

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;*
- *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 actions;*
- *oversight of U.S. private sector efforts, principally by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA); and*
- *monitoring various international bodies, which establish accounting, auditing, and independence standards designed to improve financial accounting and reporting and the quality of audit practice, including standards applicable to multinational offerings.*

What We Did

- Took a proactive role in addressing various accounting, financial disclosure, and auditor independence issues resulting from the September 11, 2001 terrorist attacks.

- Continued our involvement in initiatives to ensure independence by auditors of public companies, culminating in the issuance of revised rules that modernized the Commission’s auditor independence requirements.
 - Issued a staff accounting bulletin (SAB) on loan loss allowance methodologies and documentation.
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Accounting-Related Rules and Interpretations

The SEC’s accounting-related 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 SEC.

Suspension of Restrictions on Stock Repurchases

In response to the events of September 11, 2001, the Commission issued a series of emergency and exemptive orders pursuant to various sections under the Securities Exchange Act of 1934, including the provision that public companies repurchasing their shares during the period ending October 12, 2001 would not have adverse consequences under the pooling-of-interests requirements in Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, and related interpretations of the AICPA.

Auditor Independence

After making modifications in response to public comments, the Commission adopted rules that modernized its auditor independence regulations.¹⁰⁴ The adoption of the rules culminated 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; and a 75-day comment period that yielded approximately 3,000 comment letters and related public hearings at which approximately 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 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 the concept of being an independent auditor; and
- required the disclosure of:
 - audit fees,
 - fees for information system design and implementation,
 - fees for all other non-audit services,
 - whether the company's audit committee considered whether non-audit services provided by the auditor are compatible with the auditor's independence, and
 - whether more than 50% of the hours expended on the audit were done by persons other than the auditor's full-time, permanent employees.

Following the issuance of the revised independence rules, the accounting staff issued guidance regarding implementation and interpretive issues.

During 2001, the Commission issued a policy statement amending Financial Reporting Release No. 50 to state that the SEC will no longer look to the ISB for leadership in establishing and improving auditor independence standards applicable to auditors of the financial statements presented by SEC registrants.¹⁰⁵ As a result of the Commission's recently adopted independence rules, members of the ISB, the accounting profession, and the SEC believe that many of the issues that led to the creation of the ISB have been resolved, and that it would be preferable to involve the private sector in maintaining and improving the auditor independence requirements by working with the AICPA's Professional Ethics Executive Committee (PEEC) on discrete issues where appropriate. Standards and interpretations adopted or issued previously by the ISB will continue to be considered authoritative to the extent that they do not conflict with the Commission's rules and interpretations. The ISB discontinued its operations effective July 31, 2001.

In another initiative to address the business disruptions caused by the September 11, 2001 events, the Commission issued an interpretive release related to the provision of certain bookkeeping services to audit clients of accounting firms.¹⁰⁶ In response to inquiries from accounting firms and registrants, the release indicates that accounting firms may assist audit clients that had offices in and around the World Trade Center in recovering destroyed records and systems.

Allowance for Loan Losses

The SEC and the four federal banking agencies¹⁰⁷ completed their guidance on documentation of loan loss allowances, resulting in the issuance of a SAB¹⁰⁸ and a policy statement from the Federal

Financial Institutions Examination Council. The SAB provides guidance to registrants to assist them in improving their systematic methodologies for estimating loan loss allowances and their supporting documentation but does not change existing rules on accounting for loan loss allowances or provisions. Previously, the Commission issued guidance on loan loss methodologies and documentation in Financial Reporting Release No. 28;¹⁰⁹ the SAB provides guidance on it. In addition, the SEC and the federal banking agencies continue to support and encourage the Accounting Standards Executive Committee's (AcSEC) project to develop additional guidance on the accounting for loan losses.

Oversight of Private Sector Standard Setting

Accounting Standards

Financial Accounting Standards Board

The Commission oversees the FASB process to determine whether the process is operating in an open, fair, and impartial manner and whether each standard is within an acceptable range of alternatives that serves the public interest and protects investors. The Commission and its staff work with the FASB 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 attended meetings of the FASB's Emerging Issues Task Force, observed FASB task force meetings, and held quarterly discussions with the FASB staff. The Commission's Chief Accountant observed the quarterly meetings of the Financial Accounting Standards Advisory Council, which consults with the FASB on major policy and agenda issues.

A sampling of some of the FASB activities overseen by the staff during the year include:

- The adoption of new standards on accounting for business combinations that eliminate the pooling-of-interests method to account for business combinations and no longer require amortization of goodwill recognized under the purchase method of accounting.¹¹⁰
- The completion of a project to establish the appropriate accounting and financial disclosure for obligations associated with the retirement of long-lived assets and related asset retirement costs.¹¹¹
- The adoption of a revised standard on accounting for the impairment or disposal of long-lived assets.¹¹² The new standard supersedes an earlier FASB standard and Opinion of the APB that addressed these issues.¹¹³
- Activities relating to the FASB's long-term project to address financial instruments and off-balance sheet financing issues. The FASB considered comment letters and other input received on a preliminary views document on various issues relating to the determination and use of fair value for measuring financial instruments.¹¹⁴ During 2001, the FASB published a special report on an *ad hoc* international group's (the Financial Instruments Joint Working Group of standard setters) recommendations on reporting financial instruments and similar items.¹¹⁵
- Deliberations of the FASB's Derivatives Implementation Group, which identified issues related to implementation of the accounting standard for derivative instruments and hedging instruments,¹¹⁶ and developed recommendations for their resolution.

- The discontinuation of a project to specify when entities should be included within consolidated financial statements. From the SEC's perspective, the existing standards for determining when entities should be included in the consolidated financial statements of public companies generally should be adequate during the period preceding reassessment by the Board. (The existing standards are based on majority voting ownership, with certain exceptions under rule 3A-02 of Regulation S-X.) 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 consolidation guidance concerning SPEs.
- The completion of 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*. The report issued by the research project's Steering Committee focused on the voluntary disclosures of certain types of non-financial information being made by leading companies in selected industries.¹¹⁷ In a related initiative, Professor Jeffrey Garten, Dean of Yale's School of Management, assembled a committee of leaders from the business community, academia, the accounting profession, standard-setting bodies, and others. The group's report was issued during 2001 and focused on how current SEC disclosures could be improved or enhanced through greater disclosures of a company's measures of value creation or lack thereof, such as key performance indicators.¹¹⁸ We are evaluating the recommendations made by these two groups to determine what actions may be appropriate for the protection of investors.

- The identification and resolution of accounting issues by the FASB's Emerging Issues Task Force (EITF). During 2001, the EITF reached consensus on several significant issues, including the appropriate financial reporting of the impact of the September 11 events. On this issue, the EITF concluded that none of the losses and expenses related to the events of September 11, 2001 should be classified as extraordinary for financial reporting purposes, even though some costs may satisfy the criteria for treatment as extraordinary items. The EITF concluded that the high level of judgment necessary to determine whether or not a loss is attributable to the September 11 events would result in an accounting model that is not operational and, therefore, decided to treat all costs as operating costs.

Accounting Standards Executive Committee

Our accounting staff oversaw various accounting-standard setting activities conducted through the AcSEC, established by the AICPA to provide guidance through its issuance of statements of position and practice bulletins. AcSEC issued a statement of position to provide guidance on the appropriate accounting and financial reporting for demutualizations and other activities of insurance companies.¹¹⁹ It also adopted a revised audit guide for investment companies.¹²⁰ AcSEC also continued work on a project on accounting for credit losses and issued a proposed statement of position on the appropriate accounting for certain costs and activities related to property, plant, and equipment.¹²¹

Panel on Audit Effectiveness of the Public Oversight Board

The accounting staff continued to monitor responses to the recommendations for improving the quality and effectiveness of audits set forth in the report of the Panel on Audit Effectiveness.¹²²

The Panel's report included approximately 200 recommendations to the accounting profession, standard setters, audit committees, and regulators. Some of those recommendations also focus on the need to improve international auditing and quality control standards. We have encouraged the appropriate responsible party to address each recommendation. The Public Oversight Board (POB) also has been asked to report to the public on the progress on implementation of the Panel's recommendations.

Auditing Standards

Auditing Standards Board (ASB)

The staff continued to oversee activities of ASB, established by the AICPA to set generally accepted auditing standards, including its efforts to enhance the effectiveness of the audit process. The staff is monitoring the ASB's progress in addressing the recommendations in the report of the Panel on Audit Effectiveness. During 2001, the ASB issued a new auditing standard that addresses the effect of information technology on the auditor's consideration of internal control.¹²³ 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 year-end audits.

Quality Controls and Peer Reviews

SEC Practice Section (SECPS)

Our accounting staff oversaw the processes of the SECPS, established by the AICPA to improve the quality of audit practice by member accounting firms that audit the financial statements of public companies. 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 by other accountants is required every three years, and the Quality Control

Inquiry Committee (QCIC) reviews on a more timely basis the quality control implications of litigation against member firms that involves public company clients.

During the year, we encouraged the creation of a charter that gave the POB explicit authority to oversee additional aspects of the profession's system of governance. The charter, adopted in February 2001, gives the POB greater oversight over the setting of auditing standards in order to better coordinate the findings of the self-regulatory processes and the auditing standard setters, as well as the ability to conduct special reviews of the accounting profession.

Our accounting staff selected a random sample of peer reviews and evaluated selected working papers and the related POB oversight files and reviewed QCIC closed case summaries and related POB oversight files. The SEC staff provided the staff of the POB with comments on certain peer reviews with the goal of achieving more understandable communications to the public of the peer review findings.

The SECPS issued a new membership requirement in 2000 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 with the SEC staff to conduct a voluntary "look-back" program to assess each firm's compliance with specified independence criteria. The agreement requires firms to upgrade their quality control systems that monitor compliance with auditor independence rules. Pursuant to the terms of the look-back program, participating firms also are required to permit the POB to oversee the design and implementation of the new quality control systems. The look-back phase of the review has been completed and revealed an average of approximately 30 violations per firm--a small fraction of the professionals whose financial interests were reviewed under the program.

Self Discipline

The staff met with the PEEC to discuss the PEEC's disciplinary actions. The PEEC's disciplinary actions, including their timeliness, are affected by a lack of subpoena powers and a deferral policy that provides all other litigation to be completed before PEEC action is pursued. The PEEC has added three representatives of the public to its approximately 20-member board, and consideration is being given to further increasing the number of public members. In addition, the Panel on Audit Effectiveness made several recommendations to the AICPA and the PEEC that, if implemented, should improve the PEEC process.

International Accounting

Today, corporations regularly look beyond their home country's borders for both debt and equity capital. An increasing number of foreign companies routinely raise or borrow capital in U.S. markets, and U.S. investors have shown great interest in investing in foreign enterprises. Currently, issuers wishing to access capital markets in different jurisdictions must comply with the differing requirements of each jurisdiction. Foreign private issuers registering their securities in the U.S. are permitted to prepare their basic financial statements either in accordance with U.S. generally accepted accounting principles (GAAP) or another comprehensive body of accounting, such as International Accounting Standards or home country GAAP, along with reconciliation to U.S. GAAP. The SEC recognizes that the different listing and reporting requirements may increase the costs of accessing multiple capital markets and create inefficiencies in cross-border capital flows, and has been working with securities regulators and other bodies around the world to reduce accounting differences. The SEC, through the International Organization of Securities Commissions, is active in monitoring and reacting to accounting developments. The staff also works directly with other country regulators, and with accounting standards setters including

the FASB and the International Accounting Standards Board (IASB).

The IASB is the successor organization to the International Accounting Standards Committee and came about in a multi-year restructuring effort that changed the body to a full-time expert standards setting organization dedicated to the public interest. The new IASB established a full agenda of standards projects and began monthly meetings in April 2001. The SEC staff has observed most IASB meetings, is monitoring the progress of the IASB, and has encouraged the IASB to work with the FASB and other national accounting standards setters to create global accounting standards that will support the imperatives of a global marketplace. In particular, the staff has urged cooperation to achieve convergence on high quality accounting standards, which could reduce or eliminate the need for reconciliation.

During the past year, the staff began considering the views expressed in over 90 comment letters received in response to a concept release on accounting, auditing, and regulatory issues that impact the effectiveness of financial reporting in a global environment¹²⁴ and related research, and evaluating alternatives for SEC action, which could include recommendations for rulemaking. The comment letters reflect a wide variety of views on the present quality of international accounting standards and on the reliability of the information they produce for investors. European commenters generally favored reducing or eliminating reconciliation requirements, while U.S. commenters generally urged that present reconciliation requirements be retained. Comments vary on how consistently and reliably international accounting standards (IAS) are applied, audited, and enforced throughout the world, and on what the SEC should do regarding the use of IAS by foreign issuers listing in the United States.

International Auditing

Ensuring that high quality financial information is provided to the capital markets does not depend solely on the body of accounting standards used. Auditors have a key role to test and opine on whether the financial statements are fairly presented in accordance with Generally Accepted Accounting Principles. If these responsibilities are not met, accounting standards may not be properly applied, resulting in a lack of transparent, comparable, and consistent financial information.

For the last several years, the SEC and a number of international financial institutions have been urging the audit profession, and particularly the major global audit firms, to improve the quality of international auditing. This is a long-term goal that envisions a future global market where financial statements are subject to audit under uniform international auditing standards. Currently, financial statements presented by foreign private issuers must comply with U.S. Generally Accepted Auditing Standards.