every issuer subject to the reporting requirements of the Securities Exchange Act of 1934 to set forth in its Form 10-K and annual report to shareholders, (1) a description of management's responsibilities for maintaining an adequate internal control structure and (2) an assessment of whether that structure reasonably assures the preparation of annual and quarterly reports in conformity with generally accepted accounting principles. Management also would have been required to disclose the existence of any material weakness in the control structure that had not been substantially corrected as of the date of filing the annual report. Under this proposed amendment, the issuer's independent public accountant would have examined and reported on management's assessment of its internal control structure, and the independent accountant's opinion would have been included in the issuer's annual reports. This amendment, however, was not made part of the enacted Crime bill.

In 1991, a bill was introduced in the U.S. House of Representatives that, if enacted, would have mandated an SEC study on the extent companies are complying with the accounting and internal control provisions of the FCPA. The required study also would have examined the extent that registrants' compliance with the FCPA, and the reliability of registrants' financial statements, would be improved by a requirement for annual public reports by managements and registrants' independent accountants on the adequacy of registrants' internal control structures. This bill, however, also was not enacted.

Finally, the Committee of Sponsoring Organizations of the Treadway Commission has completed a study that is intended to provide guidance in conducting assessments of public companies' internal control structures, entitled Internal Control - Integrated Framework.

I am of two minds about an independent auditor's reporting on management's assessment of its internal controls. I recognize the argument that the more managements, audit committees, internal auditors, and external auditors think about, talk about, and focus on internal controls, the better the internal controls likely will be and will become. That argument says that management should report publicly about the effectiveness of the registrant's internal controls and that the external auditor should report publicly about management's representations about the effectiveness of the registrant's internal controls.

The Commission's experience in requiring auditor reports on the internal controls of certain broker/dealers,[12] transfer agents,[13] and investment companies,[14] would support the argument for mandatory internal control reports for public companies as well. The reports that currently are required, however, have been motivated primarily by the fact that these entities are custodians of their customers' funds and securities, and by the need to assure that these funds and securities are safeguarded. In a sense, all public companies are custodians of their investors' funds, and it could be argued that the same type of report should be required of all registrants.

I know, however, that there are in this world a certain number of people with dishonest bones in their bodies. All the reporting on internal controls in the world is not going to stop those people from defrauding the public and, in the process, the external auditor as well. Invariably, there are going to continue to be

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[12] 17 CFR §240.17a-5(j).

[13] 17 CFR §240.17Ad-13.

[14] Form N-SAR, sub-item 77B.

cases where, despite reports on internal controls by external auditors, inventories are missing, receivables are bogus or not good, and not all the accounts payable or other liabilities are recorded in the books and recognized on the face of the balance sheet. When those cases happen, and they will, the public's expectations will be dashed.

In addition, I am told that there will be a cost, perhaps a significant cost, to registrants, especially smaller ones, to get their external auditors to report publicly on their internal controls.

So, I do not know which way to lean.

The POB should be commended for the hard work and insight that is reflected in the Special Report. The issues covered in the report, although not necessarily new, are important not only to the accounting profession, but also to preparers and users of financial statements and to the legislators, courts, and regulators that administer and enforce the financial reporting system in this country. Without any prediction on what actions, if any, the Commission may take, I hope that the Report will continue to fuel the public debate on these issues. I look forward to hearing your thoughts throughout this and other conferences, in articles in the press, and in other forums.

Thank you.

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