Report of the National Commission on Fraudulent Financial Reporting

SUMMARY OF RECOMMENDATIONS

This summary is a synopsis of the organization and content of the Commission's recommendations, which appear in Chapters Two through Five of the report. The Commission urges readers to consider the recommendations along with the accompanying text, which explains, adds guidance, and in certain cases makes ancillary recommendations.

I. Recommendations for the Public Company (Chapter Two)

Prevention and earlier detection of fraudulent financial reporting must start with the entity that prepares financial reports. Thus the first focus of the Commission's recommendations is the public company. These recommendations, taken together, will improve a company's overall financial reporting process and increase the likelihood of preventing fraudulent financial reporting and detecting it earlier when it occurs.

For some companies, implementing these recommendations will require little or even no change from current practices; for other companies, it will mean adding or improving a recommended practice. Whether it means adding or improving a practice, the benefits justify the costs. The Commission's recommendations for the public company deal with (1) the tone set by top management, (2) the internal accounting and audit functions, (3) the audit committee, (4) management and audit committee reports, (5) the practice of seeking second opinions from independent public accountants, and (6) quarterly reporting.

The Tone at the Top

The first three recommendations focus on an element within the company of overriding importance in preventing fraudulent financial reporting: the tone set by top management that influences the corporate environment within which financial reporting occurs. To set the right tone, top management must identify and assess the factors that could lead to fraudulent financial reporting; all public companies should maintain internal controls that provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection—this is a broader concept than internal accounting controls—and all public companies should develop and enforce effective, written codes of corporate conduct. As a part of its ongoing assessment of the effectiveness of internal controls, a company's audit committee should annually review the program that management establishes to monitor compliance with the code. The Commission also recommends that its sponsoring organizations cooperate in developing additional, integrated guidance on internal controls.
**Internal Accounting and Audit Functions**

The Commission's recommendations turn next to the ability of the participants in the financial reporting process within the company to prevent or detect fraudulent financial reporting. The internal accounting function must be designed to fulfill the financial reporting responsibilities the corporation has undertaken as a public company. Moreover, all public companies must have an effective and objective internal audit function. The internal auditor's qualifications, staff, status within the company, reporting lines, and relationship with the audit committee of the board of directors must be adequate to ensure the internal audit function's effectiveness and objectivity. The internal auditor should consider his audit findings in the context of the company's financial statements and should, to the extent appropriate, coordinate his activities with the activities of the independent public accountant.

**The Audit Committee**

The audit committee of the board of directors plays a role critical to the integrity of the company's financial reporting. The Commission recommends that all public companies be required to have audit committees composed entirely of independent directors. To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls. The board of directors should set forth the committee's duties and responsibilities in a written charter. Among other things, the audit committee should review management's evaluation of the independence of the public accountant and management’s plans for engaging the company's independent public accountant to perform management advisory services. The Commission highlights additional important audit committee duties and responsibilities in the course of discussing other recommendations affecting public companies.

**Management and Audit Committee Reports**

Users of financial statements should be better informed about the roles management and the audit committee play in the company's financial reporting process. The Commission recommends a management report that acknowledges that the financial statements are the company's and that top management takes responsibility for the company's financial reporting process. The report should include management's opinion on the effectiveness of the company's internal controls. The Commission also recommends a letter from the chairman of the audit committee that describes the committee's activities. Both of these communications should appear in the annual report to stockholders.

**Seeking a Second Opinion and Quarterly Reporting**

Finally, the Commission's recommendations for the public company focus on two opportunities to strengthen the integrity of the financial reporting process. Management should advise the audit committee when it seeks a second opinion on a significant accounting issue, explaining why the particular accounting treatment was chosen. The Commission also recommends additional public disclosure in the event of a change in independent public accountants. Furthermore, the Commission recommends audit committee oversight of the quarterly reporting process.
II. Recommendations for the Independent Public Accountant  
(Chapter Three)

The independent public accountant's role, while secondary to that of management and the board of directors, is crucial in detecting and deterring fraudulent financial reporting. To ensure and improve the effectiveness of the independent public accountant, the Commission recommends changes in auditing standards, in procedures that enhance audit quality, in the independent public accountant's communications about his role, and in the process of setting auditing standards. On February 14, 1987, the Auditing Standards Board (ASB) exposed for comment a series of proposed auditing standards that address many issues the Commission considered. The Commission commends the ASB for its efforts in these exposure drafts, some of which are responsive to Commission concerns.

Responsibility for Detection and Improved Detection Capabilities

Generally Accepted Auditing Standards (GAAS) should be changed to recognize better the independent public accountant's responsibility for detecting fraudulent financial reporting. The standards should restate this responsibility to require the independent public accountant to take affirmative steps to assess the potential for fraudulent financial reporting and design tests to provide reasonable assurance of detection. Among the affirmative steps recommended is assessment of the company's overall control environment along with improved guidance for identifying risks and designing audit tests. In addition, the independent public accountant should be required to make greater use of analytical review procedures, to identify areas with a high risk of fraudulent financial reporting. The independent public accountant also should be required to review quarterly financial data before its release, to improve the likelihood of timely detection of fraudulent financial reporting.

Audit Quality

Improved audit quality increases the likelihood of detecting fraudulent financial reporting. In this regard, the Commission makes three recommendations. The first two are designed to improve two aspects of the profession's existing quality assurance program. Peer review should be strengthened by adding reviews, in each office reviewed, of all first-year audits performed for public company clients that were new to the firm. Concurring, or second partner, review should be enhanced by adding more explicit guidance as to timing and qualifications. In the third recommendation, the Commission encourages greater sensitivity on the part of public accounting firms to pressures within the accounting firm that may adversely impact audit quality.

Communications by the Independent Public Accountant

Independent public accountants need to communicate better to those who rely on their work. The auditor's standard report can and should convey a clearer sense of the independent public accountant's role, which does not include guaranteeing the accuracy of the company's financial statements. The standard audit report should explain that an audit is designed to provide reasonable, but not absolute, assurance that the financial statements are free of material misstatements arising as a result of fraud or error. It also should describe the extent to which the independent public accountant has reviewed and evaluated the system of internal accounting control. These two steps will promote a better appreciation of an audit and its purpose and limitations and underscore management's primary responsibility for financial reporting.
Change in the Process of Setting Auditing Standards

Finally, the Commission recommends that the process of setting auditing standards be improved by reorganizing the AICPA's Auditing Standards Board (ASB). The Commission believes that the setting of auditing standards should involve knowledgeable persons whose primary concern is with the use of auditing products as well as practicing independent public accountants. Such individuals would have particular sensitivity to the operating implications of auditing standards and to emerging policy issues concerning these standards. The recommendation contemplates a smaller ASB, composed of equal numbers of practitioners and qualified persons not presently engaged in public accounting and led by two full-time officers, that would look beyond the technical aspects of auditing and set an agenda reflecting a broad range of needs, serving public and private interests. The agenda would be implemented by auditing standards of continuing high technical quality, and the ASB would adopt these standards on the basis of their technical quality and their addressing these public and private needs.

III. Recommendations for the SEC and Others to Improve the Regulatory and Legal Environment (Chapter Four)

Strong and effective deterrence is essential in reducing the incidence of fraudulent financial reporting. While acknowledging the SEC's significant efforts and achievements in deterring such fraud, the Commission concludes that the public- and private-sector bodies whose activities shape the regulatory and law enforcement environment can and should provide stronger deterrence. The Commission's recommendations for increased deterrence involve new SEC sanctions, greater criminal prosecution, improved regulation of the public accounting profession, adequate SEC resources, improved federal regulation of financial institutions, and improved oversight by state boards of accountancy. In addition, the Commission makes two final recommendations in connection with the perceived insurance and liability crises.

New SEC Sanctions and Greater Criminal Prosecution

The range of sanctions available to be imposed on those who violate the law through fraudulent financial reporting should be expanded. Congress should give the SEC additional enforcement tools so that it can impose fines, bring cease and desist proceedings, and bar or suspend individual perpetrators from serving as corporate officers or directors, while preserving the full range of due process protections traditionally accorded to targets of enforcement activities. Moreover, with SEC support and assistance, criminal prosecution for fraudulent financial reporting should be made a higher priority.

Improved Regulation of the Public Accounting Profession

Another regulatory function, the regulation of the public accounting profession, seeks to reduce the incidence of fraudulent financial reporting through ensuring audit quality and thereby enhancing early detection and prevention of such fraud. The Commission studied the existing regulation and oversight, which includes the profession's quality assurance program, and concluded that additional regulation—particularly a statutory self-regulatory organization—is not necessary, provided two key elements are added to the present system. The first element is mandatory membership: all public accounting firms that audit public companies must belong to a professional organization that has peer review and independent oversight functions and is approved by the SEC. The SEC should provide the second element: enforcement actions to impose meaningful sanctions when a firm fails to remedy deficiencies cited by a quality assurance program approved by the SEC.
Adequate SEC Resources

The Commission directs many recommendations to the SEC, the agency with primary responsibility to administer the federal securities laws. In that regard, the SEC must have adequate resources to perform its existing functions, as well as additional functions, that help prevent, detect, and deter fraudulent financial reporting.

Improved Federal Regulation of Financial Institutions

Federal regulatory agencies, other than the SEC, have responsibility for financial reporting by certain public companies that are banks and savings and loans. The Commission recommends that these other agencies adopt measures patterned on the Commission's recommendations for the SEC. To enhance efforts to detect fraudulent financial reporting within financial institutions, the Commission also recommends that these federal agencies and the public accounting profession provide for the regulatory examiner and the independent public accountant to have access to each other's information about examined financial institutions.

Improved Oversight by State Boards of Accountancy

State boards of accountancy can and should play an enhanced role in their oversight of the independent public accountant. The Commission recommends that these boards implement positive enforcement programs to review on a periodic basis the quality of services rendered by the independent public accountants they license.

Insurance and Liability Crises

Finally, the Commission's study of fraudulent financial reporting unavoidably has led to certain topics beyond its charge or ability to address. The perceived liability and insurance crises and the tort reform movement have causes and implications far beyond the financial reporting system. They are truly national issues, touching every profession and business, affecting financial reporting as well. Those charged with responding to the various tort reform initiatives should consider the implications for long-term audit quality and the independent public accountant's detection of fraudulent financial reporting. Moreover, the SEC should reconsider its long-standing position, insofar as it applies to independent directors, that corporate indemnification of officers and directors for securities law liabilities is against public policy and therefore unenforceable.

IV. Recommendations for Education (Chapter Five)

Education can influence present or future participants in the financial reporting system by providing knowledge, skills, and ethical values that potentially may help prevent, detect, and deter fraudulent financial reporting. To encourage educational initiatives toward this end, the Commission recommends changes in the business and accounting curricula as well as in professional certification examinations and continuing professional education.
**Business and Accounting Curricula**

The complexity and serious nature of fraudulent financial reporting led the Commission to conclude that any initiatives encouraged by its recommendations should permeate the undergraduate and graduate business and accounting curricula. The Commission first recommends that business and accounting students gain knowledge and understanding of the factors that cause fraudulent financial reporting and of the strategies that can lead to a reduction in its incidence. To enable students to deal with risks of such fraud in the future at public companies, the Commission recommends that business and accounting curricula convey a deeper understanding of the function and the importance of internal controls and the overall control environment within which financial reporting takes place. Students should realize that practices aimed at reducing fraudulent financial reporting are not simply defensive measures, but also make good business sense.

In addition, part of the knowledge students acquire about the financial reporting system should be an understanding of the complex regulatory and law enforcement framework that government and private-sector bodies provide to safeguard that system and to protect the public interest. As future participants in that system, students should gain a sense of what will be expected of them legally and professionally when they are accountable to the public interest.

The Commission recommends that the business and accounting curricula also foster the development of skills that can help prevent, detect, and deter such fraud. Analytical reasoning, problem solving, and the exercise of sound judgment are some of the skills that will enable students to grapple successfully in the future with warning signs or novel situations they will encounter in the financial reporting process.

Furthermore, the ethical dimension of financial reporting should receive more emphasis in the business and accounting curricula. The curricula should integrate the development of ethical values with the acquisition of knowledge and skills. Unfortunately, the lack of challenging case studies based on actual incidents of fraudulent financial reporting is a current obstacle to reform. The Commission therefore recommends that business schools give their faculty a variety of incentives and opportunities to develop personal competence and suitable classroom materials for teaching about fraudulent financial reporting. Business school faculty reward systems should acknowledge and reward faculty who develop such competence and materials.

**Professional Certification Examinations and Continuing Professional Education**

The Commission makes two additional recommendations relating to education. Both professional certification examinations and continuing professional education should emphasize the knowledge, skills, and ethical values that further the understanding of fraudulent financial reporting and promote a reduction in the incidence of such fraud.

**Five-Year Accounting Programs and Corporate Initiatives**

The Commission makes no recommendation with regard to the much-discussed proposal to expand the undergraduate accounting curriculum from 4 to 5 years. Rather, the Commission offers a number of observations based on its research and deliberations. Similarly, the Commission outlines some of the numerous opportunities for public companies to educate their directors, management, and employees about the problem of fraudulent financial reporting.