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United States General Accounting Office
Washington, DC 20548

Accounting and Information
Management Division

B-284292

February 4, 2000

The Honorable John D. Dingell
Ranking Minority Member
Committee on Commerce
House of Representatives

Subject: Securities Exchange Act: Review of Reporting Under Section 10A

Dear Mr. Dingell:

This letter responds to your request that we review reporting under Section 10A of the Securities Exchange Act of 1934. As you know, Section 10A requires reporting to the Securities and Exchange Commission (SEC) when, during the course of a financial audit, an auditor detects likely illegal acts that have a material impact on the financial statements and appropriate remedial action is not being taken by management or the board of directors. In your letter, you expressed concern over the low level of Section 10A reporting to date and asked us to review possible reasons for the low level of reporting. We agreed with your office that our approach would be to discuss the Section 10A reporting requirements and possible reasons for the low level of reporting with knowledgeable parties at the SEC, the American Institute of Certified Public Accountants (AICPA), and the large accounting firms. On November 22, 1999, we briefed your office on the results of our work and agreed to provide you with this letter documenting the information we have gathered during our review.

Results in Brief

According to the SEC's records, six Section 10A reports have been filed through December 14, 1999. The Section 10A reporting requirements first became effective for fiscal years beginning on or after January 1, 1996. The SEC has also identified seven additional cases in which it appeared that a Section 10A report may have been required. Of those seven cases, three are now subjects of active enforcement cases, and in the remaining four cases the SEC concluded that there was no appearance of illegal acts requiring Section 10A reports. The SEC representatives we met with stated that there may be several reasons for the low level of Section 10A reporting, ranging from management resolution of likely illegal acts to auditor decisions that Section 10A reports are not required. The representatives from the AICPA disagreed with the reasons set forth by the SEC, except for management's resolution of issues.

The AICPA representatives told us that a low level of Section 10A reporting could reasonably be expected because they believe that in most cases, management or the board of directors take timely and appropriate actions to address the issues identified by the auditors, and therefore Section 10A reporting would not be required. SEC representatives indicated that because the Section 10A reporting requirements first became effective for fiscal years beginning on or after January 1, 1996, and due to the time lag involved in identifying and investigating enforcement cases, there could be potential Section 10A reporting violations currently under investigation by the SEC that may result in enforcement actions.

We requested comments on a draft of this letter from the principal representatives we met with at the SEC, the AICPA, and the large accounting firm. Generally, the officials agreed with the content of this letter, and their comments have been integrated where appropriate.

Background

The Private Securities Litigation Reform Act of 1995 (Public Law 104-67) added Section 10A to the Securities Exchange Act of 1934 (15 U.S.C. 78j-1). The requirements of Section 10A first became effective for fiscal years beginning on or after January 1, 1996.[1]

Section 10A requires a company's board of directors or its auditor to notify the SEC about possible illegal acts under certain conditions. Specifically, if the auditor detects or otherwise becomes aware that an illegal act has or may have occurred, the auditor is to inform the appropriate level of management as soon as possible and ensure that the board of directors or the audit committee is adequately informed. Section 10A also requires that the auditor report his conclusions directly to the board of directors or audit committee if he concludes the following: (1) the likely illegal act has a material effect on the financial statements, (2) senior management has not taken proper and timely remedial action, and (3) failure to take remedial action is reasonably expected to result in a departure from a standard audit report or the auditor's resignation.[2] A board of directors or audit committee that receives such a report shall inform the SEC within 1 business day of receiving the report and send the auditor a copy of the notice provided to the SEC. If the auditor does not receive a copy of the notice within the required 1 business day, the auditor is to furnish a copy of the report to the SEC not later than 1 business day following the failure to receive a copy of the notice.

Rule 240.10A-1 states that reports filed under Section 10A shall be submitted to the SEC's Office of the Chief Accountant.[3] The report must be in writing and identify the

[1]For registrants not required to file quarterly financial data with the SEC, the requirements apply to annual reports for any fiscal year beginning on or after January 1, 1997.

[2]If the auditor resigns, the reporting requirements of Section 10A are still applicable.

[3]The Chief Accountant is the principal advisor within the SEC on accounting and auditing matters arising from the administration of federal securities laws.

registrant and the auditor, and the date that the registrant received the Section 10A report from the auditor. In addition, the report must include either a copy of the auditor's report or a summary of the report including a description of the act that the auditor has identified as a likely illegal act and the possible effect of that act on the financial statements. The rule is based on the premise that the reports under Section 10A are to assist the SEC in performing its enforcement responsibilities, and therefore, the reports are nonpublic.

The purpose of Rule 240.10A-1 is to facilitate an enforcement inquiry. Therefore, after receiving and logging the reports, the Office of the Chief Accountant forwards the reports to the Division of Enforcement, which conducts investigations into possible violations of federal securities laws and prosecutes the SEC's cases. The reports are also forwarded to other divisions within the SEC, including the Division of Corporation Finance, which reviews the financial statements and other financial reports filed by SEC registrant companies. The Office of the Chief Accountant then monitors the progress on any investigation initiated or facilitated by a Section 10A report.

Objectives, Scope, and Methodology

As agreed with your office, we are providing this letter with information about the level of Section 10A reporting that has occurred since the requirements became effective and possible reasons for the low level of reporting. Our objectives were to (1) determine the number of Section 10A filings to date, (2) obtain the views of knowledgeable parties with significant roles in implementing and carrying out the Section 10A reporting requirements at the SEC and in the accounting profession, and (3) obtain information about how the Section 10A requirements were publicized and implemented.

To meet the above objectives, we interviewed officials from the SEC's Office of the Chief Accountant, Division of Enforcement, and Division of Corporation Finance. We requested information from the SEC regarding the number of Section 10A reports filed to date and the status of any related enforcement issues associated with those cases. We also made inquiries about the SEC's procedures for handling Section 10A reports in order to determine specific roles and responsibilities for Section 10A processing and tracking within the SEC. We also inquired about the SEC's specific actions to publicize the Section 10A reporting requirements and asked for the SEC representatives' views on the possible reasons for the low level of reporting to date.

In addition, we interviewed knowledgeable representatives from the AICPA and a large accounting firm about their experiences with Section 10A reporting and their views on the low level of Section 10A reporting. We also made inquiries about the accounting profession's actions to publicize and implement the Section 10A reporting requirements. From the AICPA, we met with the Chair and a member of the SEC

Practice Section (SECPS) Executive Committee,[4] the Chair of the SEC Regulations Committee,[5] the director and a staff member of the AICPA's Professional Standards and Services Team,[6] a manager from the AICPA's Practice Monitoring,[7] the Senior Vice President of Technical Services, and AICPA's legal counsel. Several of the AICPA representatives were from large accounting firms, including Arthur Andersen, Ernst & Young, and KPMG. However, they met with us in their capacities as Chairmen or members of AICPA committees. In a separate meeting, we interviewed knowledgeable individuals from PricewaterhouseCoopers.

We requested comments on a draft of this letter from the principal representatives we met with at the SEC, the AICPA, and the large accounting firm. Their comments are discussed at the end of this letter. We conducted our work from September 1999 through January 2000, in accordance with generally accepted government auditing standards.

Section 10A Reports Received by the SEC

Records from the SEC's Office of the Chief Accountant show that six Section 10A reports had been received through December 14, 1999. All six of the SEC registrants named in the reports are currently subjects of active SEC enforcement cases. The reports cover a variety of potential illegal acts, including unauthorized issuance of common stock and extension of warrants, incomplete property tax returns, false sales invoices and related inappropriate recording of sales and accounts receivable, and unrecorded liabilities.

The Office of the Chief Accountant also identifies potential Section 10A reporting situations when reviewing the letters and filings required when the client-auditor relationship is terminated, and when reviewing other correspondence received that indicates potential illegal acts. Through these reviews, the Office of the Chief Accountant identified seven more cases where it appeared that Section 10A reports may have been required but had not been filed. Of those seven cases, three are now subjects of active enforcement cases. Potential issues in these cases included unanswered questions concerning the realization of income, management's refusal to materially adjust operating results previously reported on quarterly financial

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[4]The SECPS Executive Committee is responsible for the AICPA's self-regulatory system designed to promote quality accounting practice before the SEC. The committee supervises the activities of the SECPS Peer Review Program, the Quality Control Inquiry Committee, and the SEC Regulations Committee, among others.

[5]The SEC Regulations Committee is the primary liaison between the accounting profession and the SEC staff on technical matters relating to the SEC's rules and regulations.

[6]The Professional Standards and Services Team monitors federal legislative and regulatory developments affecting the profession and provides technical counsel to policymakers on matters involving accounting, auditing, and other professional standards and services other than taxation.

[7]The AICPA has various practice monitoring programs to assist the profession in improving services and to promote quality within the profession. These programs include the Peer Review Program and other programs within the SECPS.

statements, and disagreement with management concerning the provision for certain liabilities. In the remaining four cases, the SEC has concluded that there did not appear to be illegal acts requiring Section 10A reports.

Possible Reasons for Low Number of Section 10A Filings

The representatives from the SEC, the AICPA, and the accounting profession that we spoke with cautioned us that they have not specifically studied experience with Section 10A reporting, and that they know of no empirical studies specifically dealing with Section 10A reporting. However, they provided their views on the low level of filings based on their working knowledge of Section 10A reporting in practice.

Officials from the SEC set forth several possible reasons for the low level of Section 10A reporting to date, including the following.

- Management or the board of directors take timely and appropriate actions to address the issues identified by the auditors, and therefore no report is required.
- The auditor resigns and files other SEC reports required when an auditor resigns, and therefore believes that filing a Section 10A report is not necessary. The circumstances for the auditor's resignation may include being uncomfortable with the timeliness of management's investigation of the potential illegal act, being uncomfortable with the Section 10A reporting requirement because they do not possess legal expertise, and the belief that negative perceptions may be associated with the Section 10A reporting requirement.
- Some auditors could have an erroneous interpretation of the statute that reporting is required only if the auditor determines that an illegal act has actually occurred, rather than is likely to have occurred.[8]

The officials we spoke with from the AICPA and the accounting firm stated that they would expect a low level of Section 10A reporting. They stated that situations requiring Section 10A reports are unusual, because (1) the illegal act must have a material impact on the financial statements, (2) management and the board of directors do not take timely and appropriate action to address the situation, and (3) the auditor's report will likely be a departure from a standard report or the auditor will likely resign. Representatives from the AICPA and the accounting firm told us that they believe the most likely reason for a low level of Section 10A reporting is that in most cases, management or the board of directors, often with the participation of internal or external counsel, take timely and appropriate action to address a situation involving an illegal act when it is brought to their attention. They also indicated that as a practical matter, a Section 10A issue would reach a reportable stage only if management and the board fail to undertake or cause appropriate actions to be undertaken. They further stated that if Section 10A is an effective tool for the

[8]SEC representatives pointed out that Section 10A(b)(1), "Investigation and Report to Management," has language stating that when the auditor detects that an illegal act has or may have occurred, the auditor is to determine whether it is likely that an illegal act has occurred. Section 10A(b)(2), "Response to Failure to Take Remedial Action," refers to illegal acts without any qualifiers as stated in Section 10A(b)(1).

auditor, then the expected level of reporting should be low, since clients would correct the problems identified by the auditor and a Section 10A report would not be required.

Representatives from the AICPA and the accounting firm did not believe that a low level of Section 10A reporting should be attributed to auditor resignations because, if the conditions requiring a Section 10A report are otherwise met, the report would still be required if the auditor resigns. Representatives from the AICPA and the accounting firm also stated that auditors work closely with legal counsel in situations involving potential illegal acts on the part of clients. Therefore, they did not agree that the low level of reporting should be attributed to auditors being uncomfortable due to lack of legal expertise or negative perceptions associated with Section 10A reporting. Finally, the representatives from the AICPA and the accounting firm did not agree that auditors are interpreting the statute to mean that an illegal act "has occurred" rather than "likely occurred," because auditors work closely with legal counsel in such situations.

Section 10A Implementation and Current SEC Monitoring

The officials from the SEC, the AICPA, and the accounting firm that we interviewed were supportive of the Section 10A reporting requirements. In addition, the SEC and AICPA representatives provided examples of their efforts to inform the accounting profession of the Section 10A requirements when they became effective. The AICPA and accounting firm representatives stated that procedures covering Section 10A reporting are included in the firms' operations manuals and training.

SEC representatives told us that in addition to publishing the proposed and final Section 10A reporting rules, the requirements were addressed in speeches made by SEC representatives at the time the regulations were proposed and after the final regulations became effective. The SEC staff has advised us that they are also addressing Section 10A reporting in current speeches. The AICPA provided us with examples of communication with the accounting profession regarding the Section 10A reporting requirements. For example, the requirements were described in the May 1996 issue of the AICPA's publication *Practice Alert* and in various *Journal of Accountancy* articles.[9] In addition, the requirements were discussed at various AICPA conferences and training seminars, including the 1996, 1997, and 1999 Conferences on Current SEC Developments.

The SEC has current, ongoing monitoring efforts to identify potential Section 10A reporting situations where a report has not been filed. The Office of the Chief Accountant monitors letters received from SECPS-member auditors when the client-

[9]See the following issues of *Journal of Accountancy*: February 1996, September 1996, April 1997, and June 1997.

auditor relationship is terminated[10] and other correspondence, as described later in this section, to identify potential Section 10A reporting situations. In addition, officials from the Division of Corporation Finance explained that they look for potential enforcement cases, including potential Section 10A reporting cases, when reviewing information required to be reported to the SEC on Form 8-K, item 304, "Changes In and Disagreements With Accountants on Accounting and Financial Disclosures."

An SEC registrant must file a Form 8-K within 5 business days of the date that its auditor resigns, declines to stand for reelection, or is dismissed. Item 304 of Regulation S-K, which is incorporated into the Form 8-K must state, among other things, whether there were any disagreements between the auditor and the registrant on any matter of accounting principles or practices, auditing scope or procedures, or financial statement disclosure in connection with the audits of the financial statements for the 2 most recent fiscal years, and any subsequent interim period. Item 304 must also provide disclosure of any instance within the applicable time period where the former auditor advised the registrant that (1) the internal controls necessary for developing reliable financial statements did not exist, (2) information had come to the auditor's attention that led him to no longer rely on management's representations, (3) there was a need to expand significantly the scope of the audit and the scope had not been expanded, and (4) information had come to the auditor's attention affecting the reliability of past audit reports or financial statements, or the financial statements issued or to be issued covering the periods subsequent to the date of the last audit report, and the issue had not been resolved to the auditor's satisfaction.

The SEC receives approximately 1,000 8-K Forms with item 304 disclosures each year. The Division of Corporation Finance reviews all forms and requests additional information from the registrant as needed to clarify matters reported. When the Division of Corporation Finance identifies significant potential violations of SEC laws and regulations, the cases are forwarded to the Division of Enforcement for further investigation.

The Division of Enforcement processes approximately 500 enforcement cases each year, of which approximately 20 percent involve accounting and/or auditing issues. In addition to referrals from the Division of Corporation Finance, the Division of Enforcement becomes aware of potential enforcement cases through various means, including news articles, letters, and referrals from other agencies such as the Department of Justice or the stock exchanges. When investigating cases, the Division of Enforcement considers violations of any federal securities laws and regulations, including Section 10A reporting requirements.

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[10]When an SECPS member firm has been the auditor for an SEC registrant and has resigned, has declined to stand for reelection, or has been dismissed, SECPS requirements state that the firm shall report in writing the fact that the client-auditor relationship has ceased directly to the client with a simultaneous copy to the Office of the Chief Accountant of the SEC within 5 business days.

Officials from the SEC's Enforcement Division explained to us that for various reasons, such as obtaining the needed information from registrants, auditors, and others to conduct the inquiry and subsequent follow-up inquiries with these parties and the complexity of financial reporting cases, it can take approximately 2 to 3 years or even longer to complete an investigation of such cases. In October 1999, the SEC announced that it is expecting to take its first enforcement action for failure to file a Section 10A report. However, the timing of any enforcement action is currently uncertain. The Chief Accountant of the Enforcement Division told us that additional enforcement actions involving Section 10A reporting violations are possible, and given that the Section 10A reporting requirements became effective for fiscal years beginning on or after January 1, 1996, the time lag in bringing cases was expected. He also stated that it may be several years before the effectiveness of the Section 10A reporting requirements can be evaluated due to the length of time it takes to complete these investigations.

Current Studies Related to Detecting Fraudulent Financial Reporting

In March 1999, the Committee of Sponsoring Organizations (COSO)[11] published a study entitled, *Fraudulent Financial Reporting: 1987-1997.* COSO commissioned the study to provide information to guide future efforts to combat the problem of financial statement fraud and to provide a better understanding of financial statement fraud cases. The researchers analyzed instances of fraudulent financial reporting alleged by the SEC in its *Accounting and Auditing Enforcement Releases* issued during the 11-year period from January 1987 through December 1997. The researchers identified nearly 300 companies involved in alleged instances of fraudulent financial reporting during the 11-year period. From this list, the researchers randomly selected approximately 200 companies to serve as a sample to evaluate in detail.

Key findings from the COSO study include the following.

- The companies committing fraud generally were small, and most were not listed on the New York or American Stock Exchanges.
- Pressures of financial strain or distress may have provided incentives for fraudulent activities for some companies.
- Top senior executives were frequently involved.
- The audit committees and boards of the companies involved in fraud appeared to be weak. Most audit committees rarely met, and the boards were dominated by insiders, owners, and others with significant ties to the companies.
- Severe consequences resulted when companies committed fraud, including bankruptcy, significant changes in ownership, and delisting by national exchanges.

[11]COSO was established by the Treadway Commission and is dedicated to the prevention of fraudulent financial reporting. COSO is an alliance of five professional organizations: the AICPA, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors, and the Institute of Management Accountants.

The authors of the March 1999 COSO study are currently performing additional review of the 56 financial statement fraud cases identified in the study where the external auditors are explicitly named in the related SEC Enforcement Releases. The authors of the study plan to summarize the nature of the auditor's allegedly failed audit procedures and other issues that might be identified as being related to the audit process.

In 1997, the AICPA issued a new auditing standard, Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, in order to improve auditing guidance related to the detection of material misstatements due to fraudulent financial reporting. The new standard clarified the auditor's responsibility to detect material misstatement resulting from fraudulent financial reporting, changed the auditor's risk assessment process to require documentation of the auditors' assessment of the likelihood of financial statement fraud, and provided expanded operational guidance to assist auditors in meeting their already existing responsibility for the detection of material misstatements due to fraud. In the exposure draft for the new standard, the AICPA expressed a commitment to develop a process to assess how well the new standard is accomplishing its objectives and to identify further steps that need to be taken.

The AICPA is currently sponsoring four research projects related to the above objectives that will be completed in 2000. Although the projects do not deal specifically with Section 10A reporting, they deal with the related subjects of fraud and auditor detection of fraud during financial audits. Specifically, the projects deal with how auditors should modify audit programs under elevated fraud risk conditions, the importance of fraud risk factors relating to management fraud, and fraud risk assessment in planning audits. Based on the results of the AICPA- and COSO-sponsored research, the AICPA will consider whether any revisions are needed to SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*.

The research sponsored by the AICPA and the COSO, when completed could provide additional insights into topics related to Section 10A reporting such as fraud and the auditor's detection of fraud during financial statement audits. The Committee may wish to monitor the progress of the studies and request the results of these research projects when they are completed.

In October 1998, at the request of the SEC, the Public Oversight Board(POB)[12] appointed the Panel on Audit Effectiveness to evaluate the current effectiveness of independent audits in protecting investors' interests. At issue, among other things, is the auditor's ability to detect deliberate efforts by management to misstate earnings, concerns raised by the SEC as a result of the large number of high-profile financial frauds. The panel plans on providing recommendations to improve audit effectiveness.

[12]The Public Oversight Board is an independent private sector body that oversees the self-regulatory programs of the SEC Practice Section of the AICPA.

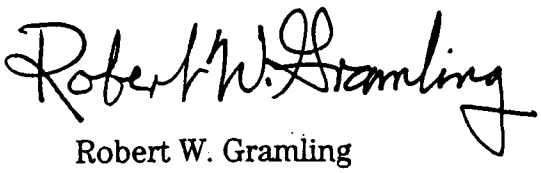
Agency Comments

We received comments on a draft of this letter from the SEC's Office of the Chief Accountant, Division of Enforcement, and Division of Corporation Finance, and the principal representatives we spoke with at the AICPA and PricewaterhouseCoopers. Generally, the officials agreed with the content of this letter, and their comments have been integrated where appropriate.

We are also sending copies of this letter to Representative Tom Bliley, Chairman of the House Committee on Commerce; the Honorable Arthur Levitt, Chairman of the SEC; Mr. Robert Elliot, Chairman of the AICPA; and Mr. Jay Brodish from PricewaterhouseCoopers.

If you have any questions, please call me at (202) 512-9406, Cheryl Clark on (202) 512-9377, or Jeanette Franzel on (202) 512-9471.

Sincerely yours,



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