Accounting and Auditing Matters

The Chief Accountant is the principal adviser to the Commission on accounting and auditing matters arising from the administration of the federal securities laws. Activities designed to achieve compliance with the accounting, financial disclosure, and auditor independence requirements of the securities laws include:

- *rulemaking and interpretation initiatives that supplement private sector accounting standards and implement financial disclosure requirements;*

- *a review and comment process for agency filings to improve disclosures in filings, identify emerging accounting issues (which may result in rulemaking or private-sector standard setting), and identify problems that may warrant enforcement action;*

- *oversight of U.S. private sector efforts, principally by the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, and the Independence Standards Board; and*

- *monitoring various international bodies, which establish accounting, auditing, and independence standards to improve financial accounting, reporting, and the quality of audit practice, including standards applicable to multinational offerings.*

What We Did

- Continued initiatives to ensure public company auditor independence.

- Issued rules that modernized the Commission's auditor independence requirements.

- Participated in industry discussions and issued a concept release for public comment on international accounting and auditing matters.

- Issued two Staff Accounting Bulletins and a related rule proposal to address financial reporting problems attributable to abusive "earnings management."

Accounting Rules and Interpretations

The SEC's accounting rules and interpretations supplement private sector accounting standards and implement financial disclosure requirements. The principal accounting requirements are contained in Regulation S-X, which governs the form and content of financial statements filed with the agency.

Earnings Management

During the past two years, SEC accounting staff focused heavily on financial reporting problems attributable to abusive "earnings management" by public companies. Abusive earnings management involves the use of accounting gimmickry to distort a company's true financial performance in order to achieve a desired result. The staff issued accounting bulletins providing guidance on the criteria necessary to recognize restructuring liabilities and asset impairments[80] and the prerequisite conditions for recognizing revenue.[81] This guidance was supplemented by a *Frequently Asked Questions and Answers* document that responded to inquiries from auditors, preparers, and analysts about how the guidance would apply to particular transactions.[82] The staff also worked on a rule proposal that specifies the disclosure requirements for changes in valuation and loss accrual accounts and that elicits certain information concerning the effects of the estimated useful lives assigned to long-lived assets.[83]

Auditor Independence

After making several modifications in response to public comments, the Commission adopted rules that modernized its auditor independence regulations.[84] The adoption of the rules culminated many years of public debate; studies by the Independence Standards Board (ISB) and private research organizations; a hearing by the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs; a 75-day comment period that generated 3,000 comment letters; and three public hearings at which 100 investors, accountants, lawyers, academics, analysts and others testified. The final rules:

- reduced the number of audit firm partners and employees whose investments in, and relatives' employment with, audit clients would impair the auditor's independence;

- provided guidance for assessing whether a non-audit service, if provided to an audit client, impairs an auditor's independence, and a list of services that are deemed to be incompatible with being an independent auditor; and

- required the disclosure of: (1) audit fees, (2) fees for information system design and implementation, (3) fees for all other non-audit services, (4) whether the company's audit committee considered whether non-audit services provided by the auditor are compatible with the auditor's independence, and (5) if greater than 50 percent of the hours expended on the audit were done by persons other than the auditor's full-time, permanent employees.

Allowance for Loan Losses

The SEC staff and the four federal banking agencies[85] through their Joint Working Group continued to study loan loss allowance issues. This group worked towards the issuance of parallel guidance in 2001 on the documentation of loan loss allowances and the disclosure of an entity's exposures to credit risks and associated allowances for loan losses. The SEC staff continued to observe and support the work of the American Institute of Certified Public Accountants (AICPA) task force developing additional accounting guidance in the area of loan loss allowances. As required by the Gramm-Leach-Bliley Act, the SEC staff consulted with the banking agencies on comments to be issued to public companies related to their reporting of loan loss allowances in the financial statements.

Audit Committees

The accounting staff coordinated its efforts with those of other divisions, the New York Stock Exchange, National Association of Securities Dealers, the Blue Ribbon Panel on Improving the Effectiveness of Audit Committees, and the Auditing Standards Board to craft rule amendments that improve disclosures related to the functioning of corporate audit committees and that enhance the reliability and credibility of public companies' financial statements.[86]

Oversight of Private Sector Standard Setting

Accounting Standards

Financial Accounting Standards Board (FASB)

The SEC monitors the structure, activity, and decisions of the private sector standard-setting organizations, including the FASB. The Commission's oversight focuses on whether the FASB process is operating in an open, fair, and impartial manner and that each standard is within an acceptable range of alternatives that serves the public interest and protects investors. The Commission works with the FASB in an ongoing effort to improve the standard-setting process, including the need to respond to various regulatory, legal, and business changes in a timely and appropriate manner. The FASB process involves constant, active participation by all interested parties in the financial reporting process.

The staff attends meetings of the Emerging Issues Task Force, observing task force meetings, and holding quarterly discussions with the FASB staff. The Commission's Chief Accountant also observed the quarterly meetings of the Financial Accounting Standards Advisory Council, which consults with the FASB on major policy and agenda issues.

A description of certain FASB activities overseen by the staff is provided below.

- The FASB's Derivatives Implementation Group, which addressed financial instruments and off-balance sheet financing issues to identify those issues related to the implementation of the accounting standard for derivative instruments and hedging instruments[87] and to develop recommendations for their resolution.

- The review of solicited public comments on issues relating to the determination and use of fair value for measuring financial instruments.[88]

- The FASB's continued deliberations on the accounting for business combinations encompassed by Accounting Principles Board Opinion Nos. (APB) 16, *Business Combinations,* and 17, *Intangible Assets.* The FASB considered the comments received on an exposure draft of a proposed new standard that would prohibit the use of the pooling-of-interests method to account for business combinations.[89]

- The FASB's continued work towards a final statement to specify when entities should be included within consolidated financial statements, including entities with specific limits on their powers. The FASB considered the comments received that would require a controlling entity or "parent" to consolidate all entities it controls unless such control is temporary.[90] For this purpose, control was deemed to involve the non-shared decision-making ability of one entity to direct ongoing activities of another entity so as to increase the benefits and limit the losses from the other group's activities. The FASB has deferred final action on this project. The staff believes the existing standards, based on majority voting ownership, generally should be adequate until the planned FASB reassessment in July 2001. However, the existing standards do not adequately address circumstances involving entities with specific limits on their powers, also referred to as "SPEs". The FASB is urged to continue its efforts to provide consolidated guidance concerning these entities.

- The completion of a project that addresses certain implementation issues involving the application of APB 25, *Accounting for Stock Issued to Employees*. An interpretative release was issued that provided accounting guidance on practice issues identified over several years in implementing APB 25.[91]

Accounting Standards Executive Committee (AcSEC)

Our accounting staff oversaw various accounting-standard setting activities conducted through AcSEC. AcSEC issued a position statement that provided revised guidance on appropriate accounting and financial reporting for producers and distributors of motion picture films.[92] It also continued to work on providing guidance for specialized industries, such as insurance companies, investment companies, and the loan loss reserves of financial institutions. AcSEC was established by the AICPA to provide guidance through position statements and bulletins.

Panel on Audit Effectiveness

During the year, the SEC requested that the Public Oversight Board (POB) study the effectiveness of audits, including an assessment of factors that could affect audit quality, such as the design and effectiveness of member firms' quality control systems and the current peer review process. The Panel on Audit Effectiveness (the Panel), appointed by the POB to undertake this study, issued a report with recommendations for improving the quality and effectiveness of audits.[93] This report included approximately 200 recommendations for the accounting profession, standard setters, audit committees, and regulators. Some of these recommendations focused on the need to improve international auditing and quality control standards.

The staff believes that the implementation of the recommendations made by the Panel is important to maintaining investor confidence in the reliability of financial statements and has encouraged the responsible parties to address each recommendation. Chairman Levitt and the Chief Accountant testified at public hearings held in New York City that implementation of the Panel's recommendations, including greater specificity in auditing standards, the development of proposed forensic auditing procedures, the renewed emphasis on the importance of auditing practice within accounting firms, a strengthened POB, and adoption of recommendations for audit committees was vitally important.

Auditing Standards

Auditing Standards Board (ASB)

The staff continued to oversee the activities of the ASB, established by the AICPA to set generally accepted auditing standards. The staff also monitored the ASB's progress in addressing the recommendations contained in the Panel on Audit Effectiveness' report and its effort to generally enhance the effectiveness of the audit process.

The ASB issued new auditing standards that require certain communications between auditors, the audit committee, and management[94] and provide revised guidance related to auditing certain financial instruments.[95] The AICPA staff issued a series of annual Audit Risk Alerts to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect the 2000 yearend audits. To complement this overview, the SEC staff sent a letter to the AICPA's Director of Audit and Attest Standards that identifies certain timely and topical issues that preparers and auditors should consider in the preparation and audit of financial statements.[96]

Quality Controls and Peer Reviews

SEC Practice Section (SECPS)

Our accounting staff oversaw the processes of the SECPS, which was established by the AICPA to improve the quality of audit practices by member accounting firms that audit the financial statements of public companies. We exercised oversight through frequent contacts with the staff of the POB and members of the SECPS committees. The accounting staff reviewed a sample of peer review working papers, closed case summaries, and related POB oversight files.

Our staff encouraged the creation of a charter that would give the POB explicit authority to oversee additional aspects of the profession's system of governance because of the importance of the POB's role in overseeing the peer review and QCIC processes and the potential for its greater overall impact were its role to be expanded. The charter ultimately adopted falls short of instituting all the recommendations of the Panel but does adopt provisions giving the POB greater oversight of the setting of auditing standards and the ability to conduct special reviews of the accounting profession.

We also worked with the SECPS staff to develop new membership requirements including quality controls over independence, foreign associated firms, and the strengthened requirements for concurring partner review.

Self Discipline

The staff met with the AICPA's Professional Ethics Executive Committee (PEEC) to discuss the PEEC's disciplinary actions. These disciplinary actions are affected by a lack of subpoena power and the ability to maintain the confidentiality of its investigations. The PEEC has taken steps to address its failure to take action in several cases brought by the SEC. The PEEC has added three representatives of the public to its Board which numbers approximately 20 members. Accounting firms within the profession have supported increasing the public members to half of the membership. This will require the approval of the AICPA Board, Council, and membership. The Panel on Audit Effectiveness also made several recommendations to the AICPA and the PEEC which, if implemented, should result in improvements in the PEEC process.

Independence

The SEC's Chief Accountant sent a letter to the SECPS highlighting worldwide quality controls that concern auditor independence matters and the possibility that there may be a systemic failure by partners and other professionals to adhere to their own firm's existing controls. He also sent a letter to the POB that stated the peer review process relating to the testing of controls over compliance with independence matters is inadequate. As a result, the POB was requested to oversee SECPS member firms' design and implementation of strengthened systems to achieve and monitor compliance, and conduct a comprehensive special review of member firms' compliance with the independence requirements.

The SECPS issued a new membership requirement that sets standards for member firms' quality control systems for monitoring auditor's independence in U.S. firms. The largest firms in the SECPS agreed to conduct a voluntary "look-back" program that will assess their firm's compliance with the specified independence criteria. The agreement also requires firms to upgrade their quality control systems that monitor compliance with auditor independence rules. In the look-back program, the POB is required to issue two reports covering the firm's design and implementation of the new quality control systems as of December 31, 2000, as well as the results of testing of the effectiveness of these systems during the first six months of 2001.

Independence Standards Board (ISB)

The ISB is a private sector body formed to promote investor confidence in the audit process and in the securities markets. The ISB issued two new standards related to audits of mutual funds and an accounting firm's independence if an audit client employs a former professional.

International Accounting and Auditing

Requirements for listing or offering securities vary from country to country. Some countries' accounting principles are comprehensive and result in financial statements that provide greater transparency of underlying transactions and events than others. As a result, securities regulators in the U.S. and elsewhere have been working on several projects to enhance the quality of international reporting and disclosure requirements.

- The Commission issued a concept release on international accounting standards in February 2000.[97] Approximately 100 comments letters were received covering the many aspects of international accounting and auditing, including under what conditions the Commission should consider accepting the financial statements of foreign issuers that are using standards promulgated by the International Accounting Standards Committee (IASC).

- In May 2000, the International Organization of Securities Commissions (IOSCO), completed an assessment of a specified set of IASC standards, the "IASC 2000 Standards," to determine whether they would be acceptable for cross-border listings of securities. Based on this assessment, IOSCO recommended that its members accept the IASC 2000 standards, as supplemented by additional requirements for reconciliation, interpretation, or disclosures where necessary to address any outstanding substantive issues at a national or regional level. The SEC's current process is consistent with the IOSCO resolution.

- The Report of the Panel on Audit Effectiveness, appointed by the Public Oversight Board, provided recommendations for improving international auditing. In particular, the Panel recommended:

  - a global oversight body with a primary goal of serving the public interest to monitor and report on the activities of individual country audit firm self-regulatory organizations;

  - an external review of the quality controls of auditing firm's accounting and auditing practices;

  - comprehensive annual reports to the public by the global oversight body on its activities, including the results of its monitoring of the quality assurance functions for the auditing profession on a country-by-country basis;

- uniform audit methodologies throughout the world;

- periodic inspection procedures covering all audits, not just foreign registrants affiliated with U.S. SEC registrants;

- personnel assigned by auditing firms throughout the world to function as technical consultants in the application of international accounting and auditing standards; and

- establishment of intra-firm international "clearing houses" to resolve differences in the application of international accounting and auditing standards and promote consistency of practice.

The staff has written to IFAC regarding the critical elements and characteristics that are needed for an international public oversight organization to be effective.[98] Among these elements are the following:

- the selection of the initial members of the oversight organization, including a chairman, should only be finalized after seeking and receiving consideration from international organizations representing the public interest, including securities regulators;

- the members of the oversight organization should be public interest representatives without ties to the accounting profession;
- the funding for the organization's operations should be structured in such a manner that the organization can be independent in fact and in appearance; and
- other characteristics noted by the staff include details relating to membership and review processes, reporting to the public and other matters.

Addressing improvements in international auditing from another standpoint, the staff has also called for the International Forum on Accountancy Development (IFAD) and in particular its "major firm" members, "to take a leadership role by raising their own firms' minimum standards while at the same time pursuing improvements in differing national requirements." These communications result from the staff's concern that the IFAD "vision" plan for international accounting and auditing improvement focuses principally on the regulatory environments of individual countries, and underemphasizes the role and responsibilities of the accountancy profession and in particular, the major firms.[99]

The SEC staff will monitor the continuing work of the international accounting and auditing standards bodies, as well as the actions of international CPA firms and professional groups, in the coming year.