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Address

to

Joint Meeting of

Houston Chapter
Texas Society of Certified Public Accountants

and

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Financial Executives Institute

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A PRE-EXPOSURE OF THE COMMISSION'S EXPOSURE DRAFT

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The Research Findings

Here are a few things our Commission's research efforts of the last year have revealed:

1. In an analysis of 456 lawsuits against auditors spanning the period from 1960 through 1985, a study prepared for the Commission revealed that:

-- Management fraud was present in about one-half of those cases. Most frequently the auditors paid large amounts to settle those cases.

-- The widespread notion that a business failure automatically leads to allegations of audit failure is not correct. Of the bankruptcies studied, the auditor was sued in only about 20 percent of the cases. Furthermore, of this 20 percent, over one-half also involved management fraud.

2. Our staff's study of 119 actions brought by the Securities and Exchange Commission against public companies

and 42 actions brought by the SEC against public auditors since 1980 found that:

-- Most alleged frauds were perpetrated by upper-level management (CEO, President, CFO) by improper revenue recognition or overstatement of assets. Very few alleged frauds involved the actual diversion of corporate assets.

-- The majority of the alleged frauds occurred because of a breakdown in internal controls.

-- A substantial number -- 31 percent -- of the public companies involved in the actions did not have an audit committee.

-- Most alleged audit failures involved a failure to obtain sufficient competent evidential matter and to exercise appropriate professional skepticism.

-- Of the auditing firms involved, 74 percent were non-national firms. Of the 31 non-national firms, 87 percent were not members of the AICPA's SEC Practice Section.

3. A study conducted by the School of Accounting at the University of Southern California on the role of the SEC

in financial reporting found overwhelming support for tougher sanctions against the perpetrators of fraudulent financial reporting. USC conducted both in-depth interviews and surveyed a broad group of financial executives, corporate secretaries, internal auditors, lawyers, and public accountants. 83% of all questioned favored tougher sanctions.

4. Another study conducted by the NAA confirmed the crucial role a high level of corporate ethics can play in reducing the risk of fraud. Foremost in establishing such an ethical awareness are the attitudes and actions of top management.

5. Two studies sponsored by the Institute of Internal Auditors indicate a trend toward increased reliance by public auditors on the work of internal auditors, particularly in audit areas involving computer systems. These studies also indicate that internal auditors -- already an effective defense against fraud -- can become even more effective through enhanced organizational status and professionalism.

6. A study sponsored by the Financial Executives Institute analyzed corporate situational forces and pressures. The findings suggest that many instances of fraudulent financial reporting do not begin with an overt act

intentionally designed to deceive. Rather, they frequently result from a mixture of Board apathy, unrealistic profit pressures, weak controls, and bonus heavy compensation plans.

In all, over 20 major studies have been conducted and digested by the Commission. Other areas not mentioned previously that have been researched include:

Computer Fraud,
Accounting Education,
Opinion Shopping,
Fraud Awareness,
Second Partner Reviews,
Quality Assurance,
Analytical Review, and
Audit Committees.

A Quick Look Back and Forward

Following votes on numerous issues at our last two meetings, our staff has begun to prepare an Exposure Draft of our Commission's Report. The draft is scheduled for delivery to the Commissioners and our Advisory Board in early December. Assuming the Commission gives final approval around the first of the year, the Exposure Draft

will be publicly distributed on approximately March 1. We plan a 90 day comment period and plan to publish our Report in final form on approximately August 1, 1987.

March 1 is almost four months away, so occasions such as this allow us to "pre-expose" the Exposure Draft and hopefully start the comment process in advance of the formal Exposure Draft. We invite all of you to submit comments, be they positive, neutral, or negative.

Those who have followed our Commission's work will recall that our long-standing charge has been to analyze all the whys and wherefores of fraudulent financial reporting and propose the ultimate solutions to eradicate forever this pernicious activity. While we have reached many specific conclusions -- and I will come to those momentarily -- one overall, dominant conclusion has emerged. Fraudulent financial reporting is -- probably always has been and will be -- a multi-dimensional problem -- that many factors contribute -- and that multiple causal influences are at work. Many of you may have heard me say that before. But I say it again to underscore that no single conclusion, observation or recommendation of our Commission can be separated from the totality of all of our decisions. The entirety of the mosaic must be taken into account.

As you will see momentarily, our initial conclusions potentially impact all -- issuer, regulator, auditor, educator, director, law enforcer, and professional organization. And some of our conclusions will be controversial and will generate considerable input and comment. You also should note that I have used the phrase "initial conclusions." That is what they are. Our Commissioners reserve the right to continue to think about any and all issues and initial conclusions and to change their minds. That process will continue until the Exposure Draft is sent to the printer and throughout the comment process.

The Reporting Entity

Let's now explore some of those initial conclusions. As you know, our Commission has focused extensively on the reporting entity and its management, recognizing that management has both the initial and final responsibility for accurate financial statements.

In considering the reporting entity, we have limited our recommendations to those that would enhance the overall control environment within the corporation. We have not considered governance issues as such, but have focused on those elements of corporate structure that are intrinsically part of the overall control environment. We further believe that a large number of companies already have in place many

of the characteristics -- the elements of a sound control environment -- we are recommending.

We have initially concluded that:

1. Mandatory Audit Committees. Audit Committees should be mandated for all publicly-owned corporations, as well as for other entities that draw on public funds for capital, such as mutual thrift institutions. The SEC should exercise the authority it has said it has to mandate Audit Committees as a condition of being a public company. Audit Committees should include at least a majority of independent directors. At the same time, we recognize that some issuers, for valid reasons, may find it difficult to attract the necessary persons to fulfill this role. We therefore will recommend that the SEC's rule requiring Audit Committees recognize this by providing a mechanism for exemptions for those issuers that demonstrate that they have (a) diligently attempted to attract the necessary independent directors to comprise the Audit Committee and (b) instituted various mechanisms and controls that perform the functions of an Audit Committee. Such exemptions should be granted only in unusual cases. This decision on mandatory Audit Committees reflects our Commission's views that an informed, diligent Audit Committee may be the single most effective influence for minimizing fraudulent financial reporting and

that Audit Committees are an integral part of internal controls.

2. Role of the Audit Committee; Guidelines. Audit Committees should be activists and should be deeply involved in the financial reporting process. To that end, we intend to publish "good practice" guidelines for Audit Committees, for we have found -- surprisingly perhaps -- great disparity among Audit Committees' functions and effectiveness. It is our hope that our guidelines will (a) offer practical guidance to those seriously concerned with their role as Audit Committee members; (b) enable an Audit Committee that essentially follows the guidelines to assert such compliance as a defense in litigation, thus addressing existing liability concerns in a positive fashion; and (c) suggest that an Audit Committee that ignores the guidelines without good and sound reasons will know that it may be doing so at its peril if fraudulent financial reporting occurs.

3. Audit Committee Resources. Audit Committees should have adequate resources to discharge their role. They also should have standing authority to initiate investigations, including the authority to retain counsel or experts.

4. Audit Committee Chairman's Letter to Stockholders. The role of Audit Committees should be more visible and

better communicated to the public. The Chairman of the Audit Committee should be required to include in the Annual Report to Stockholders his own letter describing the activities of the Audit Committee. This should be mandated by the SEC and should include, among other things, a discussion of the Committee's activities for the past year.

5. Management's Acknowledgement. Corporate management should affirmatively acknowledge in the Annual Report to Stockholders that they have the foremost and ultimate responsibility for accurate financial statements. This recommendation dovetails with a recommendation I will come to shortly about revising the standard auditors' report.

6. Fraud Risk Assessment Program. All public companies should have a fraud risk assessment and fraud risk management program. The risk of fraud should be assessed and monitored continuously by management and reviewed annually by the Audit Committee.

7. The Control Environment. Internal controls should not be structured mechanically. The correct emphasis should be on the overall control environment. This should be monitored actively by the Audit Committee.

8. Management's Opinion on Internal Controls. Corporate management should be required to express an

opinion on the adequacy of internal controls. This conclusion reflects the Commission's belief that internal controls and internal audit represent the first line of defense against fraudulent financial reporting.

9. Mandatory Internal Audit Function. All public companies should be required to maintain an internal audit function. Note that I said function, not internal auditor. The Commission believes that the function is key. It does not have to be a separate department and could even be done by the independent auditor. The size of the department and each individual's background and training should be appropriate for the size and nature of the company's business. We also intend to publish some "good practice" guidelines relating to this activity.

10. The Internal Auditor. The Chief Internal Auditor should administratively report directly to the Chief Executive Officer or a senior financial officer who does not have direct involvement in the preparation of the company's financial statements. Furthermore, the Chief Internal Auditor should have direct access to the Audit Committee and should meet privately with the Audit Committee on a regular basis.

11. Involvement of the Internal Audit. Management and Audit Committees should insist that their internal auditors

have greater involvement in the audit of the financial reporting process.

12. The Tone at the Top; Corporate Ethics. The tone and atmosphere set at the top is a crucial influence for deterring and preventing fraudulent financial reporting. To influence and reinforce that tone, all companies should adopt, publicize and enforce written codes of conduct which, among other things, deal with the obligation to account accurately to stockholders. This written code of ethics must be supported by top management; it should be general rather than overly specific; it should be prepared with employee participation; it should be appropriate for the company's business; and it should be updated as necessary so that it is a "living code." We will include one or more models as exhibits to our Report. The Audit Committee should evaluate compliance with the code, on an annual basis, including compliance by top management, focusing on matters such as perks, use of company assets, and related party transactions.

13. Special Needs For Enhanced Internal Controls. While certain management techniques -- such as management by objective and decentralized operations -- are perfectly valid management techniques, they inherently involve the potential for abuses of the financial reporting process.

Such techniques thus heighten the already pressing need for strong internal controls.

The Public Accountant

Let's turn from the reporting entity to the public accountant.

1. Detecting Fraud. On the issue of the auditor's responsibility to detect, and perhaps report, suspected fraud, our Commission has concluded that auditing standards relating to the auditor's responsibility to detect fraud need to be clarified. The revised standards should reflect, in a balanced fashion, what the courts are saying already, including the acknowledgement of some affirmative obligation to detect fraud. Those standards should spell out the auditor's obligations in clear, positive, non-defensive language.

2. Recent Legislation. While our Commission supports smoking out material fraud which can undermine the integrity of the financial reporting process, we do not agree with the approach considered in the last Congress. We believe that the approach considered would introduce an unworkable adversarial atmosphere into the audit process. In each instance when fraud were suspected, each side inevitably would scurry to lawyers to ask: "Is it fraud? Is it

material fraud? How sure are we? Do we have all the facts necessary to make a decision? Have we properly considered all the affirmative defenses to the 'suspected' fraudulent activity?" And we ought not to forget that fraud is not a clearly delineated concept -- it is not black and white. If you think otherwise, simply sit down and try to write an all-encompassing, crystal clear definition of fraud. I defy anyone to do so, having personally participated in numerous efforts to draft a clear definition of only one type of fraud -- insider trading.

3. The ASB and Public Participation. Auditing standards relate directly to the prevention, detection and elimination of fraudulent financial reporting -- they come into play as much, perhaps more, than accounting principles. The Commission believes that continued public interest and active involvement in all auditing standards is desirable. We therefore will recommend that the Auditing Standards Board be restructured to include knowledgeable public representation and participation.

This initial conclusion on the ASB does not mean that we fail to appreciate the many contributions of the ASB, nor does it mean that we are unimpressed with their efforts and results. We are most impressed. Our initial conclusion about the ASB does mean, however, that we believe that the participation of the ultimate public has much potential for

good, particularly more than an occasional Congressional look at one or two specific auditing standards. Such public participation would ensure auditing standards responsive to the public need and could have the incidental effect of dealing positively with the problem of public expectations about the audit process. Furthermore, the AICPA already has the capability of dealing with technical auditing issues through various publications such as Industry Accounting and Auditing Guides and Auditing Procedures Studies. Implicit in our conclusion is a rejection of the notion that auditing is too arcane for the non-technician to contribute meaningfully.

4. Revising the Standard Auditor's Report. We will recommend that the standard auditor's report be revised to communicate better the auditor's role and responsibilities -- including those related to fraud detection -- and the inherent limitations. This dovetails with our recommendation that the issuer acknowledge fundamental, ultimate responsibility for financial statements free of material deficiencies. We do not view this as lessening in any way the auditor's responsibilities, but as clarifying the relative and complementary responsibilities for financial reporting.

5. Mandatory Membership in a Q.A. Program. The SEC should mandate membership in a professional quality

assurance program such as the AICPA SEC Practice Section (or its equivalent) for all auditors involved in audits of public companies. No exceptions should be permitted -- absolutely none. And we believe the SEC has the rule-making authority to impose this standard. If the SEC disagrees, it should immediately move to obtain this authority.

6. Opinion-Shopping and Second Opinions. The Commission firmly believes that management should be free to seek second accounting opinions, but we also believe that the abuses inherent in opinion-shopping must be reduced. If and when a change in auditors occurs, companies should be required to disclose the nature of any material accounting issues they discussed with their old and new auditors during the three-year period preceding the change. The Audit Committee should be informed when management seeks a second opinion on a significant accounting issue. These requirements should apply with equal force to first time registrants.

7. Auditor Involvement in 10-Q's. The Commission believes that more involvement by the independent auditor in interim financial reports is merited. The Commission therefore will recommend that the independent accountants be required to conduct a timely review of quarterly financial reports, and that quarterly financial reports be accompanied

on the corporate side with increased oversight and participation by the Audit Committee.

8. Non-Audit Services. Non-audit services performed by the public auditor continue to be a matter of public interest. On that issue, the Commission has initially concluded that ASR 250 should be reinstated.

9. Analytical Review. Analytical review procedures, which have proved to be so effective in detecting potential fraudulent financial reporting, should be emphasized more. The Commission will recommend that greater emphasis be placed on analytical review procedures and that they be performed by executive level members of the audit team.

10. Auditor's Opinion on Internal Controls. The Commission will recommend that the public auditor publicly provide a negative assurance opinion on internal controls.

The SRO Issue

Statutory self-regulatory organization, a Price Waterhouse SRO, a quasi-SRO, or what? This has been a most frustrating issue, perhaps the topic of more discussion than any single topic. But before the conclusions, let me walk you through our thought process.

What does an SRO do? What are its characteristics? What are its objectives? Looking at the stock exchanges and the National Association of Securities Dealers, the general objectives of an SRO that emerge are:

(1) They impose standards of commercial or professional conduct, which standards have as their primary purpose the protection of those served by the regulated group -- i.e., the public customers, the public interest.

(2) When the conduct of the regulated fails to measure up, they impose sanctions that are not just behind the scenes paddlings, but public, believable sanctions, such as suspension, expulsion, and fines.

If those two thoughts correctly identify the characteristics and objectives of an SRO, by comparison, what do we have now, in structure and in practice? Various programs exist -- quality assurance oriented and remedial in nature -- to monitor and upgrade professional conduct. They include SECPS membership, the Public Oversight Board, the Special Investigations Committee, internal firm penalties and discipline, and so on. By and large, this quality assurance program works well, in our Commission's view, as far as it goes. But that listing does not include sanctions

that are generally accepted by the public as believable, real, meaningful sanctions.

So, how can believable sanctions -- some bluntly call them "scalps on the belt," -- be meted out. We conclude that the mechanism to perform this function already exists -- it's called the SEC. Yet, the existence of a mechanism is not, by itself, enough -- the mechanism must also work. That means that the SEC must be active, tough-minded, resourceful, and sufficiently funded and staffed; and it must possess and demonstrate the will and determination to play the primary enforcement role -- to prosecute wrongdoers -- so as to preclude any possible perception that any reluctance exists when it comes to being the enforcer. If any reluctance whatsoever were even perceived to exist, our no-SRO position may not be defensible. A void would exist, and voids are usually quickly filled. In addition, the accounting profession must support the SEC in this traditional enforcement role.

So what are we saying? That our "functional" analysis tells us that all the structural elements of an SRO presently exist. If those structural elements work, the logic and need for a statutory SRO is gone -- such a creature would only duplicate existing functions. But absolutely critical to our analysis and conclusion are (1) a robust SEC enforcement program and (2) a mandatory requirement that

auditors involved in audits of public companies be members of a professional organization with an adequate quality assurance program. And there is a third consideration -- there must be constant monitoring to prevent any possible slippage in the system. That means monitoring by the SEC of the profession's quality assurance program, with enforcement by the SEC directed against those who violate quality assurance standards, and monitoring and support by the accounting profession of the SEC's enforcement efforts.

Regulation and Law Enforcement

Many of the comments I have made are linked to law enforcement and regulatory agency activities and considerations. For example, our thoughts about an SRO and the "enforcement" role of the SEC, about mandatory Audit Committees, and about mandatory timely auditor involvement in quarterly financial reports all involve the regulatory and law enforcement process.

But much of the debate about law enforcement and regulation historically has focused on penalties and sanctions and their effectiveness, or lack thereof -- admittedly highly emotional issues. On those specific issues, the Commission has initially concluded that:

1. More Sanctions. As a general proposition, sanctions imposed on those who violate the law by their involvement in fraudulent financial reporting are not adequate. The University of Southern California study demonstrates, we believe, the need for more severe sanctions.

2. Bars. The injunction cannot be blithely dismissed as a meaningless wrist slap, as some charge, but more is needed. Barring from corporate office those who cause, aid and abet, or participate in fraudulent financial reporting is an appropriate sanction, and one which ought to be regularly considered by the SEC in enforcement proceedings. The bar proceeding ought to afford all due process protections, and we do not offer this conclusion lightly. But, if fraudulent financial reporting undermines the integrity and reliability of the entire disclosure process -- which we believe -- we see no basis for treating corporate offenders differently from auditors when it comes to sanctions. Rule 2(e) allows the SEC to bar or limit the activities of individual auditors and firms. The Commission perceives no logical reason why those with primary responsibility for accurate financial statements should not be subject to equivalent sanctions.

3. Criminal Prosecutions. More criminal prosecutions and longer sentences for fraudulent financial reporting are appropriate. The SEC, while lacking criminal prosecutional

powers, should undertake an organized, affirmative program to educate and to encourage authorities with those powers to take a greater interest in criminally prosecuting those engaged in fraudulent financial reporting.

4. Fining Authority. The SEC should have fining authority to deal with fraudulent financial reporting. Such a tool could enable the SEC to fine-tune the sanctioning process, to differentiate among degrees of culpability of offenders, and to extract any benefit gained by wrong-doing, as the SEC does now with insider trading.

5. Cease-and-Desist. The Commission believes the SEC should have cease and desist authority as a further fine-tuning device.

6. Resources. The SEC's resources should always be adequate to enable the SEC to perform, effectively and aggressively, the additional functions we are recommending, as well as performing the absolutely necessary role of an enforcer so as to obviate the need for a separate SRO.

The Liability Issue; Benefits and Burdens

Somewhere in the audience, someone is asking: "But what about liability? Auditors' professional liability insurance

is disappearing from the scene. D&O coverage is so scarce and expensive that outside directors are exiting in droves. Yet, your Commission is recommending increased responsibilities and, presumably therefore, increased exposure to liability."

Our answer is: "No, we are not oblivious. And yes, we fully understand the connection between responsibility and liability."

Our charge was not to solve the "liability crisis," but to deal with fraudulent financial reporting. In the process, if we can contribute to a clearer articulation of the relative responsibilities of management and the auditor, is that not desirable compared to the present murkiness? We believe our proposals carry that potential. If the ASB is reconstituted, does not the resulting "public" participation potentially make auditing less subject to attacks on the ground that it is too secretive, perhaps too much controlled by the "club." We believe so. Can "good practice guidelines" for Audit Committees not only guide those who wish guidance about discharging their responsibilities, but also provide "safe harbor" standards of conduct which do not presently exist? We are operating on that hope, which we believe has validity.

Somewhere in the audience, someone is also asking: "What about costs and burdens? What about benefits and practicality? Were those considered?"

Again, our answer is: "Yes, of course we considered benefits, burdens, costs and practicality. Yes, we understand costs and benefits."

In terms of understanding these issues, I note that three of our Commissioners have been CEO's of major companies -- the best training in the world about costs and benefits -- and one of those three holds a Ph. D. in Economics. A fourth is an internal auditor, who obviously understands costs and benefits. The fifth is a former CEO of a major international accounting firm and clearly has a keen knowledge of costs, burdens and benefits. In addition, four of the six Commissioners currently serve as members, if not the Chairman, of Audit Committees of public companies and regularly deal with financial reporting, costs and benefits, and practicality on a regular basis.

Our Commissioners -- who are knowledgeable and familiar with the real world -- also believe that the problem of fraudulent financial reporting is very real -- notwithstanding the absolute impossibility of quantifying the extent of its occurrence -- and that the solutions proposed are, over the long run, beneficial and cost effective. Our

Commissioners also believe that a cost may result from doing nothing, a cost which potentially could be great -- the cost of the erosion or loss of public confidence, of escalating litigation and liability, and possible governmental intervention.

Conclusion

We offer these comments in the hope that the comment process will begin now, rather than waiting for our written Exposure Draft. All comments -- positive, negative and neutral -- are welcome.

Thank you for your attention.

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