1-1-1981

Audit committees -- 1981: Developments and directions

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Audit Committees—1981

Developments and Directions
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Audit Committees—1981

Developments and Directions
Unprecedented attention has been focused recently on the broad issue of corporate accountability and the responsibilities of the audit committee in relation to it. The purpose, composition and functions of audit committees have been major concerns of the 1970s.

As we enter the 1980s, we expect more attention to be directed to the effectiveness of audit committees in their expanding role. Their interaction with groups and forces, from within and outside their organization, will influence the degree of accountability imposed as well as the credibility of the private sector.

This booklet presents developments, principally those in 1980, which help define or predict the role of audit committees in the corporate community. We discuss possible future directions and present a review of certain related technical developments of interest to audit committee members.
CONTENTS

I. CORPORATE GOVERNANCE AND ACCOUNTABILITY 5
   Introduction  5
   Audit Committees and the Foreign Corrupt Practices Act (FCPA)  6
   Proposed Amendment to the FCPA  7

II. THE EVOLVING ROLE OF AUDIT COMMITTEES 8
   Requiring Audit Committees—Recent Developments  8
   Who Serves on Audit Committees?  10
   What Activities Are Gaining Acceptance?  11
      More Involvement in the Financial Reporting Process
      Independent Auditors—Scope of Services and Fees
      Emphasis on Internal Accounting Controls
      Dialogue with Internal Audit Departments
      Overseeing Corporate Ethics Codes
      Other Emerging Responsibilities
   The Future  16
APPENDIX A. TECHNICAL DEVELOPMENTS — 
ACCOUNTING AND REPORTING

Financial Accounting Standards Board (FASB) 18
  Recent FASB Statements
  Disclosure of Pension Information
  Financial Reporting and Changing Prices
Future FASB Initiatives 20
  Conceptual Framework Project
  Foreign Currency Translation Proposal
Auditing Standards Board — Proposed Revision of
the Independent Auditor’s Standard Report 22

APPENDIX B. TECHNICAL DEVELOPMENTS — SECURITIES 
AND EXCHANGE COMMISSION

Integrated Disclosure System Adopted 24
Reaction to Justice Department FCPA Reviews 25
The Role of Corporate Lawyers — Proposed Rules
  Rejected 25
Reporting on Internal Accounting Control —
  Proposal Withdrawn 26
Future Initiatives 27
  Review of Disclosure Rules
  Proposed Registration Forms and Amendments
    to Quarterly Report Form 10-Q
  More Attention to Management’s Discussion
    and Analysis
  Proposed Federal Securities Code Supported
I. CORPORATE GOVERNANCE AND ACCOUNTABILITY

Introduction

Public attitudes have combined with governmental pressures to cause an evolution in the duties, responsibilities and structure of boards of directors and audit committees. Legislation, such as the Foreign Corrupt Practices Act, litigation, accounting and auditing developments, and SEC disclosure requirements are some of the external pressures which have made audit committees and their duties a topic of frequent discussion.

The process of establishing and structuring boards and audit committees is an evolutionary one. As A. A. Sommer, Jr., a former SEC commissioner, stated in the July 1980 issue of the *Journal of Accountancy*: “It is likely that current trends toward more outside directors; auditing, nominating and compensation committees dominated by outsiders; adoption of codes of conduct; and other corporate reforms will continue and that increasing numbers of corporations will see fit to establish these mechanisms.”

It is an accepted fact that audit committees in particular have increased in number and importance. In fact, the recent Conference Board report, *Corporate Directorship Practices: The Audit Committee*, indicates that management generally desires strong audit committees. According to the report, with a strong committee, management may experience a feeling of added assurance regarding the effectiveness of internal accounting controls and the reliability of financial statements. This favorable reaction results from responsible committees working together with management to achieve mutual goals.

During the last several years attention has been focused on the purpose, composition and functions of audit committees. This has resulted primarily from private sector initiatives assisted by encouragement from government regulators. Widely discussed has been the belief that audit committees help to balance the relationship between independent auditors and management and, therefore, help to
ensure the auditors’ independence. Regardless of the reasons for their formation, audit committees have become a part of the corporate structure in a substantial number of public companies. As we enter the 1980s, we expect the focus of attention to move to the effectiveness of audit committees.

Audit Committees and the Foreign Corrupt Practices Act

The passage of the Foreign Corrupt Practices Act (FCPA) has had a significant effect on audit committees. The Act’s provisions imply a need for an internal control environment which promotes efficient and adequate information for management and directors and discourages improprieties. This is accomplished through a system of internal accounting control and effective recordkeeping. In their oversight role, audit committees have had to deal more actively with the question of accountability in the information system.

The complexity of the FCPA and of most affected organizations has led to much confusion for corporate managers and directors. This confusion results from a lack of understanding of internal control operations and limitations, as well as confusion as to application of the Act itself. These uncertainties may result in increased reliance by audit committees on their independent auditors, internal auditors and counsel.

In response to many of the questions raised by the FCPA, the Financial Executives Research Foundation commissioned a study of U.S. internal control practices entitled Internal Control in U.S. Corporations: The State of the Art. The research was headed by Professor Robert K. Mautz of the University of Michigan. This study found that most executives see control as a “key management responsibility which they accept,” but many resent the perceived implications that “U.S. corporate executives are not adequately attentive to control practices.” Although the FCPA has encouraged a variety of actions by corporations, the report states that control measures in use differ significantly. One
Conclusion of the study is that "the FCPA has a strong tendency to encourage formal, often at the expense of informal, control measures."

A discussion of this subject is available in our firm's publication *Internal Accounting Control—Current Developments and Implications of the Foreign Corrupt Practices Act*.

**Proposed Amendment to the FCPA**

A bill was introduced in Congress in 1980 which was intended to amend and clarify the Foreign Corrupt Practices Act of 1977. If reintroduced in the next Congress, and if passed in its original form, it would, among other things:

- Change the title of the Act to *Business Practices and Records*
- Designate the Justice Department as the principal enforcer of the FCPA
- Establish a materiality standard for the accounting standards section of the FCPA
- Clarify compliance with accounting provisions

In proposing the legislation, Senator John Chafee noted that the unpredictable nature of the interpretation and enforcement of the FCPA by government agencies has caused unnecessary confusion.
II. THE EVOLVING ROLE OF AUDIT COMMITTEES

Requiring Audit Committees—Recent Developments

Public opinion and regulatory influence have had a significant impact on acceptance of audit committees by companies and boards. Our publication *Audit Committees—A Director’s Guide* includes a summary of the background of audit committee requirements. Here we present an update of recent events.

**SEC Staff Report—Rulemaking Not Now Necessary.**

The SEC’s 1980 *Staff Report on Corporate Accountability* is a compilation of data gathered over the last three years and contains staff recommendations on a number of significant issues. The report stated: “While the staff does not believe that an audit committee rule is necessary at the present time due to the significant percentage of companies that have established such committees, it will return to the Commission with further recommendations if the trend in establishment of such committees does not continue or if it appears that further guidance with respect to the functions of audit committees is necessary.”

While not requiring audit committees, the SEC continues to attempt to influence their formation, independence and conduct by proxy rules requiring disclosure of whether audit committees have been appointed, their composition, functions and number of meetings. The SEC is considering including similar requirements in their proposed registration forms, and have asked for comments concerning this issue.

**American Stock Exchange Issues Recommendations.**

The AMEX adopted a policy recommending that all companies listed on the exchange establish audit committees composed entirely of independent directors. However, it did not mandate the establishment of an audit committee as a requirement for listing because it was against interfering with the internal affairs of corporations.
U.S. Congress—Bill Introduced Requiring Audit Committees. A bill introduced in 1980 by Senator Howard M. Metzenbaum, the Protection of Shareholders’ Rights Act of 1980, would have required certain large companies to have audit committees composed solely of outside directors. The bill also specified the functions of audit committees.

SEC Chairman Williams has stated his desire to have the independence and effectiveness of corporate boards strengthened, but he raised several objections to the Metzenbaum bill during testimony before the Senate securities subcommittee. He is concerned that more attention would focus on compliance with the statute than on achieving effective boards. He stated that, “What we need, in my judgment, is to enhance private sector sensitivity to emerging public concerns and values, and allow it the flexibility to respond accordingly.”

The future of this legislation was uncertain at the end of 1980.

Court Actions. Some settlements of legal action have required establishment of totally independent audit committees. For example, a recent U.S. District Court decision required the following:

- Management must conduct internal audits, with internal auditors reporting directly to the audit committee
- The audit committee must be composed of at least three outside directors, who have no business dealings with the firm other than directors’ fees and expense reimbursement. The committee was authorized to:
  - Retain or dismiss independent and internal auditors
  - Consult with the independent auditors on their quarterly reviews of financials
- Review all monthly corporate and division financial statements and the auditor's management letter
- Receive quarterly reports from independent auditors on internal control deficiencies
- Review and approve all reports to shareholders and the SEC before dissemination

Although these activities do not necessarily reflect functions that normally would be performed by audit committees, this decision demonstrates the importance courts may attribute to audit committees. It is an example in which an audit committee was directly involved with the court's imposed remedial action.

Who Serves on Audit Committees?

The objective of committee member independence has been strongly supported by most commentators and independence is required by the New York Stock Exchange. Fulfilling this objective has caused a supply and demand "crunch". John E. Lohnes reported in Directorship (November 1980) that "the result of these trends has been a steadily growing demand for independent outside directors, the most desirable of whom are the chief executive officers of other companies. But in ever increasing numbers, CEOs are declining to make themselves available." Mr. Lohnes provides the following list of categories as being prominent in filling empty board seats: lower ranking senior officers of other companies; college presidents, administrators and others from academic life; specialists; retirees; women and minority group members.

In general, the Conference Board report shows that persons with accounting or financial background are present on committees but do not predominate. Therefore, the changes taking place in financial accounting and regulatory matters have necessitated getting more help, particularly from accounting firms and inside or outside counsel. Given proper assistance, the report states, "perhaps more valuable than knowledge or experience... are a director's personal
qualities... the audit committee has come to symbolize the increasing emphasis on independence... the essence of that independence is the integrity—and sometimes the courage—of the individual committee member.”

The Conference Board report indicated that although there are arguments in favor of systematic rotation of membership, it is not a majority practice. Also, few committees customarily rotate their chairmen. An emphasis on retaining experienced members seems to prevail.

**What Activities Are Gaining Acceptance?**

Much has been written and said regarding the traditional committee activities. These are generally described as: involvement in auditor evaluation and in the process of selection; review of the audit plan and scope; review of audit results; and making appropriate inquiries of, or communications with, auditors and others. These appear to be commonly performed, in varying detail and format, in a majority of committees—but the search for the “ideal” composition of duties will continue.

Certain specific activities appear to be gaining additional acceptance, primarily as the result of the corporate accountability issue and the apparent compatibility of these duties with traditional committee functions. These include: more involvement in the financial reporting process; concern with the total scope of services performed by the auditor and with auditors’ fees; more involvement in the attention given internal accounting controls; increased involvement with internal auditors; and overseeing corporate ethics.

**More Involvement in the Financial Reporting Process.**

Audit committee review of annual financial statements is a common practice. We have found that some audit committees are also performing reviews of quarterly financial information, including press releases and quarterly reports to the SEC, separate from the full board of directors.
The Conference Board report predicts that some involvement with quarterly or other unaudited statements “may become a preoccupation of more audit committees in the future. One reason is concern… that interim statements… might be interpreted by an investor or by the SEC as misleading or inaccurate.”

Recent SEC rule changes are intended to promote director involvement in the reporting process. The changes include a requirement that a majority of the board of directors, the principal executive officer, the principal financial officer, and the principal accounting officer or controller, sign the Form 10-K. While we have some concern about a regulatory philosophy that seeks to achieve substantive conduct on the part of directors through a signature requirement, we support the underlying objective of motivating directors, particularly audit committee members, to become more involved with the annual report as well as the review of audit results. What is now important for boards and audit committees is to plan for the necessary interaction between directors, management, outside auditors and counsel.

**Independent Auditors—Scope of Services and Fees.** The SEC’s proxy monitoring data discussed in their staff report indicates that for all companies examined, “over 58 percent of audit committees approve each professional service” provided by the auditor and over 42 percent “consider the range of audit and non-audit fees.” These percentages may be lower than expected because the proxy information examined included a period before the SEC proxy disclosure rules were in their present form. Companies now must disclose the nature of non-audit services provided by the independent auditor and must state whether the board of directors or audit committee had approved each service in advance and considered its possible effect on independence. We expect significant increases in these percentages.

The Conference Board report indicates that in 31 percent of the statements of audit committee functions which were analyzed, audit committees have been given some responsibilities in determining fees to be paid to the outside auditing firm. In addition, the survey indicates that as a result of the
disclosure requirements, many more companies plan to require their boards to pre-approve non-audit services. For most of these companies this process will involve the audit committee.

**Emphasis on Internal Accounting Controls.** The FCPA has caused committees to place increased emphasis on the effectiveness of internal accounting controls. The SEC proxy monitoring data shows that the audit committees of a "significant majority" of companies are now involved in overseeing internal accounting controls. This may cause committees to request more help and information from their independent auditor, counsel (regarding FCPA compliance), and the internal audit department. The FCPA and internal controls are discussed further in Section I of this booklet.

**Dialogue with Internal Audit Departments.** Internal auditors are becoming regularly involved in discussions with audit committees, sometimes making formal presentations or meeting separately with the committee. A formal dialogue is developing. In their 1977 publication *Corporate Audit Committees—Policies and Practices*, Mautz and Newman stated that "one of the surest marks of a maturing committee is increased attention to the internal audit function." With their added responsibilities, audit committees need this help and expertise—particularly for overseeing internal accounting controls, and in meeting the challenges of the FCPA. Audit committees may find that objective and competent internal auditors can provide a range of services that is considerably broader than would be possible for independent auditors to provide at a reasonable cost.

According to the Conference Board report, almost 80 percent of the committee charters examined now "make internal auditing one of the assigned areas of oversight or responsibility." Certain of these duties deal with reviewing and evaluating the internal audit function. The Institute of Internal Auditors has published standards that recommend external reviews of internal audit departments, similar to the peer reviews undertaken by public accounting firms.
The scope of the review should be based on the level of sophistication of the internal audit function. A limited approach would be to have the following evaluated: qualifications of staff; training; quality control; staffing plans; and the internal audit department’s position in the organizational structure.

A comprehensive discussion of this subject is included in a report prepared by Alan S. Glazer and Henry R. Jaenicke for the Institute of Internal Auditors entitled A Framework for Evaluating an Internal Audit Function. The report presents a method for planning the evaluation and reporting the results.

Because of their experience with their own profession’s peer review process, independent auditors are prepared to provide guidance for establishing review procedures; or they can conduct a review themselves and report the results of the evaluation to management and the audit committee or the full board of directors.

**Overseeing Corporate Ethics Codes.** The audit committee is sometimes involved with corporate ethics. The term “corporate ethics” is used here to describe the legality of corporate actions and their propriety in terms of a corporate “code of conduct.”

The growth of written codes of conduct and passage of the FCPA are both direct results of numerous disclosures of sensitive corporate payments. According to a survey appearing in the Summer 1980 issue of Directors and Boards, and conducted by the Opinion Research Corporation for the Ethics Resource Center, “as of 1979 as many as 50 percent of corporate codes of conduct were less than five years old.” In fact, 73 percent of the corporations surveyed reported having written codes of ethics, most of which “consist of general principles rather than specific rules.” Almost all existing codes are updated periodically.

These codes deal with many topics including political contributions, conflicts of interest, payments to government officials or suppliers, receipt of payments, entertainment, gifts and many others.
The Conference Board report found that a "newer area of oversight is monitoring compliance with the corporate policies to prevent or control significant conflicts of interest on the part of executives or other employees." Audit committee involvement in this process implies a broader responsibility than is traditional and may involve receiving assistance from internal auditors, attorneys or others.

Internal auditors have sometimes been involved in conducting special investigations for audit committees. Forty percent of the companies responding to a 1978 Conference Board report on internal auditing said that their internal audit staff had been involved in special auditing or information gathering initiated by the audit committee.

The audit committee of a large corporation was recently involved in overseeing a special investigation conducted by outside counsel and independent auditors. Management brought to the attention of the audit committee the possibility of questionable payment arrangements between some operating units and certain of their suppliers. The audit committee retained both outside counsel and auditors to conduct the investigation. This particular investigation was conducted totally independent of management, with audit committee oversight, and with those performing the investigation reporting directly to the audit committee.

**Other Emerging Responsibilities.** In addition to activities discussed previously, certain others are being encouraged by commentators and sometimes adopted by audit committees. These may be totally new, or they may be only more detailed or intensified applications of responsibilities already assigned.

The Conference Board survey found that some audit committees have been empowered to "approve or decide upon" the scope of an audit and to "make the decisions in situations that involve a choice of accounting principles." Some commentators have suggested that audit committees should have more involvement in all aspects of the audit process, accounting and reporting matters, internal audit administration and matters involving business conduct.
It is our position that some suggestions imply responsibilities which should not be considered within the appropriate review and oversight role of audit committees. Only in extreme or unusual situations should a committee be directly involved in activities which are within the province of management’s, or another group’s, responsibilities.

Some observers believe that there are many negative aspects to an ever-expanding role for audit committees. How much, they ask, can an audit committee actually accomplish if they are spread so thin? How can a small group of individuals be expected to comprehend and apply such a large body of knowledge requiring accounting, legal and operational expertise?

We agree that society must not expect more from audit committees than can reasonably be accomplished. We must continue to guard against dilution of the primary audit committee function, which is oversight. A clear distinction between management and oversight must be retained. Credibility of audit committees is important but it can be maintained only if their role is realistically defined.

The Future

We believe that there are some clear signs for the future. The 1980s have begun by electing a new President and essentially a new Congress. The philosophies of the new members, and of the reelected incumbents as well, seem to reflect a shift in the nation’s mood toward conservatism and productivity, and away from big government and regulation as the sources of solutions to our economic problems. This bodes well for a business sector burdened by over-regulation and faced with major challenges to its strength and viability.

Some observers suggest or predict revision of the FCPA; others see a reduced emphasis on corporate governance. While these changes may occur, we do not believe they will result in any reduction of the importance of audit com-
mittees or their responsibilities. The validity of the role and activities of audit committees has been proven and they make good business sense. Tremendous strides have been made in recognition of the audit committees' key role in corporate governance.

Audit committees should expect continued scrutiny of their activities, but with more focus on effectiveness rather than compliance with a rigid set of rules. Success in meeting this challenge will be measured by further increases in public and governmental confidence in, and reliance upon, initiatives taken by the private sector toward more effective accountability.
Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB), and its predecessor, the Accounting Principles Board (APB), have been responsible for formulating accounting standards in the private sector. Although the SEC has the statutory authority to establish accounting standards, it has traditionally looked to the private sector to respond to this need.

Recent FASB Statements. If detailed information on the FASB is desired, the various statements of Financial Accounting Standards and related information on the FASB’s activities and agenda are discussed in our firm’s regularly updated booklet Financial Accounting Standards Board—Summary of Activities. Following is a listing of recently issued FASB statements:

No. 44—Accounting for Intangible Assets of Motor Carriers (an amendment of Chapter 5 of Accounting Research Bulletin No. 43, Intangibles Assets, and an interpretation of APB Opinions No. 17, Intangible Assets and No. 30, Reporting the Results of Operations)

No. 43—Accounting for Compensated Absences

No. 42—Determining Materiality for Capitalization of Interest Cost (an amendment of FASB Statement No. 34)

No. 41—Financial Reporting and Changing Prices: Specialized Assets—Income-Producing Real Estate (a supplement to FASB Statement No. 33)

No. 40—Financial Reporting and Changing Prices: Specialized Assets—Timberlands and Growing Timber (a supplement to FASB Statement No. 33)
Disclosure of Pension Information. The FASB decided that the lack of comparable disclosures in employers' financial statements about the financial status of their pension plans required the amendment of existing disclosure standards as an interim measure pending completion of a project on accounting by employers for pensions. Certain of the disclosures now required by FASB Statement No. 36, Disclosure of Pension Information, are generally the same as prior requirements. However, for defined benefit pension plans, additional disclosures are to be determined in accordance with Statement No. 35, Accounting and Reporting by Defined Benefit Pension Plans. These disclosures include the actuarial present value of accumulated plan benefits and the pension plan assets available for those benefits.
We expect significant future developments on this subject as the FASB completes its project on accounting for employer's cost of pension plans and other post-employment benefits with characteristics similar to pensions. In addition, the SEC staff has taken an active interest in pension disclosures and has indicated that it will be carefully reviewing this year's disclosures. Chairman Williams recently stated: "If the disclosures are not adequate, the staff may recommend that the Commission consider implementing additional requirements until such time as the FASB is able to complete its project. . . ."

**Financial Reporting and Changing Prices.** FASB Statement No. 33, *Financial Reporting and Changing Prices*, requires that certain large publicly held companies disclose certain supplementary information concerning the impact of changing prices. Because of the lack of consensus and general uncertainties as to a satisfactory solution to accounting for inflation, this Statement is a cautious and experimental approach to this issue. The FASB has been more flexible than is customary, apparently to encourage experimentation that would help develop techniques for accumulating, reporting and analyzing data on the effects of price changes. The Statement requires two different sets of disclosures—one for current cost information (reflecting specific price changes) and another for constant-dollar information (reflecting general inflation).

Those desiring more information will find this statement discussed and explained further in our firm's publication *Financial Reporting and Changing Prices*.

**Future FASB Initiatives**

**Conceptual Framework Project.** The Conceptual Framework Project is a major undertaking by the FASB which is intended to lead to consistent financial accounting and reporting standards. As Oscar S. Gellein, a retired senior partner of our firm and former member of the FASB, recently stated, "the credence given financial reporting will deter-
mine whether the private sector’s role in standard setting will grow or shrink. An operable conceptual framework will go a long way in providing the necessary level of credibility. Without an operable conceptual framework, continuation of standard setting in the private sector would stand in considerable jeopardy."

Some of the specific benefits expected from the framework are: guidance for the FASB in standard setting; provision of a frame of reference for resolving questions if no standard exists; determination of bounds for judgment in preparing financial statements; an increase in financial statement users’ understanding and confidence; and enhancement of comparability of financial statements.

In conjunction with the framework project, the FASB has issued the first four of a series of *Statements of Financial Accounting Concepts*. Statements in the series are intended to set forth objectives and fundamentals that will be the basis for development of financial accounting and reporting standards.

Clear progress on this project will do much to strengthen the FASB’s position as the leader in establishing and improving accounting standards.

**Foreign Currency Translation Proposal.** In 1980 the FASB issued an exposure draft of a proposed statement which would supersede Statement of Financial Accounting Standards No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*. This proposed statement, which would be effective for fiscal years beginning on or after December 15, 1981 (with earlier application encouraged), was in response to widespread objections to FASB Statement No. 8. These objections included: undue emphasis placed on exchange rate fluctuations by reporting exchange gains and losses and translation adjustments in current income; inconsistency between reported foreign currency exposure and concurrent economic exposure; failure to recognize exten-
sive economic hedges of foreign exchange risk exposure; and distortion of normal relationships within the financial statements of a foreign subsidiary or division.

The proposed statement attempts to overcome these objections by drastic changes including: use of the current rate translation method in most situations; accumulation of foreign currency translation adjustments in a separate section of shareholders' equity; reporting, with certain exceptions, gains and losses from foreign exchange transactions in current income; and reduction of the effect of exposed net monetary liability positions by broadening the criteria used for determining hedges.

Our firm's response to the FASB, dated December 1, 1980, included several major conclusions. Our primary conclusion was that modifications needed to overcome the major objections to FASB Statement No. 8 could more logically and easily be made by amending that Statement than by adopting a proposal that would be inconsistent with present U.S. generally accepted accounting principles. We suggested that the FASB postpone any final action on the exposure draft to permit analysis of the potential effects of applying its provisions. We also offered observations as to areas where changes would be needed if the FASB should issue a final statement having the thrust of the exposure draft.

For those desiring more information on this subject, a more comprehensive discussion and explanation of the proposed statement is available in our firm's publication *Foreign Currency Translation*.

**Auditing Standards Board-Proposed Revision of the Independent Auditor's Standard Report**

The AICPA Auditing Standards Board has proposed to change the wording of the standard report on audited financial statements. The intent of the proposed change is to more clearly indicate the nature of the audit process and the degree of the auditor's responsibilities. The revised wording incorporates concepts that currently exist in au-
Authoritative accounting and auditing literature but are only implied in the current form of the report. In addition, the intent is to remove certain terms that the Board believed were unnecessary or ambiguous, without changing the auditor's responsibilities or the basis for forming an opinion.

Our firm opposes the revisions to the report because, among other things:

- We are not persuaded that an explanation of the audit process, and its inherent limitations, is necessary or even feasible on any meaningful basis.

- Reference to generally accepted accounting principles without including the term "fairly" (which the Board proposes to delete), cannot convey that there are limits to the precision that is reasonable and practicable to obtain in financial statements; nor can it convey that the accounting principles selected are appropriate in the circumstances.
APPENDIX B

TECHNICAL DEVELOPMENTS—SEcurities AND EXCHANGE COMMISSION

Integrated Disclosure System Adopted

The SEC’s integrated disclosure efforts are an attempt to standardize and simplify reporting requirements under the Securities Acts. The integrated disclosure system is premised on the belief that investors expect to be furnished the same basic information package—audited financial statements, a summary of selected financial data and a meaningful description of an enterprise’s business and financial condition—both to support current information requirements of an active trading market and to provide information with the sale of newly issued securities. The SEC’s initiative is intended to:

• Improve disclosure to investors and other users of financial information

• Achieve a single disclosure system at reduced cost

• Reduce current impediments to combining shareholder communications with official SEC filings

The SEC did not adopt its proposal for mandatory incorporation by reference into the Form 10-K of the basic information package in the annual report to shareholders. Instead, it adopted an optional approach, expecting that the design of the new integrated disclosure system would encourage both incorporation by reference and the combination of the annual report and Form 10-K into one document. The SEC views the annual report to shareholders as the most effective means of shareholder communication and the adopted changes are not intended to affect the format, readability or quality of existing shareholder reports. The principal thrust of the changes was to standardize disclosure items in annual reports to shareholders to make them consistent with similar requirements in SEC filings.

Those desiring a more comprehensive discussion of this subject can refer to our firm’s publication The SEC’s Integrated Disclosure System.
Reaction to Justice Department FCPA Reviews

The Justice Department, which is responsible for criminal enforcement of the FCPA, established a FCPA review procedure permitting companies to obtain guidance concerning the applicability to a certain transaction of the FCPA’s bribery prohibitions. The SEC, which is responsible for civil enforcement of the FCPA, chose not to participate in the program. However, to encourage companies to use the Justice Department’s review procedure, the SEC has decided it will not commence a civil enforcement action alleging violations of the FCPA in any case where a company receives a clearance letter from the Justice Department prior to May 31, 1981. The SEC has stated it will reevaluate its position in 1981.

The Role of Corporate Lawyers—Proposed Rules Rejected

The SEC recently rejected proposed rules to require disclosure of the relationship between corporations and their attorneys. One of the primary reasons given for the rejection was that “companies are experimenting with a variety of ways for information to flow to the board of directors.”

The SEC also rejected rule proposals which would have required lawyers (inside counsel or outside) to report directly to the board of directors, or through the audit committee, any questionable corporate activities involving a law enforced by the SEC, or any other law, if the violation could result in material financial liability or call into question the quality or integrity of management.

While these proposals have been rejected, the SEC has continued to urge an expanded role for corporate lawyers and inside counsel.
Reporting on Internal Accounting Control—Proposal Withdrawn

In May 1980 the SEC withdrew a proposed rule which would have required registrants to include a statement by management on internal accounting control in reports to shareholders and in Form 10-K filings. The proposal would also have required auditors to examine and report on the statement.

Chairman Williams said the SEC would look instead to the corporate community and the accounting profession to develop management reporting and auditor review techniques. The efforts of the Financial Executives Institute and the AICPA were cited by the SEC as having promoted the increased number of voluntary management reports in 1979, providing one reason for the withdrawal.

Another important factor in the SEC's decision was the pending development by the AICPA's Auditing Standards Board of Statement on Auditing Standards No. 30, Reporting on Internal Accounting Control. The Statement describes procedures for an auditor to apply in connection with examining internal controls and the forms of reports to be issued in connection with the examination. This guideline will be used by auditors when companies voluntarily engage them to evaluate and report on their internal controls.

The SEC plans to continue monitoring voluntary private sector developments and to reevaluate their position in 1982. Chairman Williams recently stated: "The Commission continues to believe that management disclosure concerning its system of internal accounting control has considerable value. The value is, however, partially dependent on meaningful auditor involvement. . . . I anticipate a substantial increase in both the quantity and quality of such information in 1980."
The message is clear. The SEC expects public companies to present management reports in their financial statements. And they expect some form of auditor involvement with those reports, if such involvement is cost justified.

Although audit committees may find independent auditors' reports on internal accounting controls to be useful, they should realize that such reports have several limitations. For example, such reports do not assure compliance with the FCPA. One reason is that the independent auditor studies, evaluates, and reports only with respect to material items even in an overall evaluation of the system. The Act contains no materiality standard. Also, compliance with the Act is a legal determination that independent auditors are not qualified to make. Finally, the Act goes beyond internal accounting controls by including a requirement for accurate books and records, and it includes anti-bribery provisions.

Management and audit committees should give this subject careful consideration during the next year. They should consider the form of management's expression of their assessment of the system of internal accounting control. In addition, they should consider the extent of the independent auditor's involvement and whether the auditor should also report publicly on their evaluation of the system.

**Future Initiatives**

**Review of Disclosure Rules.** In addition to monitoring the effectiveness of the recently adopted integrated disclosure system, the SEC will continue to consider other appropriate modifications. The purpose of the continuing project is to reduce unnecessarily burdensome or complex rules. Items requiring further study include:

- What disclosures, if any, beyond those required by generally accepted accounting principles have significance to users of the information, and in what format should they be presented
• The significance and utility of parent company financial statements and separate financial statements of unconsolidated subsidiaries and "50 percent or less owned persons"

Proposed Registration Forms and Amendments to Quarterly Report Form 10-Q. Included in the SEC’s adoption of the integrated disclosure concept were the following major rule change proposals:

• New registration statement forms which would constitute the basic disclosure document format for most 1933 Securities Act registrations. It would establish different levels of disclosure requirements for different classes of enterprises. Included among the specific issues on which the SEC has requested comment is whether there should be audit committee disclosure information required by these forms.

• Amendments to Form 10-Q which are intended to make interim period and annual disclosure requirements more consistent and to encourage the integration of Form 10-Q reports with quarterly reports furnished to shareholders.

More Attention to Management’s Discussion and Analysis. As a result of the recent reorganization of the SEC’s Division of Corporation Finance along industry lines, the SEC believes they can "better ascertain the disclosure needs of different industries and more readily identify industry trends." We understand that the SEC staff will be seeking more consistent application of its disclosure rules, particularly by giving closer scrutiny to the management discussion and analysis section of filings. This will require emphasis on developing an analysis that will provide informative insight into the reported financial results of a company.
Proposed Federal Securities Code Supported. The SEC recently announced its support for enactment of a proposed Federal Securities Code. The draft code endorsed by the Commission was completed over a period of ten years under an American Law Institute project. The code seeks to draw together the seven separate federal securities statutes currently in effect into a single comprehensive law—updated to address the issues and problems arising over the past four decades.

The next step is for the draft code to be introduced in Congress, possibly in 1981. However, enactment is not expected in the near future.