

Accounting and Auditing Matters

Overview

“Everything we do is live, and we can’t just take a timeout. We must keep up the pace, but the result—significant improvement in the quality of financial reporting and improved corporate governance—is worth the effort.”

Donald Nicolaisen
SEC Chief Accountant

31 staff in the Office of Chief Accountant:

- Provided extensive oversight of the formation and start-up activities of the Public Company Accounting Oversight Board (PCAOB), an entirely new mechanism to regulate the auditing profession.
- Oversaw activities of the Financial Accounting Standards Board (FASB), including the development of new accounting standards to respond to recent corporate scandals.
- Conducted and participated in 12 rulemaking initiatives in response to the provisions of the Sarbanes-Oxley Act of 2002, including initiatives on auditor independence, off-balance sheet disclosures, and pro forma disclosures.
- Led efforts towards improvement and convergence in accounting and auditing standards through the International Organization of Securities Commissions (IOSCO) and by encouraging the FASB and the International Accounting Standards Board (IASB) to coordinate their agendas and eliminate existing differences.
- Increased our monitoring of, and interaction with, international organizations that establish accounting, auditing, and independence standards.

Key Results

Issue	Result
Regulation of the Accounting Profession	The Commission issued an order announcing its determination that the PCAOB, established by the Sarbanes-Oxley Act of 2002 to regulate auditors of public companies, is so organized and has the capacity to carry out its responsibilities imposed under the statute. ¹⁰⁵
Deletion of Obsolete/Duplicative Guidance	The Commission staff issued a Staff Accounting Bulletin that codifies interpretive guidance of previous bulletins that is consistent with current accounting literature and SEC rules. ¹⁰⁶
Oversight of the Accounting Standard-Setting Process	The Commission staff issued to Congress a study and report on the adoption of a principles-based accounting system in the United States. ¹⁰⁷

Main Activities	Fiscal 2003	Fiscal 2002	% Change
U.S. Accounting Standard-Setting Projects and Issues Monitored	75	60	25%
International Accounting Standards and Interpretations Monitored	20	8	150%
Quality Reviews of Accounting Firms Subject to SEC Oversight	4	0	NA

Significant Financial Reporting Accomplishments

Regulation of the Accounting Profession

During the year, the Office of Chief Accountant worked closely with the PCAOB during its start-up phase to ensure that it was ready to perform its duties within the time period established by the Sarbanes-Oxley Act. This included obtaining Commission approval of rules covering the PCAOB's bylaws, code of ethics, process for setting auditing standards, and registration of auditing firms.

We also worked closely with the Offices of the Executive Director and Economic Analysis (OEA) to develop the PCAOB's support fee and budget, which the Commission also approved.

The accounting staff continued to work with the Transition Oversight Staff of the American Institute of Certified Public Accountants (AICPA) on peer reviews of auditing

firms and to transition to the PCAOB's investigations. We led the development of the Commission's new rules on auditor independence in response to the Sarbanes-Oxley Act. Key provisions include new rules that prohibit a number of non-audit services from being provided by the auditor to its client, restrict compensation to audit partners from selling non-audit services, and require periodic rotation of audit partners.

The Commission staff issued a frequently asked questions (FAQ) document to address implementation questions received by the staff regarding the SEC's new independence rules. Among other issues, the FAQ clarified the requirements for audit committee consideration of all non-audit services to be provided and expanded the available guidance on partner rotation.

Accounting Standards

The Commission issued a policy statement that recognizes the FASB as a designated private sector accounting standard setter, in accordance with criteria set forth in Section 108 of the Sarbanes-Oxley Act. This action reiterated the importance and usefulness of the private sector standard setting effort.

The accounting staff oversaw the FASB's work to develop new accounting standards for guarantees, consolidation of special purpose entities, and distinguishing liabilities from equity, all of which were

problems highlighted by Enron and other corporate scandals.

The Sarbanes-Oxley Act mandated that the Commission conduct a study of the adoption by the United States financial reporting system of a principles-based accounting system. Congress recognized that questions remained regarding how accounting standards are established. Office of the Chief Accountant staff worked with OEA to draft and issue a staff report on the approach to standard setting in the United States. This report describes the optimal approach to writing accounting

standards as one that would include clearly stated objectives, a framework of implementation guidance, and

no arbitrary scope exceptions or bright-line tests and makes recommendations about how to proceed.

Commission's Disclosure Rules

We participated in rulemaking projects to enhance disclosures of off-balance sheet activities and the use of *pro forma* information. Registrants must now explain why they believe the *pro forma* information is useful and reconcile that information to information prepared under Generally Accepted Accounting Principles. These new requirements provide important new information to investors.

We also participated in rulemaking to require

registrants, beginning in 2004 or 2005 depending upon their size, to annually assess the effectiveness of their internal controls and report on that assessment in their annual report. This is the first time public companies will be required to report on their internal control effectiveness.

We worked with the PCAOB to develop standards to facilitate auditor reporting on management's evaluation of internal control effectiveness. These standards are expected to be issued in January 2004.

International Accounting and Auditing Activities

During 2003, we worked with the FASB and IASB to identify and begin eliminating key differences between U.S. and international accounting standards.

The accounting staff also participated in efforts to provide public interest oversight of the International Federation of Accountants, which sets standards for audits performed outside of the United States.

Finally, the accounting staff increased resources devoted to working with IOSCO Standing Committee No. 1 (SC1) on multinational accounting, auditing, and disclosure. SC1 provided input on all IASB and IFAC proposed standards, and issued important documents about principles of management's discussion and analysis disclosures, auditor independence and auditor oversight.

Outlook for 2004

Our main objectives are to:

- Oversee the PCAOB's regulation of the accounting profession.
 - Monitor compliance with the Commission's independence requirements and continue to oversee the FASB's accounting standard-setting projects.
 - Keep pace with the increasing workload of the IASB and multiple accounting standards and interpretations undertaken as part of the convergence project with the FASB.
 - Increase monitoring and oversight of international auditing standards development and joint efforts with foreign regulators to strengthen auditor oversight and audit quality assurance.
- Complete a study and report for the President and Congress on the use of and financial reporting for off-balance sheet transactions and the special purpose entities (entities with specified limited powers) used to facilitate such transactions. This is the Chief Accountant's last remaining directive under the Sarbanes-Oxley Act.
 - Resolve an increasing number of complex accounting and reporting issues commensurate with the expected influx of foreign private issuer registrants using international financial reporting standards.