Accounting and Auditing Matters

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

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

- *resolving issues arising from the review of documents filed with the Commission to improve disclosure, identify emerging accounting issues (that may result in rulemaking or private-sector standard setting), and identify problems that may warrant enforcement actions;*

- *concurring in Commission enforcement actions to deter improper financial reporting by enhancing the care with which registrants and their accountants analyze accounting issues; and*

- *overseeing private sector efforts, principally by the Financial Accounting Standards Board (FASB), the American Institute of Certified Public Accountants (AICPA), the Independence Standards Board (ISB), and various international accounting bodies, that establish accounting, auditing, and independence standards designed to improve financial accounting and reporting and the quality of audit practice.*

What We Did

- Worked on staff accounting bulletins and a rule proposal to address financial reporting problems attributable to abusive “earnings management”.

- Continued initiatives to ensure public company auditor independence.

Accounting-Related Rules and Interpretations

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

Earnings Management

During 1999, we focused on financial reporting problems attributable to abusive “earnings management” by public companies. Abusive “earnings management” involves the use of various forms of gimmickry to distort a company’s true financial performance in order to achieve a desired result. Staff Accounting Bulletin No. 99 reemphasized that the exclusive reliance on any percentage or numerical threshold in assessing materiality for financial reporting has no basis in the accounting literature or in law.[112] Two other bulletins provide guidance on the criteria necessary to recognize restructuring liabilities and asset impairments[113] and the conditions prerequisite to recognizing revenue.[114]

Allowance for Loan Losses

The SEC worked with the federal banking agencies (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision) on loan loss allowance issues. This effort resulted in the issuance of three joint statements that outline important areas of consensus and set forth ongoing efforts to provide guidance. Specifically, the SEC and the banking agencies formed a Joint Working Group to:

- gain a better understanding of the procedures and processes, including “sound practices,” used by banking organizations to determine the allowance for credit losses;

- develop additional guidance related to appropriate methodologies, supporting documentation, and enhanced disclosures for loan loss allowances;

- encourage and support the FASB’s process of providing additional guidance regarding accounting for allowances for loan losses; and

- support and encourage the AICPA task force that is developing more specific guidance on the accounting for allowances for credit losses and the techniques of measuring the credit loss inherent in a portfolio at a particular date.

The staffs of the SEC and the banking agencies, through their Joint Working Group, met frequently during 1999 to advance the initiative of issuing guidance on appropriate methodologies, supporting documentation, and enhanced disclosures for allowances for loan losses. Also during 1999, the staff participated as an observer in the meetings of the AICPA task force that is addressing accounting issues related to loan loss allowances.

Also during 1999, the Commission's staff observed the AICPA task force meetings that addressed accounting issues related to loan loss allowances.

Oversight of Private Sector Standard Setting

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 and its staff work with the FASB in an ongoing effort to improve the standard-setting process and to respond to various regulatory, legal, and business changes in a timely and appropriate manner. Commission staff participate as an observer on all FASB task forces formed to consider major FASB projects. A description of FASB activities overseen by the staff is provided below.

As a key element in a long-term project to address financial instruments and off-balance sheet financing issues, the FASB established an accounting standard for derivative instruments and hedging activities.[115] Due to the complexities associated with derivative instruments, the FASB formed a Derivatives Implementation Group to identify issues related to implementation of the standard, and develop recommendations for their resolution. In response to its constituents' requests for more time to study, understand, and implement the provisions of the new standard, the FASB deferred the standard's effective date until fiscal years beginning after June 15, 2000.[116] As another key element of the project, the FASB decided that fair value is the most relevant attribute for measuring financial instruments. A preliminary views document was issued to solicit public comment on various issues relating to the determination and use of fair value.[117]

The FASB continued its deliberations on a project to reconsider the accounting for business combinations encompassed by Accounting Principles Board Opinion Nos. (APB) 16, *Business Combinations,* and 17, *Intangible Assets.* An exposure draft of a proposed new standard was issued that, among other things, would prohibit the use of the pooling-of-interests method to account for business combinations, consistent with actions taken in Australia and those proposed by Canada. The International Accounting Standards Committee (IASC) also has a project on accounting for business combinations. The IASC's existing standards are much more restrictive than U.S. standards regarding the ability to use pooling. The FASB's proposed action would result in a greater international comparability of accounting for business combinations.[118]

The proposed statement also would establish new accounting standards for identifiable and unidentifiable intangible assets, including goodwill acquired in a business combination. Under the proposed statement, goodwill would continue to be recognized as an asset and would be amortized over its estimated useful economic life, not to exceed 20 years.[119]

The FASB resumed work on a project to specify when entities should be included within consolidated financial statements. An exposure draft of a proposed standard was issued that would require a controlling entity or "parent" to consolidate all entities that it controls unless such control is temporary.[120] For this purpose, control is deemed to involve the nonshared decisionmaking ability of one entity to direct ongoing activities of another entity to increase the benefits and limit the losses from the other group's activities.

Because the determination of control requires judgment, the FASB commissioned a test group to evaluate a number of cases involving complex relationships between entities for purposes of determining whether similar conclusions are reached when applying the definition of control and implementation guidance set forth in the exposure draft.

The FASB also worked on a project to address certain implementation issues involving the application of APB 25, *Accounting for Stock Issued to Employees.* An exposure draft of a proposed standard was issued to provide accounting guidance on practice issues identified over a number of years in implementing APB 25.[121] This project will not effect the more recent FASB Statement 123 on accounting for stock-based compensation.

The FASB also continued work on a research project on business reporting that evolved from previous recommendations made by the AICPA Special Committee on Financial Reporting and the Association for Investment Management and Research through its study, *Financial Reporting in the 1990s and Beyond.* Its objectives are to:

- develop recommendations for the voluntary and broad disclosure of certain types of nonfinancial information for all or for selected industries that users of business reporting find helpful in making their investment decisions;

- develop recommendations for ways to coordinate generally accepted accounting principles and SEC disclosure requirements and to reduce redundancies; and

- study present systems for the electronic delivery of business information and consider the implications of technology on future business reporting.

The FASB's Emerging Issues Task Force (EITF), in which the Commission's Chief Accountant participates, continued to identify and resolve accounting issues. During 1999, the EITF reached consensus on a number of significant issues, including those relating to application of the equity method of accounting, accounting for financial instruments, and the appropriate reporting of subsequent events caused by Year 2000.

American Institute of Certified Public Accountants (AICPA)

Our staff oversaw various processes and activities conducted through the AICPA. These included (1) the Auditing Standards Board (ASB), which establishes generally accepted auditing standards, (2) the Accounting Standards Executive Committee (AcSEC), which provides guidance through its issuance of statements of position and practice bulletins; and (3) the SEC Practice Section (SECPS), which seeks to improve the quality of audit practice by member accounting firms that audit public company financial statements.

Auditing Standards Board (ASB)

The staff continued to oversee efforts of the ASB to enhance the effectiveness of the audit process. The ASB issued a rule proposal relating to communications between the independent accountants, the audit committee, and management.[122] The proposal would require the auditors to discuss with the audit committee certain information relating to the auditor's judgment about the quality of its client's financial reporting. In connection with a review of interim financial information in accordance with the auditing literature, the auditors also would be required to determine whether any matters regarding the scope and results of the review should be communicated to the audit committee prior to the release of interim financial information. Final rules were adopted after year-end.

The ASB also issued a series of annual Audit Risk Alerts to provide auditors with an overview of recent economic, professional, and regulatory developments that may affect 1999 year-end audits. To complement this overview, the SEC staff, as it has in the past, sent a December 1999 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 presented in SEC filings.[123]

Also in 1999, the AICPA issued a booklet, *Audit Issues in Revenue Recognition*, that summarizes the significant accounting and auditing guidance on revenue recognition. Finally, in response to the expanding requirements for financial instruments, the ASB issued a proposed standard to provide guidance to auditors in planning and performing auditing procedures for financial statement assertions about financial instruments.[124]

Accounting Standards Executive Committee (AcSEC)

The AcSEC issued a position statement to modify the criteria supporting revenue recognition in multiple-element computer software arrangements.[125] The AcSEC continued to address accounting issues involving specialized industries, including motion picture accounting, investment companies, and financial institutions.

SEC Practice Section (SECPS)

Two programs administered by the SECPS are intended to evaluate whether the financial statements of SEC registrants are audited by accounting firms that have adequate quality control systems. A peer review of member firms is required every three years, and the Quality Control Inquiry Committee (QCIC) reviews the quality control implications of litigation against member firms that involves public company clients.

The Commission oversees the SECPS through frequent contacts with the staff of the Public Oversight Board (POB) and members of the Executive, SEC Regulations, Peer Review, and Quality Control Inquiry Committees. During 1999, our staff selected a random sample of peer reviews and evaluated selected working papers of the peer reviewers and the related POB oversight files. The staff also reviewed QCIC closed case summaries and related POB oversight files. The SEC staff provided the POB staff with comments on certain peer reviews.

The current accounting profession self-regulatory structure was established in 1977. The accounting profession has undergone fundamental changes since then, including a significant increase in the types and number of audit services offered, a significant decrease in the percentage of firm revenues generated by audits, a globalization of the network of affiliates practicing using a single firm name, and changes in audit methodologies. As a result, the POB has been requested to study audit effectiveness and assess the factors which can 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, which was appointed by the POB to undertake this study, is expected to issue a report and recommendations in 2000.

During 1999, the staff identified significant issues regarding auditor independence matters which were highlighted in a letter from the SEC's Chief Accountant to the SECPS.[126] Shortly after year end, another letter was sent to the SECPS noting that "firms with public company audit clients practicing before the Commission may lack sufficient worldwide quality controls to assure their independence under the applicable Commission and professional rules" and that there may be a "systematic failure by partners and other professionals within certain firms to adhere to their own firm's existing controls."

A similar letter issued from the Chief Accountant to the POB states that "the peer review process relating to testing of controls over compliance with independence matters is inadequate or is not working properly."[127] The letter requests the POB to oversee SECPS member firms' design and implementation of strengthened systems and to conduct a comprehensive special review of member firms' compliance with the independence requirements of the profession.

The staff also met with members of the AICPA's Professional Ethics Executive Committee (PEEC) to gain additional information on the accounting profession's disciplinary mechanism and actions. The PEEC's disciplinary actions, including their timeliness, are affected by a lack of subpoena powers and ability to maintain the confidentiality of its investigations. It also was noted that the PEEC did not take any action in several cases, when the SEC had taken disciplinary action.

Independence Standards Board (ISB)

The ISB is a private sector body formed in 1997 to promote investors confidence in the audit process and in the securities markets. The ISB adopted rules requiring auditors of public companies to disclose in writing to the company's audit committee all relationships with the company that could affect auditors' independence.[128]

Requirements for listing or offering securities vary from country to country. Issuers wishing to access capital markets in more than one country may have to comply with requirements that differ in many respects, including accounting principles to be used in the preparation of financial statements. Some countries' accounting principles are more comprehensive and result in financial statements that provide greater transparency of underlying transactions and events than others. As a result, securities regulators have been working on several projects to enhance the quality of international reporting and disclosure requirements.

For the past several years, the IASC has been working to complete a core set of accounting standards for financial reporting in cross-border securities offerings. The International Organization of Securities Commissions (IOSCO) is assessing the completed set of standards to determine whether they should be endorsed for cross-border listings and securities offerings. Our staff is assessing the completed core standards to determine whether we should propose changing the current reconciliation requirements for foreign issuers that file financial statements prepared using IASC standards.

From 1997 to 1999, a strategy working party (SWP) of the IASC developed recommendations on how the IASC might improve its structure. The SWP recommendations, that included the establishment of a new board of trustees and independent accounting standard board, were issued and approved by the IASC.

The SEC staff also is directing parallel efforts to identify auditing and quality control issues that could affect the financial statements prepared in accordance with IASC standards. Potential issues include:

- whether the accounting profession and firms have adequate international auditing standards, training, and technical resources to ensure high quality audits of financial statements prepared using international accounting standards; and

- the need for improved international quality controls to monitor the application of auditing standards for audits on non-U.S. GAAP financial statements (for example, a peer review function like that administered by the SECPS).[129]

The SEC staff also has participated in discussions with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants and has, through IOSCO, commented on some of the IAPC's recent proposed international standards on auditing.