

# Accounting and Auditing Matters

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*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 actions;*
- *oversight of U.S. private sector efforts, principally by the Financial Accounting Standards Board (FASB), the Public Company Accounting Oversight Board (PCAOB), and the American Institute of Certified Public Accountants (AICPA); and*
- *monitoring of 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.*

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## What We Did

- Played a proactive role in responding to a turbulent financial reporting environment through issuance of guidance to company management, auditors, audit

committees, and investors on various topical financial reporting matters emerging from this environment.

- Proposed rules which would have established a Public Accountability Board (PAB) to improve investor confidence in the quality of reporting.
  - Began implementing numerous provisions of the Sarbanes-Oxley Act of 2002.
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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.

SEC staff identified several deficiencies in our current financial reporting system and undertook the initiatives described below to address these deficiencies. Among the most significant of these deficiencies was the failure of the accounting profession's self-regulatory system.

### **Pro Forma Financial Information**

On December 4, 2001, the Commission issued a cautionary release in response to an increase in the use of measures of earnings and results of operations calculated using methodologies other than U.S. Generally Accepted Accounting Principles (GAAP).<sup>126</sup> This information is presented in earnings releases and often is referred to as "pro forma" financial information. The release cautions public companies that the use of "pro forma" information entails certain risks and alerts investors to the potential dangers in relying on such information. Shortly after

fiscal year-end, as directed by section 401(b) of the Sarbanes-Oxley Act, the Commission issued proposed rules to govern the presentation of non-GAAP financial information.<sup>127</sup>

### Disclosure of Critical Accounting Policies

The Commission issued a second cautionary release to remind company management, auditors, audit committees, and other advisors that the selection and application of the company's critical accounting policies and practices must be appropriately reasoned.<sup>128</sup> The release emphasized the demands by investors for transparent disclosure of accounting policies and their effect. As a follow up action, the Commission subsequently proposed rules to require that public companies provide disclosures about the selection of critical accounting policies within Management's Discussion and Analysis (MD&A).<sup>129</sup>

### Commission Statement Regarding MD&A

In response to a rulemaking petition submitted by certain major accounting firms and the AICPA, the Commission issued a statement regarding disclosures that should be considered by registrants in preparing MD&A disclosures.<sup>130</sup> The release focuses on the need to provide disclosures on (1) liquidity and capital resources, including dependence on off-balance sheet arrangements, (2) trading activities involving non-exchange trading contracts, and (3) related-party transactions.

### Requirements for Arthur Andersen LLP Audit Clients

The Commission adopted certain temporary and final rules to ensure a continuing and orderly flow of information to investors and U.S. capital markets and to minimize potential disruptions resulting from the indictment of Arthur Andersen LLP.<sup>131</sup>

### Improved Oversight and Accountability of Auditors

In June, the Commission proposed rules that would have established a framework for enhancing the quality of financial

information through needed improvements in oversight of the auditing process.<sup>132</sup> The rule proposal was designed to restore investors' confidence in the financial information being relied upon to make investment decisions. As emphasized by Chairman Pitt in congressional testimony of March 21, 2002, concerning accounting and investor protection issues raised by Enron and other public companies, "[t]he number of sudden and dramatic reversals of public companies' financial statements calls into question the regulatory system currently used to oversee the quality of audits of public company financial statements."<sup>133</sup>

Under the proposed rules, a registrant's financial statements would not have complied with the requirements of the securities laws and Commission rules unless the registrant's independent accountant was a member of a PAB. The proposed rules also would have required that the registrant engaging an accountant to audit or review financial statements that are filed with the Commission be an adjunct member of the same PAB to which the independent accountant belongs.

The proposed rules set forth a number of specified conditions and functional performance requirements that must be met before the Commission would recognize a PAB. Examples included:

- the PAB must be committed to improving the quality of financial statements and the professional conduct of accountants by (1) directing periodic reviews of accounting firms' quality controls over their accounting and auditing practices, (2) disciplining accountants when appropriate, and (3) performing other related functions;
- a majority of the PAB's membership must be persons who are not members of the accounting profession;
- the PAB must be subject to SEC oversight; and

- the PAB has the authority to establish audit, quality control, and ethics standards, or to designate and oversee other private sector bodies that would establish such standards.

The PAB was intended as a replacement for the then-current system of self regulation to which the accounting profession was subject. There was general consensus among affected parties that this system of oversight (involving firm-on-firm peer reviews overseen by the Public Oversight Board under the aegis of the AICPA) had not produced a credible result. Longstanding deficiencies in the regulatory system to oversee the quality of audits and reviews of financial statements filed with the Commission have contributed to a decline in investor confidence and provided the impetus for the Commission's proposal. This policy initiative was superseded by the Sarbanes-Oxley legislation.

### Implementation of the Sarbanes-Oxley Act

In addition to the sudden bankruptcy of Enron Corporation and the indictment and collapse of Arthur Andersen LLP described earlier, reports that WorldCom would restate its financial statements with respect to billions of dollars in operating expenses further eroded investor confidence in the integrity of reported information. In response, Congress passed the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act established the PCAOB and addressed issues related to auditor independence, corporate responsibility, full disclosure, analysts' conflicts of interest, criminal sanctions, and other matters. The staff provided input during consideration of the bills that formed the Act and is participating in drafting several of the rules mandated by the Act. These rules relate to, among other things:

- the formation of the PCAOB;

- preventing an issuer’s officers, directors, and persons acting under the director of an officer or director from fraudulently influencing, coercing, manipulating, or misleading an auditor of the issuer’s financial statements for the purpose of rendering the financial statements materially misleading;
- auditor independence, including prohibited non-audit services, an audit committee’s pre-approval of services provided by the auditor, and limitations on certain audit firm partners becoming officers of audit clients;
- management and auditor reports on an issuer’s internal controls for financial reporting;
- disclosure of material off-balance sheet transactions;
- disclosure of “pro forma” financial information;
- recognition as “generally accepted” the accounting standards promulgated by the Financial Accounting Standards Board; and
- the retention of relevant audit records.

Also, pursuant to section 108(d) of the Act, the staff has initiated a study on the adoption in the United States of a system of principles-based accounting standards.

## **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 and its Emerging Issues Task Force (EITF), observed FASB task force meetings, and held quarterly discussions with the FASB staff. The Commission's Office of the Chief Accountant observed the quarterly meetings of the Financial Accounting Standards Advisory Council, which consults with the FASB on major policy and agenda issues.

### Special Purpose Entities

During 2002, the FASB resumed work on a project to specify when entities with specific limits on their powers, also referred to as special purpose entities (SPE), should be included within consolidated financial statements. In previous SEC annual reports, we noted that the existing standards do not adequately address circumstances involving SPEs and urged the FASB to continue its efforts to provide consolidation guidance for these entities.

The FASB issued a proposed interpretation that would establish standards for consolidation of SPEs that do not have sufficient equity interest to finance their own activities without additional financial support.<sup>134</sup> Under the proposed interpretation, an enterprise that provides significant financial support to a SPE would be required to consolidate the SPE if it provides either significantly more financial support than any other party or a majority of the financial support.

At fiscal year-end, the FASB was evaluating comment letters received on the proposed interpretation along with input from participants at a public roundtable conducted on September 30 to

discuss issues relevant to this project. The FASB plans to issue a final interpretation in early 2003.

### Recognizing Expense for Stock-Based Compensation Arrangements

During 2002, several prominent public companies announced plans to adopt the provisions of FASB Statement 123 in recognizing expense for stock-based compensation arrangements.<sup>135</sup> In response to these actions, the FASB reached a number of decisions intended to ease the transition for companies that voluntarily adopt the fair value method of recording expenses related to employee stock options as prescribed by the FASB standard. The FASB issued an exposure draft of a proposed amendment to Statement 123<sup>136</sup> that would permit three alternative methods of transition for companies choosing to adopt the preferable method of accounting for stock-based compensation arrangements. The exposure draft also would amend Statement 123 to require expanded disclosures about the costs of stock-based compensation and to require disclosures in interim financial statements.

### Revenue Recognition

The FASB added to its agenda a project to develop a comprehensive standard on revenue recognition applicable to business entities generally. The scope of the project will include a reconsideration of the guidance on revenue recognition set forth in the FASB's Concepts Statements on revenue recognition and measurement. From the SEC's perspective, this project should be given high priority in view of the substantial number of financial frauds involving improper revenue recognition by public companies.

During 2002, the FASB's EITF reached consensus on several significant issues relating to the appropriate method of revenue recognition for certain specific types of transactions. The EITF also devoted significant resources to addressing a related issue of how an arrangement involving multiple deliverables should be divided into units for accounting purposes.<sup>137</sup>

## Principles-Based Accounting Standards

Also during 2002, the FASB initiated a project to address concerns about an increase in the detail and complexity of U.S. accounting standards. The project entailed issuance of a proposal for a principles-based approach to accounting standards setting, which the FASB intends to pursue. As presently contemplated, the accounting standards developed under a principles-based approach focus on establishing general principles derived from the conceptual framework concerning the recognition, measurement, and reporting requirements for the transactions covered by the standards. The major differences envisioned between existing accounting standards and standards developed under a principles-based approach relate to exceptions and the level and nature of additional guidance.

Under the principles-based approach being contemplated, accounting standards would provide few, if any, exceptions to the general principles. Furthermore, additional guidance would be restricted to the transactions typically covered by the relevant standard; the exercise of professional judgment would be necessary in applying the general principles to other transactions.

As discussed earlier, the Sarbanes-Oxley legislation directs the SEC to conduct a study of principles-based accounting standards. Compliance with the legislation will require that a report of such a study be made to Congress no later than July 30, 2003.

## Other

The FASB completed a project on the financial reporting for costs associated with exit or disposal activities.<sup>138</sup> The standard resolved a conflict between guidance previously issued by the EITF and the FASB's conceptual definition of a liability.<sup>139</sup>

The FASB also worked on a project to amend its existing requirements for applying the purchase method in acquisitions for financial institutions. The amendments would conform these requirements with newly adopted Statements No. 141, *Business Combinations* and No. 142, *Goodwill and Intangible Assets*. The

FASB issued a final standard conforming these requirements in October 2002.<sup>140</sup>

### *Accounting Standards Executive Committee (AcSEC)*

The Commission's accounting staff oversaw various accounting-standard setting activities conducted through the AcSEC. The AICPA established AcSEC to provide guidance through its issuance of statements of position and practice bulletins. AcSEC continued work on various projects, including one concerning the accounting for certain costs and activities related to property, plant, and equipment.<sup>141</sup>

### *Panel on Audit Effectiveness of the Public Oversight Board*

In August 2000, the Panel on Audit Effectiveness (Panel) issued its report, which included recommendations to the accounting profession, standard setters, regulators and others.<sup>142</sup>

Organizations are implementing the Panel's recommendations voluntarily. In the course of carrying out its oversight responsibilities, SEC staff has monitored the implementation of the Panel's recommendations, including the Auditing Standards Board's responses to the Panel's recommendation (described below).

In addition to the staff's activities, the Transition Oversight Staff (TOS) (formerly the staff of the Public Oversight Board) periodically monitored and reported on the actions taken by those organizations necessary to respond to the Panel's recommendations. The TOS completed its most recent analysis early in 2002. The TOS, SEC staff or PCAOB staff may complete future analyses.

### *Public Company Accounting Oversight Board (PCAOB)*

The Sarbanes-Oxley Act established the PCAOB to oversee the audits of public companies and related matters, to protect investors, and to further the public interest in the preparation of informative, accurate, and independent audit reports. The PCAOB is expected

to accomplish these goals through registration, standard setting, inspection, and disciplinary programs. Under the Act, the Commission, among other things, is to approve the PCAOB's rules, hear appeals from the PCAOB's disciplinary process, and oversee the PCAOB's inspection program. At fiscal year-end, the PCAOB was in the formative stages. SEC staff will work closely with the Board as it develops its programs and begins operations.

## Auditing Standards

### *Auditing Standards Board (ASB)*

The staff continued to oversee activities of the ASB, including its efforts to enhance the effectiveness of the audit process. The staff monitored the ASB's progress in addressing the recommendations in the report of the Panel on Audit Effectiveness. During 2002, the ASB issued new auditing standards regarding audit documentation,<sup>143</sup> the hierarchy of Generally Accepted Auditing Standards,<sup>144</sup> and consideration of fraud in a financial statement audit.<sup>145</sup> The ASB also issued guidance on the appropriate reporting of restated financial statements previously audited by Arthur Andersen<sup>146</sup> and amended its existing guidance to eliminate auditors reporting on hypothetical transactions.<sup>147</sup>

## Quality Controls and Peer Reviews

### *SEC Practice Section (SECPS)*

The Commission's 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. The peer review program requires a review of member firms by other accountants 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.

Significantly, in January of this year, the Public Oversight Board voted to cease operations after the Commission proposed establishing a new Public Accountability Board. The staff of the POB was reconstituted as the TOS and will perform an oversight role over the peer review and QCIC processes until the PCAOB is operational next year.

During the year, the Commission's staff selected a random sample of peer reviews, evaluated selected working papers and related POB oversight files, and reviewed QCIC closed case summaries and related POB oversight files. The SEC staff provided the POB staff (currently the TOS) 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 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 was completed. The second phase of the program, under which the TOS is to test the firms' quality controls, is in the final stages. SEC staff will continue to consult with the TOS and the accounting firms during this phase of the review.

## International Accounting and Auditing

Transparency in financial reporting and the impartial assurance provided through audits of public company financial statements by independent accountants are critical to the capital formation provided in all investing activities. It is especially valuable in international investing, where great distances and substantial differences in business and economic conditions may be involved.

Investors need high quality information on the performance and financial position of the companies that look to attract their investments. Companies seeking funds for growth are obligated to produce reliable and useful financial information, in accordance with GAAP and SEC requirements, to supply the full and fair disclosure that will aid investor decision-making.

### International Accounting Standards

International accounting standards have been a subject of interest in the global financial community for some time. The SEC, the International Organization of Securities Commissions (IOSCO), and other international financial institutions and professional bodies have noted the benefit that could be provided to investors if a single set of high quality global accounting standards could be developed and applied in such a way as to become widely accepted and recognized for use in cross-border investing activities. The International Accounting Standards Board (IASB) and its predecessor, the International Accounting Standards Committee, have been working to develop and improve such a set of global accounting standards for more than 25 years. Such work has become more prominent in recent years, in part due to the decision of the European Union to adopt International Accounting Standards (IAS) as its official body of accounting standards in 2005 and similar actions announced or being considered in several other countries. SEC staff regularly monitored the accounting standards development work of the IASB and communicated with the IASB on areas of concern, either directly or through staff involvement in IOSCO.

The IASB established an agenda of significant accounting projects soon after its reorganization into a full-time, independent private sector accounting standards-setting body in 2001. During 2002, several additional projects were added to address current matters of concern in financial reporting, and the IASB also established the International Financial Reporting Interpretations Committee (IFRIC). The SEC staff attended the meetings of IFRIC as one of the IOSCO observers of the process, and also sends an SEC representative to the meetings of the IASB Standards Advisory Council. The SEC staff also observes the work of IFRIC and encourages the development of guidance that will promote the consistent interpretation and application of IAS.

### Convergence of Accounting Standards

U.S. GAAP has long been recognized as the most comprehensive and robust body of accounting guidance in the world. GAAP has been widely accepted for financial reporting by U.S. companies listing in markets outside the U.S., and for use in some instances by non-U.S. companies. At the same time, participants in cross-border investing activities, regulators with oversight responsibilities, and others in the international financial reporting community have noted the desirability of achieving a single set of high quality global accounting standards that could be used in cross-border offerings of securities.

In 2000, the SEC issued a concept release seeking public comment on experiences using IAS issued by the International Accounting Standards Committee, the predecessor to the IASB, and also raised a number of questions regarding current and potential use of IAS by foreign private issuers listing in the U.S. markets.<sup>148</sup> A significant topic in the release involved the SEC's requirement for reconciliation of financial statements of foreign issuers prepared under IAS to net income and equity prepared under U.S. GAAP.

Also in 2000, IOSCO completed an assessment of the IAS then in existence and issued a recommendation that IOSCO members accept IAS in incoming filings of cross-border issuers, subject to

additional requirements for interpretation, disclosure or reconciliation that might be needed to meet national concerns in member jurisdictions.

The SEC staff continued consideration of potential actions with respect to use of IAS by foreign issuers in the U.S. Staff activities included identification and consideration of the accounting differences that are being encountered in the reconciliations from IAS to U.S. GAAP in foreign issuer filings under SEC Form 20-F, as well as attention to other differences that exist in the two bodies of accounting standards.

In discussions of accounting differences between IAS and U.S. GAAP, the SEC staff encouraged the FASB and the IASB to work together to achieve greater convergence in accounting standards. The two standards-setting boards responded by agreeing to work toward reducing the differences in IAS and U.S. GAAP as they work to improve accounting principles and address issues in financial reporting.

### Consistency in International Financial Reporting

A set of high quality international accounting standards is a critical foundation for international financial reporting, but other elements of a global financial reporting infrastructure are needed to support their consistent use. Other elements of a global financial reporting infrastructure include:

- high quality auditing and auditing standards;
- consistent interpretation of accounting standards;
- effective oversight of standards setters and auditors;
- independence of auditors;
- ethics and competence on the part of preparers, auditors, and others;

- corporate governance over financial reporting;
- quality controls within accounting firms; and
- reviews and enforcement of financial reporting by authorities.

The SEC staff works with regulators within the IOSCO to promote consistent interpretation and application of IAS across jurisdictions, to enhance international financial reporting in other ways, and to promote cooperation in regulatory oversight, review, and enforcement activities. During 2002, the staff participated in a number of IOSCO initiatives to curb abuses in the use of non-GAAP performance measures, and to establish general principles for auditor oversight, auditor independence, and transparency and disclosure. These efforts resulted in the IOSCO issuance of a “Cautionary Statement on Non-GAAP Results Measures” and also in issuance of three IOSCO statements of principles to guide securities regulators in dealing with critical areas necessary for investor confidence in securities markets. The principles describe essential features of regulatory systems requiring transparency and disclosure by listed entities, the independence of external auditors, and the need for public oversight of the audit function.

The staff is engaged in ongoing dialogues with other countries’ regulators regarding ways to promote consistent interpretation of IAS across jurisdictions as well as ways to communicate on other accounting and reporting matters of concern. The staff met this year with representatives of the European Commission and authorities from jurisdictions around the world to discuss ways in which regulators can promote high quality financial reporting and auditing.

### International Audit Quality

It has been noted that the quality and amount of effort associated with audits of public company financial statements varies

significantly around the world. The SEC staff has been working, through IOSCO and directly, with public and private sector bodies that are concerned with international auditing. During 2002, the staff participated in an ongoing assessment of the International Standards on Auditing issued by the International Federation of Accountants. The staff met with representatives of the European Commission, regulators in other countries, and audit firms and professional groups to discuss ways to improve international auditing through auditor oversight, internal and external reviews, and audit firm quality controls.